Lesson 13

The role of costing information in pricing decisions

12.1 Introduction

The purpose of pricing decision and profitability analysis to assist management in planning and controlling the resources of their organisation, and enhancing company's decision making. Organisations that sell products and services that are highly customised or differentiated from each other by special features, or who are market leaders, have some discretion in setting prices. The cost of information that is accumulated and presented is therefore important for pricing decisions.

12.2 Learning Outcomes

- Discuss the three major factors that affect pricing decisions.
- Discuss the cost of allocations
- Compute the target costing approach to pricing.

12.3 Required Readings

Drury, Chapter 10

12.4 Points to Ponder/Takeaways

Target Costing	Target selling price- Target Profit= Target Cost

12.5 Learning materials

1. Major factors that affect Pricing decisions

Customers—influence price through their effect on the demand for a product or service, based on factors such as product features and quality.

Competitors—influence price through their technologies, plant capacities and operating strategies which affect their costs.

Costs—influence prices because they affect supply (the lower the cost, the greater the quantity a firm is willing to supply).

The 3 influences on demand and supply are explained in more detail here:

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2.Cost allocation

- Recall that indirect costs of a particular cost object are costs that are related to that cost object but cannot be traced to it in an economically feasible (cost-effective) way.
- These costs often comprise a large percentage of the overall costs assigned to cost objects.
- Cost allocations influence managers' cost management decisions as well as the products that managers promote.
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2.1

Purpose	Examples
To provide information for economic decisions.	To decide on the selling price for a product or services. To decide whether to add a new product features.
1. To motivate managers and other employees	To encourage the design of products that are simpler to manufacture or less costly to service.

	To encourage sales representatives to emphasize high margin products or services.
2. To justify costs or compute reimburse amounts	To cost products at a “fair” price, often required by law and government defence contracts.
3. To measure income and assets	To cost inventories for reporting to external parties. To cost inventories for reporting to tax authorities.

3. Target Costing

- An approach that considers **manufacturing costs early** in the **design decisions**
- Helps engineers design new products that **meet customers’ expectations** and that can be manufactured **at a desired cost**.
- An important management accounting method for cost reduction during the design stage that helps manage total-life-cycle costs.

3.1The Traditional Method

- Begins with market research into customer requirements followed by product specification
- Companies engage in product design and engineering and obtain prices from suppliers
- After the engineers and designers have determined product design, cost is estimated

3.2 Major differences between the traditional costing method and target costing

Although the initial steps appear similar to traditional costing, there are some notable differences:

- Marketing research is customer-driven.
- Project engineers attempt to design costs out of the product before design & development end and manufacturing begins.
- The total-life-cycle concept is used by making it a key goal to minimize the cost of ownership of a product over its useful life.
- Engineers set an allowable cost that enables the targeted product profit margin to be achieved at a price customers are willing to pay.

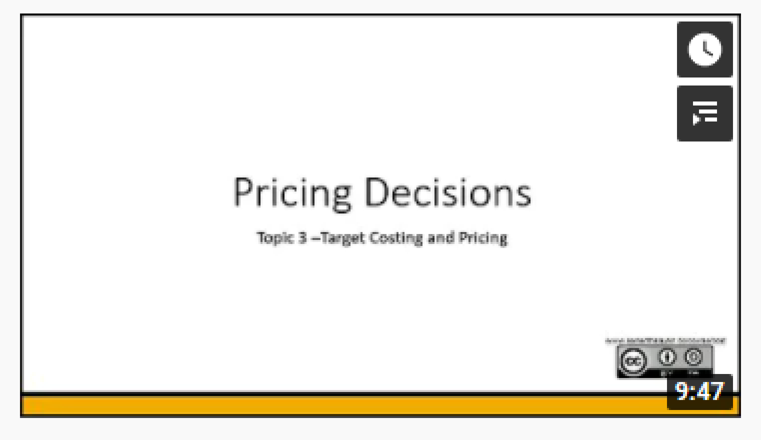
- The target profit margin results from a long-run profit analysis, often based on return on sales.
- The target cost is the difference between the target selling price and the target profit margin.
- Once the total target cost has been set, the company must determine target costs for each component.

- The value engineering process includes examination of each component of a product to determine whether it is possible to reduce costs while maintaining functionality and performance.
- Several iterations of value engineering are usually needed before the final target cost is achieved.

3.2.1Two other differences characterize the process:

- Throughout the entire process, cross-functional product teams made up of individuals representing the entire value chain guide the process.
- Suppliers play a critical role in making target costing work.

12.5.1 Video



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