TARGET COSTING FUNCTIONS

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Abstract

This article aims to highlight the concept of Target Costing. Based on the characteristics of Target Costing, identified in specialized literature, the article presents its main advantages and disadvantages. Also, a comparison is being made between Target Cost and Traditional Cost (in its traditional form, the cost represents an independent variable on the basis of which the sell price is established; and in the Target Cost form the cost represents a dependent variable which is determined on the basis of selling price), and between Target Cost and Standard Cost (the difference between Target Cost and Standard Cost is the same as the one between cost reduction and cost control: Target Cost generates structural improvements and Standard Cost generates operational improvements). After a thorough review of the specialized literature and taking into account the fact that this concept represents in fact a management method, the authors identify and present the most important functions of the Target Costing: analysis of market and product characteristics function, informative function, decisional function, the function of stimulating designing for manufacturing, integrative function, coordination function, warning function and continuous function.

Keywords*: Target Cost, Target Costing, Target Profit, Managerial Accounting*

JEL classification: *M41*

1. Introduction

The actual economic conditions (the tendency of offer growth in comparison with demand) oblige the entities to innovate, to quickly respond to changes and to focus all resources in their activity, to be able to be competitive

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on the market in order to achieve their goals. Thus, every entity is forced to use strategies and action plans that allow maneuvering useful and reliable information, which, used in time, lead to making the right decisions fact that contributes to achieving the established goals.

One of the latest management form used for cost management and optimization of the performance of the entities is Target Costing. This one seeks to minimize the effect of economic pressure of globalization by creating strategies that lead to countering the prevailing market fluctuations and to maintaining a competitive advantage based on satisfying clients and increasing profitability, trying to obtain a large number of clients willing to pay the products price and constantly monitoring costs by optimizing them.

Nowadays, because of the recent crisis, the entities manifest a growing preoccupation for maintaining and increasing their competitiveness on the market. This can be done by Target Costing Management which implies applying some strategic processes with the help of which they minimize products cost by optimizing internal and external processes, so that they obtain products which correspond to clients needs, at the lowest possible price and at the most stringent levels of quality and functionality, maximizing in this way the planned benefits.

Traditionally, when an entity wants to launch a new product on the market, it starts with its designing and then it determines the selling price accordingly with the desired benefit. The selling price was determined based on the equation Cost + Benefit = Selling Price. This process, no doubt, can't be applied taking into account the actual economic realities, the market being the one that ultimately decides the products price.

In the perspective of Target Costing, the entity starts by determining the price that market is willing to pay, analyzing the strategic position of the product in comparison with other products of the entity and of those of the competition. Taking into account this price, the multidisciplinary teams establish, design and build the product taking into account the Target Costing which assures the benefit desired by the entity. Thus, a product is conceived and developed taking into account the demands of the client and of the market.

In Romania, before 1990, the manufactured products were quickly absorbed by the market because the demand was a lot higher than the offer. This period represents a clear example of the equation presented in the price formation in the traditional way, the selling prices, based on costs, were

growing easily, and due to the shortage of products they were accepted by consumers.

Nowadays, a series of factors, like economic globalization, increasing competition (internal and external), reduction of the life of the products, rapidity of wear and tear due to technological changes, have determined the change of the traditional approach modifying the equation: Selling price – Benefit = Cost. This new approach implies the necessity of a change in the mentality of Romanian entities the purpose being to know the demands of the market and of the consumers they address to.

Due to its undisputable benefits, the Target Costing is used worldwide, by famous companies like: Compaq, Daihatsu, Ford, General Motors, Honda, Intel, Panasonic, Sharp, Toyota, Toshiba etc.

2. Target Costing

2.1. The advantages and disadvantages of Target Costing

Based on the characteristics of Target Costing (Alston, 1986; Ansari and Bell, 1997; Ax, Greve and Nilsson, 2008; Brash, 1995; Briciu, 2006; Briciu et al., 2010; Briciu, Tabără et al., 2012; Briciu and Căpuşneanu, 2013; Buggert and Wielpütz, 1995; Căpuşneanu and Briciu, 2011; Cooper, 1995; Cooper and Slagmulder, 1997; Dekker and Smidt, 2003; Ellram, 2002; Ellram, 2006; Everaert et al., 2006; Feil, Yook and Kim, 2004; Fisher, 1996; Hansen and Mowen, 1999; Hasegawa, 1994; Horváth, 1993; Ibusuki and Kaminski, 2007; Kato, 1993; Kato, Böer and Chee, 1995; Kim, Ansari, Bell and Swenson, 1999; Leahy, 1998; Monden and Hamada, 1991; Monden, 1995; Morgan, 1993; Ofileanu and Bumbescu, 2014; Sakurai, 1989; Seidenschwarz, 1993; Tanaka T., 1993; Tanaka M., 1989) we have identified the following advantages and disadvantages:

