

APPLIANCE POSIBILITIES OF TARGET COSTING FOR DETERMINATION OF SERVICE PRICES IN PUBLIC SECTOR

MOGUĆNOST PRIMJENE METODE CILJANIH TROŠKOVA U ODREĐIVANJU CIJENE JAVNE USLUGE

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Abstract: *Costs are important element in a decision making process by determination or calculation prices and remunerations for provided services or purchased goods from budgetary users. Information about costs are relevant even then when the price of provided services or purchased goods is lower than with them related occurred costs, or when it is purely political-social question, or when the price of provided services or purchased goods is determined with certain criteria and market fluctuations. In Republic Croatia practice for price determinations of provided services is usually political and social question rather than economical one.*

Key words: *target costing, public sector, cost accounting, service price*

Sažetak: *Troškovi su važan element u procesu donošenja odluka o cijenama ili nakandama za pruženu uslugu ili za kupljene proizvode od korisnika proračuna. Informacije o troškovima su relevantne čak i kada je cijena pružene usluge ili kupljenog proizvoda niža od troškova vezanih uz njih ili kada je to čisto političko – socijalno pitanje, te kada je cijena određena na osnovu određenih kriterija ili tržišnih fluktuacija. U Republici Hrvatskoj praksa pokazuje da je određivanje cijena za pruženu uslugu najčešće političko i socijalno pitanje, a ne ekonomsko pitanje.*

Ključne riječi: *metoda ciljanih troškova, javni sektor, troškovno računovodstvo, cijena usluge*



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1. Introduction

This paper is the result of the research funded by the Ministry of Science, Education and Sports, Croatia, as a part of the scientific project No. 067-0811272-1074, titled "The perspectives of the managerial accounting implementation in Croatian public sector". Efficient managing with governmental units demands from public management appliance of wide range on cost and managerial accounting techniques and methods and it's usage in wider aspect of informational technology and financial managing. Often reasons for insufficient usage of cost and managerial accounting are some facts as follows:

- some services provided from state are for free, some are partially charged and some completely;
- cost incurred in the process of providing services couldn't be reliably computed because inputs in those processes aren't completely paid e.g. the usage of natural resources or all costs aren't tracked e.g. depreciation;
- criteria for evaluation or assessment of some activities and projects, even with tracked costs, aren't familiar;
- programs, services, projects and activities are often issue of political and social decisions and because of that goals of such decisions are usually more important than tracking of incurred costs;
- state budget is institutionalized and defined in accordance with cash accounting basis, so control of budgetary sources and public money are usually primarily or the only interest of the legislator.

Regardless, more and more restrictions for available resources and increasing debts from one side, bigger public needs and public criticism from the other side, are forcing public management on decreasing costs and increasing quality of provided services. It isn't possible to satisfy those demands without appliance of proper cost and managerial accounting. Methods, techniques, instruments, cost concepts and performance processes of cost accounting that are scientifically and practically developed and deeply rooted in managing process in profit sector, could be applied also in managing processes in public sector. Present experiences in Republic of Croatia but also in most other countries are showing that the range of appliance cost and managerial accounting in public sector is very small. Research field for this paper is public sector and their implementation of cost and managerial accounting into the accounting system. Since, the price determination of public services in generally is a very significant topic, it is very important to understand that entities in public sector don't have relevant information's about occurred costs and internal settlement on which basis they could determined price of their services. With that on mind, the leading hypothesis was set up, that target costing could be applied in public sector as relevant method for price determination. For quality decisions making about prices in public sector it is necessary to have relevant information's about costs. Using different modern methods for managing costs, information about costs are significantly different. Based on that, the process of decision making in public sector and decision made on costs could vary. So, it is very important to implement the right cost allocation method. More and more expressed demands for efficient public

government and public management transparent work impose the need for new forms of reporting to which is impossible to satisfy without the usage of the set of instruments of cost and managerial accounting. Those set of instruments are unavoidable in a management process in public sector, such as: budgeting, cost control and cost decreasing, determination of prices and remunerations, measurement of performance, program assessment, different choices for economic decisions and taking actions to increase effectiveness and to raise quality of services by decreasing costs. Today is specially emphasized on the demand in the privatization of some traditionally public actions. Financial possibilities of those public actions developed a specific model of public-private partnership which will be transparent for determining prices of served goods and services.

