



REVIEW OF TARGET COSTING SYSTEM AND PROFITABILITY OF FIRMS IN NIGERIA

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ABSTRACT

Informative technology has introduced serious competition in a manufacturing environment among business worldwide. In order to remain relevant, manufacturing firms are in search of better and innovative cost management systems.

Target costing represents one of such innovation cost systems. It emphasizes better understanding of competition markets and requirements of consumers as it affects quality, products, delivery time as well as product price.

This study examined the concept of target costing profitability and the relationship between targeting cost system and profitability of firms in Nigeria through the review of related literature. Findings reveal that target costing is an innovation system employed by business organizations in minimizing the cost of their products and/or services.

Japan was the first to develop target costing, its application has spread across the globe, including Nigeria, and target costing is used for product cost immunization. The result also found out that target costing system has a significant relationship with corporate profitability of firms in Nigeria. Firms that use target costing have reported increased profitability, and enhanced company competition. It recommended that firms that have started using the system to start doing so in their interest.

KEYWORDS: Profitability, Target Costing Cost Management System

1. INTRODUCTION

Business globally now operates in a rapidly changing manufacturing and competitive environment (Ghafeer, Rahman & Mazahrih, 2014; Akinyomi, 2014). This brought about huge investment in research and development leading to innovative cost management control. Such management control includes activity based costing (Akinyomi, 2014), target costing (Olabisi & Dafe, 2014).

Target costing is a costing system that emphasizes improved understanding of competition, markets and consumer requirements in terms of quality, products, functions, delivery time and price.

The main purpose of target costing is to facilitate profitable management of business in firms that employ its uses, and enhance survival of such business in a competing environment. (Zengin and Ada, 2010).

Idowu(2014) maintains that target costing seeks to reduce a product's life cycle cost before production commences in order to attain the desired profitability. It

provides opportunity for managing a business' expected profits through the integration of strategic variables in other to plan concurrently law to meet the customers need, capture market shares, generate profits plan and control costs (Anasia and Bell, 1997). In other words it is a philosophy in which product development is based on what the market is ready to pay instead of production cost. This means that market price becomes the determinant of cost and not the other way round.

This study described target costing as a method of efficient cost management system that minimizes product's cost through cost planning and control at the sizes of products design development.

Leagat(2006) observed that firms that have adopted target costing do devote a great deal of their time talking comprehensive market research including surveys and focus on groups to determine what functions and attributes consumers want and the price they are willing to pay for them.



The target price depends on the result of the market research, the price of the competitive products, and the business initial plans to deliver a new product with definite functions, quality, aesthetics and other feature. Historically target costing is traced to Japan's economy after the 2nd world war, when they made efforts to rebuild their economy. (Feil, Yook and Kim, 2004).

Recently Western organizations have started introducing target costing in their products development processes due to stiff competition. Target costing has been employed by manufacturing firms like NISSAN motor company, Toyota Motor Corporation and Sony Corporation (Kaur, 2014). There is a limited number of studies which have highlighted the relationship that exist between target costing system & business profitability. Hence the gap that informed the concept believed the study.

2. LITERATURE REVIEW

2.1. Concept of Target Costing

The Chartered Institute of Management Accountants (CIMA, 2005) defines target costing as a product cost estimates obtained by deducting a desired profit margin from a competitive market price. It represents a cost accounting process in which an organization determines the acceptable cost for a product or service given a competitive market price & targeted profits. As one of the strategic management accounting systems, target costing represents the efforts made toward reducing a product's life cycle costs before its manufacturing commences in order to attain desired profitability (Kato, 1993).

Furthermore, Jalaee (2012) describes target costing as a management tool for minimizing the total costing of a commodity over the commodity's life cycle. Target costing is fundamentally product development and develops cost based on price, and then works backward, to design the products and then the production process (Fidth & Borgermas 2003).

Cooper and Kaplan (1988) cited in Idowu (2014) opine that target costing's fundamental nature can be grouped into three categories thus: (i) allow the market to set the product's selling price (ii) deduct the determined product margin required by the company and (iii) resulting in the target costing. Tanaka (1993) furthermore recognized three fundamental methods for setting up target costing. These methods include: subtraction, addition and integrated methods. Using the subtraction method according to Hamood, Omar and Sulaiman (2011) the crucial factor in establishing target costing is the price charged by competing companies. Therefore, the target cost can be arrived at through the use of the following formula: Target Costing = Selling Price less Required Return.

Moreover, in the addition method, the spotlight will be on the internal factors and capabilities of the company including the level of technology, the production plant and

machinery, the delivery time, the production volume, and the company's strategy as a whole (Hamood, *et al* 2011). Tanaka (1993) also highlighted three ways of using addition method to establish a target cost based on similar products, design properties and new ideas. Conversely, the integrated method combines the subtraction method which is based on the market approach, and the addition method which is based on the existing technology and capabilities. Nevertheless, Hamood, *et al.* (2011) observed that the subtraction method is the common method in use. It works backwards from the market price to identify the target cost and simultaneously it may be impossible to be achieved by using the company's existing technology.

Cooper and Slagmulder (1997) identified seven major questions usually raised during target costing adoption. These questions include: (i) What are the company's long-term sales and profit objectives? (ii) Where will the new product's survival zone be when it is launched? (iii) What is the target profit margin? (iv) What level of cost reduction is realistic? (v) How can we achieve this cost-reduction objective? (vi) Are there extraneous circumstances that allow the target cost to be relaxed? (vii) How can we distribute the cost reduction among the components? The answers to these questions will ensure that a company realize its expected profit at the end of the day, all other things being equal.