Advantages:

- its value lies in the process that it triggers and less in the numerical result acheived, process which requires constant thinking in terms of efficiency and productivity in all departments of the entity and throughout the entire life cycle of the product;
- it can offer orientations regarding the competitiveness of the entity;
- it integrates the various zones of the entity in cooperation activities;
- stimulates communication between people and departments;

- contributes to the operational planning process;
- helps reducing costs in the most important moment: the design phase;
- it is a pro-active approach in cost administration;
- it orients the entity towards the client;
- eliminates the barriers between departments;
- unites employees in order to achieve clear and measurable objectives;
- uses the joining and working with suppliers;
- minimizes activities that don't add value;
- stimulates choosing the mimimal cost for the activities that add value;
- reduces the trading time of the products;
- it is essential for effective management of the costs because it offers the objectives that aim all attempts of cost control;
- generates information which helps the entity in maintaining and improving the competitiviness;
- promovates inovation and creativity, focusing, in an abstract way, on the product and on its cost;
- it is analyzed and assessed the service potential more than its physical dimension, using functions and function domains such as system cost objects; this guides the development of the product towards generating new products effective from the point of view of cost-value relationship, products that are innovative and meet clients' technical and price requirements;
- answers to the word tendency to satisfy the particular needs of the clients;
- encourages teamwork and commitment to continuous improvement; thus, joining in the work team of people from different departments, creates links, which on long term, will cause the entity to be able to respond more quickly to the market demands;
- makes the entity to channel efforts towards products that generate additional value and rejecting the ones that don't offer a profit margin defined in the entity's strategy;

- orients the products to the puchasing power of the client or to a price accepted by the market.

Disadvantages:

- long developing period;
- much effort made by the members of the entity ;
- excessive attention to the customers ' demands;
- requires a total, permanent and supported compromise of the entity;
- it can't be implemented by an entity which doesn't have a permanent vision of continuous improvement and systematic cost reduction incorporated into all departments;
- its use needs detailed cost data;
- asks for the integration of the staff and willingness to work in a team;
- requires time for reuniting and coordinating the team.

2.2. Target Cost versus Traditional Cost

As we shown earlier, in its traditional form, cost represents an independent variable, based on which we can determine the selling price (Figure no. 1); in the form of Target Cost, the cost represents the dependent variable which can be determined based on selling price (Figure no. 2).

Figure no. 1. Target Cost approach

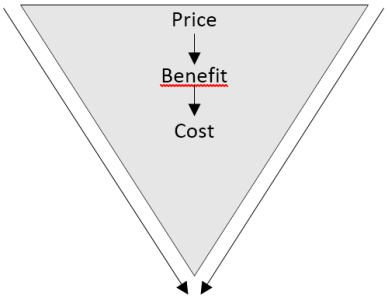
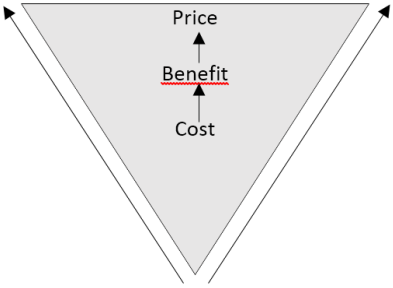


Figure no. 2. Traditional Cost approach



In its traditional form the cost is characterized by:

- doesn't take into account the market when planning the costs;
- the costs determine the price;
- cost reduction is focused on the inefficiencies and loss adjustments;
- cost reduction is not client-oriented;
- cost reduction is conducted by cost controllers;
- the suppliers are invited to participate only after starting the production;
- it doesn't involve the value chain.

Unlike Traditional Cost, Target Cost has the following approach:

- competition market conducts cost planning;
- the prices determine the cost;
- the project is the basis for cost reduction, avoiding inefficiencies and loss;
- the information comming from the clients boost cost reduction;
- costs are administered by interdisciplinary groups;
- the suppliers are invited in the design phase;
- takes into account the value chain planning.