2. Defining Target costing

Target costing isn't totally new cost management method even though only small number of companies in the United States started to use some of its elements in the 1930s. This inverse approach for determining product cost can be found first at the beginning of last century at the Ford in the United States, but full development of this method was in Japan. The first use of target costing occurred at Toyota in the 1963. [1] This method, also known as "genka kikaku" in Japan, was developed in order to face with competitive market environment. After that many companies, such as Nissan, Canon, Sony, started to use target costing and nowadays this method is developed and spread in private sector all over the world. Target costing describes a process of first determining a selling price and then determining target cost and at the end designing a product or introducing service. This method include set of instruments for planning, control and management accounting of products and services on the set quality and which are introduced in the early stage of their development and they are compared through all time of product life cycle. [2] Target costing begins with question: "How much product or service should cost?", while traditional cost management methods begin with questions: "How much product or service cost?". So, from these questions it is obvious that the main orientation of target costing is on desires and demands of customers and also on acceptance of competition, because the selling price is setting first. The answer on this main target costing question can be given through following equation: $SELLING\ PRICE - TARGET\ PROFIT = TARGET\ COST$. The contrast of target costing equation can be seen in traditional practices of many companies where the selling price is determinate at the end of product life cycle and it is written on following way: $COST + PROFIT\ MARGIN = SELLING\ PRICE$. Also it is important to mention that target costing is focused on early stages of product life cycle or introducing new service. The product life cycle is shorter every day and because of that only companies that earn enough profit and have resources for research and development of new products can maintain on markets and be in front of their competition. Determining cost of products or services from their development phase until their market exit enables life cycle costing. Also, it gives more detailed and real information about costs of certain

products through all phases of life cycle, and not only in production phase. [2] Michiharu Sakurai (1989) says target costing can be defined as a strategic management tool for deducting the overall costs of a product over its entire life cycle with the help of the production, engineering, research and design, marketing and accounting departments.

2.1. The process of target costing

The target costing process is very complicated and long lasting process that starts in the early phase of product life cycle or introducing new service. Just as there is no single definition of target costing, there is also no single target costing process. Each company must evolve its own organizations and practices and has its own way in introducing target costing process. Nevertheless, all companies share a series of general steps. Entire process of target costing can be seen on the chart 1. below.

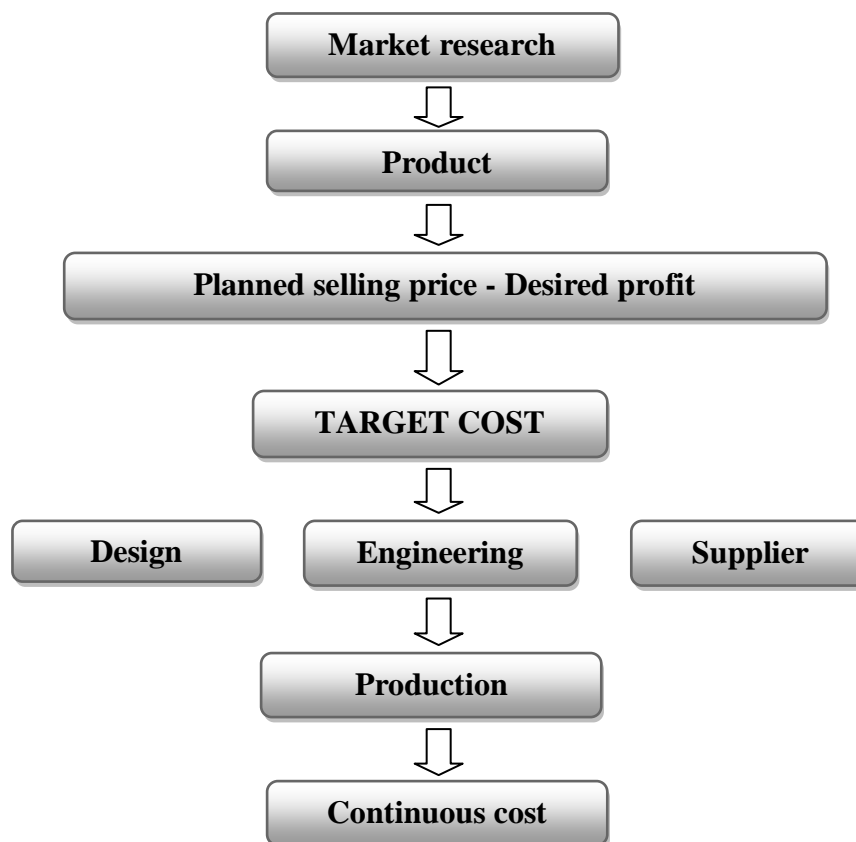


Chart 1. The process of target costing [8]

