

## **“POLASKI PLUMBING PRODUCTS INC. EXPERIMENT WITH TARGET COSTING” – CASE STUDY**

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### **Abstract:**

*Target Costing is a disciplined process for determining and realizing a total cost at which a proposed product with specified functionality must be produced to generate the desired profitability at its anticipated selling price in the future. CIMA defines target cost as “a product cost estimate derived from a competitive market price. Target Costing is a disciplined process that uses data and information in a logical series of steps to determine and achieve a target cost for the product. In addition, the price and cost are for specified product functionality, which is determined from understanding the needs of the customer and the willingness of the customer to pay for each function. Target costing is a formal process that attempts to match a proposed product's features/benefits with a viable market price that achieves the company's profitability goals.*

### **KEYWORDS:**

Polaski Plumbing , Experiment , Target Costing, organization.

### **INTRODUCTION**

Target costing affects profitability of an organization depending on the commitment of management to its use, the constant involvement of cost accountant in all phases of a product's life cycle, and the type of strategy the organization follows. Target costing improves profitability in two ways. First it places a detailed continuing emphasis on product costs through out the life cycle of every product. The management team is completely aware of costing issues since it receives regular reports from the cost accounting members of all design teams. Second, it improves profitability through precise targeting of the correct prices at which the company feels it can place a profitable product in the market place that will sell in a robust manner. This is opposed to the more common cost-plus approach under which a company makes a product, determines its cost, adds profit to cost and then does not understand why its resoundingly high price does not attract buyers. Thus, target costing results not only in better-cost control but also in better price control. A company's strategy can also have its impact on profitability. If it constantly issues a stream of new products, or if its existing product lines are subject to severe pressures, it must adapt target costing a central part of its strategy so that the correct prices are used for products and actual costs match those originally planned.

### **CASE STUDIES - Polaski Plumbing Products Inc.**

Polaski Plumbing Products Inc. manufactures a line of plastic plumbing products that are sold through hardware stores. The company's sales have declined for the previous two years resulting in idle plant and equipment. Although Polaski is not operating at capacity the company generated a profit last year as shown in the following income statements

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Income Statement ( in thousands)	Amount in USD	%
	\$1,500	100
Sales		
Cost of goods sold		
Direct material	200	13
Direct labour	400	27
Manufacturing overhead*	390	26
.....		
Manufacturing overhead before		
Underapplied manufacturing overhead	510	34
Underapplied manufacturing overhead	10	1
.....		
Manufacturing margin	500	33
.....		
Operating expenses	60	4
Sales commissions	30	2
Sales administration	110	7
.....		
General administration	200	13
.....		
Total operating expenses		
Net income before incomes taxes	300	20
Income taxes ( 40 per cent )	120	8
.....		
Net income	180	12%
.....		
Schedule of manufacturing overhead		
Variable -		
Indirect labour	100	
Supplies	40	
Power	120	
Fixed costs applied		
Factory administration	60	
Depreciation	70	
.....		
	390	

A Polaski engineer met a former college classmate at a trade show. The classmate was working with Paddington Company which was also in the business of plastic products. During their conversation it became evident that Polaski might be able to make a particular product for Paddington with its currently unused equipment and space

The following requirements were specified by Paddington for the new product

1. Paddington needs 80,000 units per year for the next three years.
2. The product is to be built to Paddington specifications
3. Polaski is not to enter into independent production of the product during the 3-year contract
4. Paddington would provide Polaski without charge a special machine to finish the product. The machine becomes the property of Polaski at the end of the three year period. Polaski's engineering production and cost management departments agreed up on the following facts if the contract was accepted.

**Sales**

A sales commission of \$10,000 would be paid to the sales personnel arranging the contract  
No additional sales or administrative costs would be incurred

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**Manufacturing**

The present idle capacity would be fully used.  
 One additional part-time factory supervisor whose annual salary would be \$15,000 would be required.  
 The annual quantity of direct material and direct labour would increase by 10 per cent at current prices.  
 There would be no increase in indirect labour.  
 The power and supply quantity requirements would increase 10 per cent at current prices due to reactivation of idle machines.  
 The machine provided by the Paddington would increase the annual power and supply costs by \$ 10000 and \$ 4000 respectively at current price.