Unlike cost based prices, Target Cost implies a lot more work but it is a lot more efficient.

In the case of Target Cost, the product profitability analysis starts in the designing phase and in this way the performance is improved and the competitiveness of the entity grows. Target Cost aim is to trigger a process at the end of which the cost of a product is obtained, the starting point being the selling price strategically fixed and taking into account the expected benefit of the product. Target Price, calculated depending on the clients' demands and taking into account the possible reactions of the competition, are the base for determining the Target Cost.

A multidisciplinary team of specialists formed of planning engineers, production engineers, accountants, market analysts, marketing analysts, and people involved in production etc. work to establish Target Cost. They are responsible for achieving the objective. If this team comes to the conclusion that the Target Cost can't be achieved, the new product is abandoned, avoiding what usually happens in the case of traditional methods, when clients don't buy the product at the fixed price.

Using Target Cost in fixing the price has as main advantage the fact that is focuses on the client and on the market. They won't manufacture a new product until the entity is sure that the product will produce a adequate profit and the client affords to buy it.

Target Cost insists on the strategic management of cost levels, respecting products functionality, which will surely determine obtaining cheaper attractive products. Target Cost creates a continuous pressure to eliminate useless costs.

Unlike traditional systems, in Target Cost the product's own project results as a consequence of the characteristics of the process that has been selected from all possible alternatives (Fisher, 1996).

2.3. Target Cost versus Standard Cost

At first sight, confusion can be made: Target Cost represents in fact a Standard Cost which has to be respected.

Standard Cost is the one that actual costs are compared with, and the criteria used to determine Standard Cost don't take into consideration the conditions in which the entity's sector can get, the technological, organizational and commercial level asked for the entity to be able to cope with the competition.

Unlike Target Cost, Standard Cost covers only the production phase, leaving aside the other previous and posterior manufacturing phases.

The difference between Target Cost and Standard Cost is the same as between cost reduction and cost control. Thus, the aim of the reduction processes is to minimize potential cost standards, while the cost control tries to maintain the costs at the level expected for the different cost concepts.

The essential difference between cost reduction and cost control lies in the result and not in the time period they are applied and neither in the consequences resulted from resource economy.

The structural improvement refers to entity's capacity to adapt its activities to market's changes in the perception of value. The structural characteristics of the entity are those that determine its relative position on the market, depending on its capacity to create value, meaning the economic efficiency of its activity.

The difference between Target Cost and Standard Cost in a given period of time it is a valid indicator of the improvement potential of the entity in relation with structural problems and represents the efficiency of the entity's activity.

Standard Cost is characterized by:

- focuses on keeping costs;
- planned annual standards;
- a deviation analyzes for eliminate the causes;
- a standard approaches;
- analyzes when standards are not achieved.

Target Cost has the following approach:

- focuses on cost reduction;
- creates new goals periodically;
- suggests improvements to achieve objectives;
- it approaches the objectives;
- analyzes when objectives are not achieved.

2.4. Target Costing Functions

Lots of important authors talked about the characteristics of Target Costing (Sakurai, 1989; Monden and Hamada, 1991; Tanaka, 1993; Morgan, 1993; Bransh, 1995; Kato et al., 1995; Fisher, 1996; Cooper, 1995; Cooper and Slagmulder, 1997, Briciu et al., 2010), but up until now there isn't any work which refers to the functions that Target Costing performs. Based on the characteristics they set up, on the detailed description of Target Costing and on its application methodology, we can say that the functions performed by Target Costing are:

1. **Market and product characteristics analysis function** – to apply Target Costing one has to start from the functional characteristics of the product and from the future market analysis. Specifically, one has to know aspects like:

- what is the time frame in which the product can be traded;
- what is the demand curve;
- which are the needed functions to obtain the product.

The demand curve can be estimated starting from market study and based on competition's strategy; in this way it is evaluated the market accessible to the entity for an estimated selling price taking into account the market potential and the market share which the entity may get in relation to its competitors.

The detailed analysis of product's potential on the market leads to the maximum risk assessment in a unfavorable scenario or to evaluation of gain in a favorable scenario.

Target Costing determines the unmet needs of the actual or potential clients taking into account a variety of possible variables related with the economic situation in general, the market in particular and the product in specific form.