It can be seen that the process of target costing starts with market research and the main goal of this phase is to find out more information about customers demands and competitive products. This market research is a base for the next step and this is formation of product characteristic of a new product. This two steps are very important for quality implementation of target costing because the most cost can be reduce during the planning and design phase of the product life cycle since the majority of product cost is determined at this phase and therefore the most time is spend during this first steps. After these two steps companies establishes selling price for a new product based on marker research. From this target selling price, the

desired (target) profit is subtracted to determine the TARGET COST. [9] This target cost is allowable cost for the company and management accounting plays an important role in effectively determining target profits and target costs. In all likelihood, this target cost is below the company's current production cost and therefore company establish a cross-functional teams from many different departments in the company (such as marketing, design, engineering, production, purchasing and accounting) that perform functional cost analysis in attempt to reach target cost. [10] In order to minimize costs, team members focus on eliminating non-value-added costs of the process, improving product design and modifying process methods. [11] In comparison to traditional product costing methods, target costing allocates more of the total cost to the development stage, simultaneously reducing costs during the production stage. That team use all kind of tools for cost reduction, such as value engineering in the design process and pursuing cost reduction using "kaizen costing" once production is started, Just In Time system, Total Quality Control, Material Requirements Planning. Once the target cost is achieved, management makes final decision to introduce the product. Also, it is very important to track cost of new introduced product through all phases of product life cycle, because target costing is dynamic process and target cost changes through product life cycle. So, companies must tray to continuously reduce the costs if it wants to satisfy customer's needs and be competitive on the market. In concept, target costing process might appear easy to understand and implement. However, the straightforwardness of target costing should not lead to an assumption that implementing target costing process will inevitably lead to the desired results. [12] The key to the success of target costing is the adoption of its underlying philosophy throughout a company.

2.2. Benefits from application of target costing

Although the initial emphasis of target costing may be planning, management and cost reduction, a number of other benefits result from its application. The benefits diversify from company to company. So, further in the text will be mentioned some most significant benefits from introducing target costing in private sector and this benefits could also on some way transfer to public sector. The most important characteristics of target costing is customer orientation. So, the very important benefit from target costing application is an understanding of the market and customer in terms of price, quality and features. Also, target costing has a positive effect on the connection of different departments in the company and their mutual understanding, because to be able to achieve their common goal and that is target cost companies must create cross-functional teams from many different departments in the company. So, this reflects positive on company's environment. Beside the improvement the relationships in the company, it also helps to improve supplier relations by providing an avenue for earlier supplier involvement. For producing business, the focus of target costing shifts from product to the process, and for service business the focus is the service delivery system. Although, the key issues – understanding the needs of the market, customers and users, end ensuring satisfactory financial performance at a

given cost or price which does not exceed the target cost – remain. This method or as some called business philosophy is based on continuous education and implementation of new tools (such as JIT, value engineering, kaizen costing etc.)

3. Target costing in public sector

A need for improvements in financial skills and systems is identified in order to meet the challenges facing the public sector service. First-class financial management has a vital role in delivering improvements to public services. Primer purpose of public sector isn't to gain profit but at least to cover all cost that incurred in regards with provided service. Determining prices of public sector services is a question that has several connotations like social, political and economical. The unprecedented level of pressure was put on the public sector financial regime due to the combined effect of increased annual expenditure, structural reforms, and developments in information technology and most important are changes in funding. In this environment, better costing of services and management of those costs have particular impact in helping organizations to meet their financial responsibilities to at least break-even by ensuring that services are delivered within budgeted costs. In addition cost comparisons with other organizations and other financial analyses can provide important information in tacking deficits which do arise. Better understanding of cost will also help in forecasting and transparency. Target costing may provide a framework for achieving this. Service developments in public sector should be based on the needs of users and whether their revenue and value to users offset the cost. Because resources are limited and costs need to be managed, they shouldn't create new services just because they can and because of that the use of target costing could be of relevance. Off course, due to the variations there should be an emphasis on different types of public sector entities and their users, like geographical consideration and the characteristic of the local population. Also, implementing the accrual principle, cost control and proper cost allocation method into the all governmental units, would help in getting accurate, timely information about costs that would ensure that the right decisions are made and would give target costing method credibility as an approach. [13] But also target costing method could help entities in public sector to understand why some services are performing well and while others don't. So, public sector entities need to invest more in costing and improve the accuracy of cost information.

4. Conclusion

Target costing could be applied in public sector as relevant method for price determination and there are a lot of target costing method advantages to prove that hypothesis. Price determination in public sector mostly depends on some external elements like social criteria and public interest. Different trends, terms and assumptions which are appearing in Republic of Croatia are presumption for the usage and appliance of different tools which will enable public sector to provide high

quality services within budgeted costs. Target costing method requires true data given by the right tracking and proper cost allocation method. With those methods they could target prices of provided services but to know precisely what the actual occurred cost of provided service is. Implementing the accrual principle and cost control into the all governmental units, the performance measurements and program efficiency evaluation will be made on actual relevant data and in accordance to that, the decision making process will be based on relevant data. Target costing could be especially used when entity is considering in introducing new service or when they are changing and improving some old one. Important thing is that target costing method has an emphasis on users of service which is also important for public sector in providing public services.

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Photo 042. Apple flower / Cvijet jabuke