

RCM COLLEGE

BEST COLLEGE IN EAST AND CENTRAL AFRICA

0793555000

ADVANCED MANAGEMENT ACCOUNTING

1.0 Definitions

Management accounting

It is the process of preparing and providing financial and non-financial information to managers to help in planning, decision-making, and control of business activities.

Strategic Management Accounting (SMA)

Strategic management accounting is the use of management accounting information with a long-term and outward-looking focus, especially by considering competitors, markets, and strategy to support sustainable competitive advantage.

1.1 Sources of Strategic Management Accounting Information

- **Internal:** budgets, cost records, performance reports, financial statements.
- **External:** market trends, competitor analysis, industry benchmarks, economic data.
- **Other:** customer feedback, government policy, technology trends.

1.2 Role in Strategic Planning and Control

- Helps in **setting long-term goals** (profitability, growth).
- Guides **resource allocation** to profitable areas.
- Provides **performance measures** (KPIs, balanced scorecards).

- Supports **risk management** and cost control.

1.3 Governance and Control of Information

- Ensures accuracy, reliability, and timeliness of data.
- Protects against misuse of sensitive info.
- Promotes accountability through proper reporting systems.
- Aligns with corporate governance rules.

1.4 Scope and Limitations of Management Accounting

- **Scope:**
 - Costing, budgeting, variance analysis.
 - Strategic decision support (pricing, make-or-buy, investment appraisal).
 - Performance measurement and control.
- **Limitations:**
 - Based on estimates and assumptions. o Can be time-consuming and costly. o Relies heavily on quality of input data.
 - May not capture qualitative factors effectively (e.g., employee morale).

1.5 Ethical Standards for Management Accountants

- **Integrity** – be honest and straightforward.
- **Objectivity** – avoid bias or conflict of interest.
- **Confidentiality** – protect sensitive information.

- **Professional Competence** – maintain knowledge and skills.
- **Professional Behaviour** – follow laws and avoid discrediting the profession.

Past paper practice questions

May 2025 question 5a

Describe the following types of business data analytics as used in strategic management accounting: (i) Pricing analytics. (2 marks) (ii) Forecasting analytics.

(i) Pricing Analytics (2 marks)

- Use of data to **set or adjust product prices** based on costs, customer demand, competitor prices, and market conditions.
- Helps businesses find the **best price** that maximises **profitability, competitiveness, and customer value**.
- *Example:* Supermarket analysing sales data to adjust prices of fastmoving items.

(ii) Forecasting Analytics (2 marks)

- Use of historical data, trends, and statistical models to **predict future outcomes** such as sales, costs, or cash flows.
- Supports **strategic planning**, budgeting, and resource allocation.
- *Example:* Airline predicting passenger demand to plan ticket prices and flight schedules.

August 2024 question 4.

(a) One of the roles of management accounting is to provide information that is useful for managers of an organisation of various departments, in decision making.

In line with this statement, explain THREE types of accounting information a management accountant could communicate to a human resource manager.

Answer

A management accountant can provide the following information to support HR decisions:

1. **Labour Cost Information** o Details on wages, salaries, overtime, and benefits.
 - o Helps HR in **salary negotiations, budgeting, and staff cost control.**
2. **Labour Productivity Reports** o Data on output per employee, absenteeism, and efficiency.
 - o Assists HR in **performance appraisal and training needs analysis.**
3. **Budget and Forecast Information**
 - o Estimates of future staffing costs (recruitment, training, promotions).
 - o Guides HR in **workforce planning and resource allocation.**
4. **Employee Benefits & Incentive Costs** o Costs of medical cover, pensions, bonuses, and allowances.
 - o Supports HR in **designing reward systems and retention strategies.**

April 2024 QUESTION THREE

(a) “Management Accounting is an invaluable tool to any organisation at both the operational level and the strategic management level”.

Discuss THREE reasons to support the claim.

Management Accounting at the Operational Level

Focus = **day-to-day activities, short-term efficiency, and control.**

1. Cost Control

- Provides detailed cost reports (materials, labour, overheads) to monitor daily expenses.
- *Example:* Tracking wastage in production.

2. Budgeting and Variance Analysis

○ Compares actual vs budgeted costs to identify deviations quickly.

- *Example:* If wages are higher than expected, HR can investigate overtime.

3. Performance Monitoring

- Uses KPIs, productivity ratios, and efficiency reports to check departmental performance.
- *Example:* Output per worker in a factory.

4. Short-term Decision Making

○ Supplies information for routine decisions like make-or-buy, pricing for special orders, or scheduling production.

- *Example:* Deciding whether to outsource a service to reduce costs.