2.2 Concept of Profitability

Usually, most non-governmental business organizations are driven by profit motive. Business would not normally invest in any venture which will not add to the wealth of their shareholders. In an effort to describe profit, Delmar (1997) opines that profit is a business finance term which focuses on the sum of money generated from selling commodity over a period of time, usually twelve calendar months. Similarly, Chandler and Hanks (1994) affirmed that it is imperative for every business to keep proper records of its annual profit so as to establish if selling a particular commodity would be valuable or not. If the business fails to generate enough annual profit, a prudent choice is to change the commodity and its marketing strategy or to drop the commodity completely, after given due consideration to other qualitative variables that the business does not keep on making losses (Olabisi 2009).

Baum, Locke and Smith (2001) quantify profitability increase in terms of number of employees, and also in terms of yearly turnover and profits. Shepherd (2005) on the other hand opines that an organization's growth can be quantified in terms of productivity, specifically, sales proceeds and profits.

Delmar (1997) suggests that the probable measures of profitability increase are assets, number of employees, market share, physical productivity and turnover. Profit is the difference between turnover value and cost of sales (Ayirtde, 2006). According to Ayinde (2006), the association between



turnover and profit is that average profit can be enhanced either by increasing the average turnover value or reducing the cost or both simultaneously. Nevertheless, Olabisi (2009) opines that in most cases, turnover value depends on market forces, which may be outside the control of business managers.

2.3 Empirical Framework

Imeokpana and Adebisi (2014) conducted an investigation on target costing and performance of manufacturing industry in Southwestern Nigeria. The study focused on establishing the degree of target costing implementation on one hand and the effect of the implementation on financial performance of manufacturing companies on the other hand. Using a cross sectional survey, the study obtained secondary data from the selected companies. The result revealed a significant degree of target costing implementation in the zone. It also showed a significant relationship between target costing adoption and production cost reduction; and a significant relationship between target costing implementation and improvement in financial performance.

Olabisi and Dafe (2014) carried out a study on the implementation of target costing in small and medium scale businesses in Nigeria. The study was a cross-sectional survey which primary data were obtained from the selected small and medium scale enterprises in the three senatorial districts of Ogun State, Nigeria. The study set out to ascertain the relationship that exists between target costing and turnover on one hand and target costing and profitability on the other hand. The results of regression analysis carried out substantiate the fact that profit can be enhanced either by the sales value or reducing the cost components of products or both.

Rahman and Mazahrih (2014) examined the relevance of target costing in strengthening the competitiveness of manufacturing companies in Syria. The study was propelled by the inability of several companies in the contemporary lecturing environment to trim down costs. Adopting descriptive analytical tool, the study obtained data from primary sources using questionnaire. The results of the regression analysis revealed that a significant relationship exists between target costing system and strategic cost reduction. It also showed that a significant association exists between target costing system and product quality enhancement.

Kaur (2014) reported on the process of four stages in product development with the use of target costing. According to the study, there is a general observation that target costing is not so applicable to service sector organizations because of the nature of their operations. This account for the low level of use of target costing by service oriented enterprises unlike the practice in the manufacturing

companies. The four stages of product development in which target costing can be applied, as identified by JCaur (2004) include: product strategy and profit planning, product concept and feasibility, product design and development, and production and logistics. The study described that both the traditional costing and target costing methods have similar characteristics. The study observed that the traditional costing method was suitable and popular before 1960s but in contemporary business environment target costing is better than traditional costing method. The study concluded by asserting that the philosophy of the target costing is better for the production and development of new as well as for existing products than the traditional costing method.

Waheed and Jamal (2012) examined the connection between target costing and competitiveness at Jordanian private universities. The study highlighted the dimensions of target costing to include six core principles as follows; leadership of target selling price, focusing on customers, using and developing a team work, reducing the cost of the product lifecycle, focusing on stages of product design, attention to all stages of the value chain. The study focused on ascertaining the association between target costing technique dimensions and the dimensions of the competitive advantages. In order to elicit necessary information from respondents, questionnaire was administered to financial managers,

Directors of planning and heads of accounting departments in the selected universities. The results of the study revealed that private universities in Jordan do enjoy a medium competitive advantage. Furthermore, the findings showed that target costing technique represented one of the cost management systems used by private universities, and that they support the process of decision making.

Idowu (2014) investigated the impact of target costing on competitive advantage in the Nigerian manufacturing industry. The study recognized target costing modern management accounting tools developed mostly by Japanese manufacturers. The objective of the study was to establish the effect of target costing on competitive advantage on Nigeria manufacturing companies. The study adopted a cross sectional survey design, while primary data were obtained from respondents in ten manufacturing companies in Nigeria. The result of the regression analysis revealed that target costing enhances cost quality and cost advantage in manufacturing firms in Nigeria.

3. CONCLUSION AND RECOMMENDATIONS

The evidence from the literature review above clearly indicates that target costing, one of the innovative cost management systems employed by business organizations in general and manufacturing enterprises in particular in minimizing the cost of their products and/or services. Although this cost management system was developed by



Japanese manufacturing companies, its implementation has spread across the globe. Even in emerging economies like Nigeria, target cost management system is being used in product cost minimization. The results of prior studies indicate that target cost management system has a significant relationship with corporate profitability, companies using target cost management system have reported an increased profitability. The use of target cost management system has also enhanced companies' competitive advantage.

RECOMMENDATIONS

Following the conclusions arrived at the researcher makes the following recommendations:

- Manufacturing that want to survive stiff competition should adopt target costing management and controls.
- Management of companies should provide necessary support finance and otherwise for successful adoption of target costing system.

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