**General Administration**

No additional general administration costs would be incurred

**Other Information**

Estimated cost increases due to inflation for the entire three year period were as follows

Direct material	05%
Direct labour	10%
Power	20%
Depreciation	00%
Sales commission	00%
Income taxes	00%
All other items	10%

Inventory balances which have remained stable for the past three years will not be increased or decreased by the production of the new product.

**COMPUTER PROFESSIONALS INSTITUTE**

Computer Professionals Institute (CPI) a professional association for systems analysts and computer programmers has 50,000 members. CPI holds a convention each October and planning for the current year's convention is progressing smoothly. The convention budget for promotional brochures fees and expenses for twenty speakers equipment rent for presentations the travel and expenses of twenty five members of the staff consultant fees and volunteer expenses is \$ 3330,000. This amount does not include the hotel charges for meeting rooms luncheons banquets or receptions.

CPI has always priced each function at the convention separately. Members select and pay only the functions that they attend. Members who attend the convention pay a registration fee that allows them to attend the annual reception and meeting. The annual convention committee has recommended that CPI set a single flat fee for the entire convention registered members would be entitled to attend all function.

The following table presents the convention functions the percentage of attendees that can be expected given the price CPI would charge for each function if it were priced separately and the hotel charges for food service and meetings rooms. The percentage of attendees expected to attend each function is based on past experience and is expected to hold regardless of the pricing scheme used.

Function	Per cent of attendees Will Participate	Separate Price of Function	Hotel Charges
Registration fee	100	\$5	None
Reception	100	Free	\$25/attendee
Annual meeting	100	Free	\$2,000 hall
Keynote function	90	\$40	\$25/attendee
*Six current session	70	\$60	\$200/room
Plenary session	70	\$50	\$2000 hall
Six workshops	50	\$100	\$200/room \$1,200 total
Banquet	90	\$ 50	\$ 3/attendee

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**Attendee selects one session for the fee**

The hotel's package of services to CPI and the convention attendees is as follows.

1. Three free rooms for convention headquarters and storage.
2. Twenty per cent discount for all convention attendees who stay in the hotel during the three day convention. The types of rooms, regular posted rate and the proportion of each type of room taken by attendees are as follows. Attendees are to make room reservations directly with the hotel and all hotel room charges are the responsibility of the attendees.

Type	Regular posted Rate/Night (in USD)	Proportion Rented (in per cent)
Single	100	10
Studio	105	10
Double	125	75
Suite	200	5

3. CPI is given credit for one free double room for three days for every fifty convention registrants who stay at the hotel. The credit will be applied to the room charges of staff and speakers.
4. Meeting rooms and halls for professional sessions are free if 1,000 members are registered at the hotel.
5. Meal costs given in the table include all taxes and gratuities.
6. The hotel receives all revenue from cash bar sales at the reception and before the luncheons and banquet. The total estimates that the average consumption at these functions will be one cocktail per attendee at \$ 1.50 per cocktail.

If CPI continues to price each convention function separately the prices given in the table will apply. Expected attendance under this type of pricing scheme is 2,000 . The annual convention committee has estimated the convention attendance for three different single flat-fee pricing structures as follows.

Proposed Single Flat (\$)	Estimated Attendees
325	1,600
300	1,750
275	1,900

CPI estimates that 60 per cent of the people who attend the convention will stay in the convention hotel and each attendee will need a separate room for an average stay of three nights.

**CYBER RESEARCH**

Germain Boer and John Ettlie “Target Costing Can Boost Your Bottom Line” strategic Finance July 1999. While Japanese companies have developed and mastered in target costing American companies are quickly adopting this technique. A survey of top research and development performing companies indicates that better technology and the cooperation of the design team the accountants and finance managers can help companies increase profits. Discuss the two approaches available to production designers for estimating the unit cost.

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