Management Accounting at the Strategic Level

Focus = **long-term goals, competitiveness, and growth.**

- Guides **capital investment** (NPV, IRR, Payback).
- Provides **market/competitor analysis** (strategic costing, value chain).

- Supports **sustainability and risk management** decisions.
- Aligns resources with **corporate strategy** (e.g., Balanced Scorecard).

Note

- **Operational level** → daily efficiency & control.
- **Strategic level** → long-term direction & sustainability.

April 2025

QUESTION THREE (a) Distinguish between “sunk costs” and “opportunity costs” as used in decision making.

COSTING TERMS AND CONCEPTS

Cost Definition and Identification

- Cost = resources (money, time, effort) used to produce goods/services.
- Direct cost: traceable to product (e.g., flour in bread).
- Indirect cost: supports production but not directly traceable (e.g., rent).

2.2 Cost Classification

- Grouping costs into categories for easier management.
- Direct vs Indirect – materials/labour vs overheads.
- Fixed vs Variable – rent vs raw materials.
- Product vs Period – stock vs expensed immediately.

Bases of Classification

- By Time: Historical (past) vs Predetermined (budgeted).
- By Behaviour: Fixed, Variable, Semi-variable.
- By Function: Production, Admin, Selling, Finance.
- By Stock Relation: Product vs Period costs.
- By Decision Relevance: Relevant vs Irrelevant.

- By Management Control: Controllable vs Uncontrollable.

Types of Cost Systems

- Job costing – unique jobs (e.g., printing order).
- Process costing – continuous (e.g., sugar, cement).
- Batch costing – group of items (e.g., bakery).
- Contract costing – long-term contracts (e.g., roads).
- ABC – activity-based costing, traces costs via activities.

Maintaining a Cost Database

- Central record for cost info: used for budgets, variance analysis, pricing, decision-making.
- Must be accurate, updated, and accessible.

AMA: TOPIC 2

Cost Estimation and Interpretation

2.1 Ordinary Least Squares (OLS)

Ordinary Least Squares (OLS) is a statistical method used to estimate the relationship between dependent (costs) and independent variables (e.g., output, labor hours) by minimizing the sum of squared residuals.

Key Points:

- • Single predictor: $\text{Cost} = a + bX$ (e.g., cost depends only on units produced).
- • Multiple predictors: $\text{Cost} = a + b_1X_1 + b_2X_2 \dots + b_nX_n$.
- • Tests of significance:
 - - Goodness of Fit (R^2 /Adjusted R^2) – measures explanatory power.
 - - ANOVA/P-Value – overall model significance.
 - - t-test for variables – checks significance of each predictor.

- - Economic Plausibility – coefficients should make sense economically.

Example 1: Single Predictor Regression

Suppose total cost (Y) depends on units produced (X).

Equation: $\text{Cost} = 5,000 + 20X$

Interpretation:

- • Intercept (5,000): Fixed cost when no units are produced.
- • Slope (20): Variable cost of Sh.20 per unit.
- • If 1,000 units are produced $\rightarrow$ Predicted Cost = 25,000.

November 2017

NOVEMBER 2017 QUESTION TWO B AND C

QUESTION

(b) Actross Ltd., subsidiary of Master pack Ltd., a packaging company is preparing a budget for the year ending 30 June 2018. In respect of fuel consumption, the company desires to estimate an equation in the form of $y = a + bx$, where “y” is the total expense at an activity level “x”, “a” is the fixed cost and “b” is the variable cost.

The following information relates to the year ended 30 June 2017.

Year and Month	Machine hours Sh. “000”	Fuel expenses Sh. “000”
2016		
July	34	640
August	30	620
September	34	620
October	39	590
November	42	500
December	32	530
2017		
January	26	500

February	26	500
March	31	530
April	35	550
May	43	580
June	48	680

The annual total and monthly average figures for the year ended 30 June 2017 were as follows:

	Machine hours Sh. "000"	Fuel expenses Sh. "000"
Annual total	420	6,840
Monthly average	35	570

Required:

Estimate the fixed and variable elements of fuel expense from the above data using the following methods:

- (i) High-low.
- (ii) Least squares regression.

(c) From the information in (b) above, the coefficient of determination arising is approximately 0.25. Interpret the significance of this information.

Answer

Part (b) – Split fuel costs into fixed and variable elements

We model monthly fuel expense as: $y = a + bx$, where y = fuel expense (Sh. '000') and x = machine hours ('000).