2. **Informative function** – Target Costing involves the use of a high quantity of information regarding the clients, competition, product and costs. The most important information are those received from clients and they refer to what the client wants, the value assigned to the product and the price they are willing and able to pay.

The possible reactions of the competition are more difficult to obtain; these can be estimated if the products, the costs, technology, their financial conditions etc. are known. Target Costing uses for this so called "reverse engineering", which consists in decomposing and studying the products of the competition to analyze the designing, the materials and technology used for that product. Also, Target Costing generates information regarding the future performances of the entity.

3. **Decision-making function** – the use of the Target Costing implies providing detailed information regarding the costs of alternative activities. For those who make the decisions these information allow the choice of projects and manufacturing alternatives which respond the to the product's functionality demands and established prices. The decision in designing the products and the processes which can achieve the fixed objectives is made after consulting a lot of data bases with information about costs and manufacturing variables.

The decision-making function is an extension of the informative function, to be competitive on the market it is important for the entity to have reliable and relevant information, this being essential o making strategic and operative decisions.

4. **The function of stimulating the design for manufacturing** – Target Costing pays a special attention to designing phase of the product; in this way are provided important amounts of resources in product's planning and designing activities with the aim of reducing resources used in the following phase.

The difference between the employed cost and the supported cost is very important. Cost supporting describes the use of resources in the production

process, the production activity is developed in consonance with product designing where these costs have been employed when the type of material used, the processes that must be performed and the execution tests were determined. The employed costs are the costs included in product designing but which haven't been actually realized, but due to the decisions made, they will be supported in the future.

Target Costing stresses the importance of product's design phase due to the its influence on costs: in general it is considered that about 80% of costs are employed in this stage. Once the employed costs are established, any subsequent change is difficult and costly.

In the absence of Target Costing approach, project engineers are tempted to incorporate new technological discoveries in product's characteristics, often ignoring the real demands of the clients regarding price and quality. Most of the times the final consumer doesn't need all final technology (which can be expensive and useless) and refuses to pay what he doesn't need. Focusing on Target Costing maintains the designing towards the final consumer.

5. **Integrative function** – Target Costing involves an integrated mechanism to coherently unite the different departments of the entity which are connected, in a way or another, with the product. Also, usually the suppliers are part of the multidisciplinary team, improving in this way the optimization possibilities when purchasing and using the materials.
6. **The coordination function** – Target Costing requires a culture of teamwork and a standing consensus, the coordination of activities being made around the strategic objective set. It can be said that by using Target Costing it is ensured the synergy of a project team which work together to obtain a continuous cost reduction.
7. **The warning function** – Target Costing predetermines the cost to be achieved (achievable) of the product based on available information regarding similar real processes, on the expected actual cost and on including the identified activities to reduce costs. Target Costing is determined by deducting the expected benefit from the selling price accepted by the market. Thus, any deviation between the predetermined acceptable cost and Target Costing warns the entity regarding the failure to comply with the objectives, triggering activities to optimize product design with operations which constitute the productive process.

8. **Continuous function** – Target Costing is a cost reduction process which takes into consideration all costs during product's life time. Thus, in the research, designing and preproduction phases Target Costing uses "continuous improvement".

Target Costing involves keeping track of costs in the life cycle of the product, along a global and continuous process different from the traditional one where are taken into consideration the costs related directly to the production. Target Costing requires that cost reduction activities not to stop when the product passes to the final production phase, they remain and maintain by applying "continuous improvement".

3. Target Costing

Each entity aims to be effective and efficient, that is, to set the correct targets to achieve by using their optimal resources. The main benefit of Target Costing is the fact that it combines effectiveness with efficiency, meaning that makes the right things in the right way.

Although it needs a longer period of time to be implemented and demands effort from entity's members, implementing the Target Costing determines many advantages, most of them are long term advantages, helping to maintain and improve the competitiveness of the entity. By no means neglected is that Target Costing involves getting the maximum possible for any objective which the entity follows.

Because of the fact that the costs are easier to evaluate than benefits, Target Costing acts obsessively over respecting a cost level for which, the obtained benefit is the hoped one, suggesting continuous improvements in order to achieve the objectives set, having as origin a thinking based on effectiveness and efficiency..

Acting pursuant to the functions it performs, Target Costing reflects the entity's capacity to produce the quantity and the quality of results imposed by the environment in which it evolves. On long term, Target Costing ensures adaptability and the development of the entity, based on its ability to identify the contextual needs.

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