Q. 12

C 1. Difference between Standard cost and Target Cost

standard cost is an expected cost for a unit of product or service based on the resources required (materials, labour etc) and the expected prices for the resources. Standard costs are used in standard costing systems, which aim to control an organisation's costs.

A target cost is calculated by deducting a target profit from a predetermined selling price based on customers views. Functional analysis, value engineering and value analysis are used to change production methods and/or reduce expected costs so that the target cost is met. This is all part of a target costing system.

Target cost are therefore based on the price set by the external market, a factor over which an organisation has no control. Standard costs, on the other hand, are internally derived costs to be used as part of an internal control system.

C.2 Review of pricing policy

When the product was new and the price was first set, this was possibly the only product of its kind in the market. So the price charged was high. The price was based on earning a 25% margin on the cost to ensure a profit was made. The strategy of setting high prices when a product is first launched is known as market skimming.

The product has now been on the market for six months. Competitors have entered the market with their own versions. They are able to work out how the product is made and hence copy it. AVX plc is therefore probably facing competition and is unable to sell at ` 1,200 per batch. The price therefore needs to be successively lowered in order to maintain some market share and continue to earn profits. By adopting target costing and applying continual pressure to ensure target costs are met, the organisation can charge prices that the market will pay and maintain profits.

Q.15 The product life cycle comprises four stages:

- Introduction
- Growth
- Maturity
- Decline

In the introduction stage the company needs to price the product to achieve its market strategy using either penetration or skimming pricing policies.

A penetration policy is used with the objective of achieving a high level of demand very quickly by using a low price that is affordable to a large number of potential customers. This has the effect of discouraging new suppliers to the market because the unit profitability is relatively low, but the high volume of sales enables the initial supplier to recover their development costs.

A skimming policy is particularly appropriate to a product that has a novelty value or that is technologically advanced. Such a policy uses a price that is high and this restricts the volume of sales since only high worth customers can afford the product, but the high unit profitability enables the initial supplier to recover their development costs. However, the high unit profitability attracts competitors to the market so that it is important for the initial supplier to be able to reduce the price and can prevent new entrants to the market from being able to reverse engineer the product and make significant profits from little or no development investment.

The Q organisation is launching a technologically advanced product which will be demanded by high worth customers who are proud to be amongst the first to own such a state of the art product. This is exactly the type of product for which a price skimming policy is appropriate.

The initial price will be high as this will quickly recover the development costs of the product. The high worth customers will not be deterred from buying the product as it will be sold on the basis of its technological value rather than its price.

Competitors will be attracted to the product by its high price and will seek to compete with it by introducing their own version of the product at much lower development costs (by reverse engineering Q’s product) so it is important for Q to reduce the price during the growth stage of the product's life cycle. There may be many price reductions during this phase so that the product gradually becomes more affordable to lower social economic groups.

As the product enters the maturity stage the price will need to be lowered further, though a profitable contribution ratio would continue to be earned. However, in this type of market the price will tend to be set by the market and Q will have to accept that price. Thus Q will need to focus on the control of its costs to ensure that the product will remain profitable.

When the product enters the decline phase, a loyal group of customers may continue to be prepared to pay a reasonable price and at this price the product will continue to be profitable, especially as costs continue to reduce. Eventually the price will be lowered to marginal cost or even lower in order to sell off inventories of what is now an obsolete product as it has been replaced by a more technologically advanced item.