Data (12 months, Jul 2016 – Jun 2017)

$\Sigma x = 420$, $\Sigma y = 6,840$, $\Sigma xy = 241,670$, $\Sigma x^2 = 15,212$, $n = 12$

(i) High–low Method

Highest activity: $x = 48$, $y = 680$

Lowest activity: $x = 26$, $y = 500$

$$b = (680 - 500) / (48 - 26) = 180 / 22 = 8.18$$

$$a = 680 - (8.18 \times 48) = 287.27$$

$$\text{Equation: } y = 287.27 + 8.18x$$

Interpretation: Fixed fuel cost $\approx$ Sh.287.27k; variable fuel cost $\approx$ Sh.8.18k per machine-hour ('000).

(ii) Least Squares Regression

Slope:

$$b = [12 \times 241,670 - (420 \times 6,840)] / [12 \times 15,212 - 420^2]$$

$$b = 27,240 / 6,144 = 4.434$$

Intercept:

$$a = (6,840 - 4.434 \times 420) / 12 = 414.82$$

$$\text{Equation: } y = 414.82 + 4.434x$$

Interpretation: Fixed fuel cost $\approx$ Sh.414.82k; variable fuel cost $\approx$ Sh.4.434k per machine-hour ('000).

Note: High–low uses only 2 points; regression uses all 12 months and is more reliable.

Part (c) – Interpretation of $R^2 = 0.25$

- • $R^2 = 0.25$ means 25% of variance in fuel expense is explained by machine hours; 75% is due to other factors and error.
- • Correlation magnitude $|r| = \sqrt{0.25} = 0.50$, a moderate positive relationship.
- • Managerial implication: model has limited explanatory power; other cost drivers (fuel price changes, idle time, maintenance, routes) should be considered.
- • Recommendation: Use regression estimates but refine model with additional predictors for better budgeting accuracy.

Example 3: Multiple Regression

Equation: $\text{Cost} = 2,000 + 15X_1 + 10X_2$

Interpretation:

- Each additional unit (X_1) adds Sh.15.
- Each additional labor hour (X_2) adds Sh.10.
- Level of significance is 5%

Sample Computer Output

Variable	Coefficient	t-value	p-value
Intercept	5,000	4.5	0.002
Units (X_1)	20	3.8	0.004
Labor hours (X_2)	10	1.2	0.25

- $R^2 = 0.82 \rightarrow 82\%$ of variation explained.
- Managerial insight: focus on Units produced as the key cost driver.

INTERPRETATION- P VALUES

A **p-value** tells us how likely it is that a result happened **just by chance**.

Small p-value (below 0.05): The result is real and important.

Big p-value (above 0.05): The result might just be luck, not reliable

Units (X_1): $p = 0.004$ $\rightarrow$ Less than 0.5% chance this result is random $\rightarrow$ very strong evidence that units produced truly drive costs.

Labor hours (X2): $p = 0.25$ → 25% chance the observed effect is random → too high, so we say labor hours are **not a reliable predictor** in this model.

Intercept: $p = 0.002$ → Fixed costs are statistically significant (they definitely exist).

2.2 Assumptions and Issues of OLS

- • Linearity – relationship between X and Y must be linear.
- • Independence – residuals must not be correlated.
- • Homoscedasticity – constant error variance.
- • Normality – residuals should be normally distributed.

Problems:

- • Serial Correlation – errors correlated over time (common in time series).
- • Multicollinearity – independent variables highly correlated; coefficients unstable.

2.3 Computer Output vs Managerial Interpretation

- • Technical (Computer Output): regression coefficients, t-tests, p-values, R^2 .
- • Managerial Interpretation: translate coefficients into business insights (e.g., every unit increases cost by Sh.20).

2.4 Learning Curve Models

Learning curve models show that as cumulative production increases, the time/cost per unit declines at a constant percentage.

Formula: $Y = aX^b$

Where:

- • Y = average time/cost per unit after X units.
- • a = cost/time of the first unit.
- • b = learning index = $\log(\text{learning rate})/\log(2)$.

Example: 80% Learning Curve

- First unit = 100 hours.
- Learning rate = 80% $\rightarrow b = \log(0.8)/\log(2) \approx -0.322$.

For 4 units ($X=4$):

$$Y = 100(4^{-0.322}) \approx 69.3 \text{ hours per unit.}$$

$$\text{Total time for 4 units} = 69.3 \times 4 = 277.2 \text{ hours.}$$

Managerial use: budgeting, pricing contracts, labor planning, productivity improvement.

Topic 3: Short term planning

Question

Shifters Haulage (SH) is considering changing some of the vans it uses to transport crates for customers. The new vans come in three sizes; small, medium and large. SH is unsure about which type to buy. The capacity is 100 crates for the small van, 150 for the medium van and 200 for the large van.

Demand for crates varies and can be either 120 or 190 crates per period, with the probability of the higher demand figure being 0.6. The sale price per crate is Ksh.10 and the variable cost Ksh.4 per crate for all van sizes subject to the fact that if the capacity of the van is greater than the demand for crates in a period then the variable cost will be lower by 10% to allow for the fact that the vans will be partly empty when transporting crates.

SH is concerned that if the demand for crates exceeds the capacity of the vans then customers will have to be turned away. SH estimates that in this case goodwill of Ksh.100 would be charged against profits per period to allow for lost future sales regardless of the number of customers that are turned away. Depreciation charged would be Ksh.200 per period for the small, Ksh.300 for the medium and Ksh.400 for the large van. SH has in the past been very aggressive in its decision-making, pressing ahead with rapid growth strategies. However, its managers have recently grown more cautious as the business has become more competitive.

Required

- (a) Prepare a profits table showing the six possible profit figures per period. (9 marks)
- (b) Using your profit table from (a) above discuss which type of van SH should buy taking into consideration the possible risk attitudes of the managers. (6 marks)

Solution

All calculations and reasoning are shown below.

(a) Profit Table – Computation

Formula: Profit = (Units Sold × Selling Price) – (Units Sold × Variable Cost) – Depreciation – Goodwill (if applicable)

Details:

- Selling price per crate = Ksh.10
- Variable cost = Ksh.4 normally; Ksh.3.60 (10% lower) if capacity > demand
- Goodwill charge = Ksh.100 when demand exceeds capacity
- Depreciation: Small Ksh.200, Medium Ksh.300, Large Ksh.400
- Demand = 120 crates (p=0.4) or 190 crates (p=0.6)

Van Type	Demand (Crates)	Computation	Profit (Ksh.)
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Small (100)	120	Revenue = $100 \times 10 = 1,000$; $VC = 100 \times 4 = 400$; Depn=200; Goodwill=100	300
Small (100)	190	Revenue = $100 \times 10 = 1,000$; $VC = 100 \times 4 = 400$; Depn=200; Goodwill=100	300
Medium (150)	120	Revenue = $120 \times 10 = 1,200$; $VC = 120 \times 3.6 = 432$; Depn=300; Goodwill=0	468
Medium (150)	190	Revenue = $150 \times 10 = 1,500$; $VC = 150 \times 4 = 600$; Depn=300; Goodwill=100	500
Large (200)	120	Revenue = $120 \times 10 = 1,200$; $VC = 120 \times 3.6 = 432$; Depn=400; Goodwill=0	368
Large (200)	190	Revenue = $190 \times 10 = 1,900$; $VC = 190 \times 3.6 = 684$;	816

		Depn=400; Goodwill=0	
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Payoff table

Van Type	Profit @ Demand 120	Profit @ Demand 190
Small (100)	Ksh.300	Ksh.300
Medium (150)	Ksh.468	Ksh.500
Large (200)	Ksh.368	Ksh.816

(b) Decision Analysis Based on Risk Attitudes

Expected Monetary Values (EMVs) based on probabilities of 0.4 for demand 120 and 0.6 for demand 190:

$$EV(\text{Small}) = 0.4 \times 300 + 0.6 \times 300 = 300$$

$$EV(\text{Medium}) = 0.4 \times 468 + 0.6 \times 500 = 487.2$$

$$EV(\text{Large}) = 0.4 \times 368 + 0.6 \times 816 = 636.8$$

→ The Large van has the highest expected profit (Ksh.636.8).

Risk Attitude Discussion

- Maximax (Aggressive): Choose highest possible payoff → Large van (Ksh.816).
- Maximin (Cautious): Choose best worst-case profit → Medium van (Ksh.468).
- Minimax Regret (Regret-Averse): Choose lowest possible maximum regret → Large van.

Recommendation:

Given SH's current cautious strategy, the Medium van offers a safer option with a steady profit and minimal downside. However, if SH wishes to

pursue higher returns and maintain its growth-oriented approach, the Large van remains the optimal choice.

Key limiting factor

The key limiting factor is the *resource or variable that restricts activities and prevents an organization from achieving higher levels of profit*

THROUGHPUT ACCOUNTING

Definition

Throughput is the sales revenue minus direct material cost. It measures the cash a company generates from sales after covering only material costs, since all other costs are fixed in the short term. When a resource is scarce (bottleneck), throughput accounting helps identify which products generate the highest contribution per unit of that limiting resource.

Steps to Solve

1. Compute throughput per unit = Selling price – Direct material cost
2. Compute throughput per unit of scarce resource = Throughput per unit ÷ Resource usage per unit
3. Rank the products by highest throughput per scarce resource
4. Allocate available resource to products in that rank order until bottleneck hours are used up

MULTIPLE CVP CHARTS

Assume that budgeted sales are 2,000 units of X, 4,000 units of Y and 3,000 units of Z. A breakeven chart would make the assumption that output and sales of X, Y and Z are in the proportions 2,000: 4,000: 3,000 at all levels of activity, in other words that the sales mix is 'fixed' in these proportions.

The variable cost per unit is Sh.3, Sh.4, Sh.5. The selling price is sh.8, Sh.6, Sh.6 respectively.

Budgeted costs

Costs

Revenue

			Sh.		Sh.
Variable costs of X	(2,000 × Sh.3)		6,000	X (2,000 × Sh.8)	16,000
Variable costs of Y	(4,000 × Sh.4)	×	16,000	Y (4,000 × Sh.6)	24,000
Variable costs of Z	(3,000 × Sh.5)	×	15,000	Z (3,000 × Sh.6)	18,000
Total variable costs			37,000	Budgeted revenue	58,000
Fixed costs			10,000		
Total budgeted costs			47,000		

5.

Product	Contribution Revenue/Sales – variable costs	Sales	C/S ratio	
	Sh.	Sh.	%	Rank
X	10,000	16,000	62.50	1
Y	8,000	24,000	33.33	2
Z	<u>3,000</u>	<u>18,000</u>	16.67	<u>3</u>
Total	<u>21,000</u>	<u>58,000</u>	36.21	

By convention, the **products are shown individually** on a P/V chart from **left to right, in order of the size of their C/S ratio**. In this example, product X will be plotted first, then product Y and finally product Z. A dotted line is used to show the **cumulative profit/loss and the cumulative sales** as each product's sales and contribution in turn are added to the sales mix.

Product	Cumulative sales		Cumulative profit
	Sh.		Sh.
X	16,000	W1 (Sh.16,000 – Sh.16,000)	-
X and Y	40,000	W2 (Sh.40,000 – Sh.32,000)	8,000
X, Y and Z	58,000	W3 (Sh.58,000 – 47,000)	11,000

CHAPTER 4- Pricing Decisions

4.1 External Pricing Methods

External pricing methods determine selling prices based on market and cost considerations. The main approaches are summarized below:

Method	Description	Key Point
Cost-plus pricing	Adds a profit margin to total or variable cost per unit.	Simple but ignores market demand.
Marginal (variable) cost pricing	Based on variable cost plus a contribution margin.	Useful for short-term decisions.
Market-based pricing	Price determined by market forces (competition, demand).	Common in competitive industries.
Penetration pricing	Low initial price to gain market share quickly.	Used for new product launches.
Price skimming	High initial price to recover costs before competitors enter.	Suitable for unique or innovative products.
Perceived-value pricing	Price set based on customer's perceived value, not cost.	Common in luxury or premium brands.
Competitive pricing	Price matched or slightly below competitors.	Useful in oligopolistic markets.

4.2 Transfer Pricing in Divisionalised Companies

Transfer pricing refers to the price charged for goods or services exchanged between divisions within the same company. It is applicable in both domestic and international contexts.

Objectives

- Promote goal congruence
- Ensure fair divisional performance measurement
- Comply with tax and regulatory rules (especially internationally)

Methods of Transfer Pricing

Method	Explanation	Best Used When...
Cost-based	Based on actual or standard production cost.	No external market exists.
Market-based	Uses prevailing external market price.	Active external market exists.
Negotiated price	Price agreed upon between divisions.	Both divisions have negotiation power.
Dual pricing	Supplying and receiving divisions record at different prices.	To balance autonomy and corporate goals.

International Transfer Pricing

International transfer pricing applies to cross-border transactions between company divisions. It influences taxation, tariffs, and profit repatriation. The OECD's Arm's Length Principle requires transfer prices to reflect fair market value.

4.3 Product Life Cycle Costing, Target Costing and Kaizen Costing

a) Product Life Cycle Costing (PLCC)

Tracks and manages all costs of a product from design to disposal. Phases include Introduction, Growth, Maturity, and Decline. It focuses on long-term profitability and encourages early cost control during design and R&D.

Question

Solaris manufactures solar panels and plans to introduce a new slimline solar panel designed for small houses. The development of the new panel is about to begin, and Solaris is determining its selling price. The company expects the following costs over the product's 4-year life cycle.

Cost Data

Item	Year 1	Year 2	Year 3	Year 4
Units manufactured and sold	2,000	15,000	20,000	5,000
R&D costs (Ksh.)	1,900,000	100,000	-	-
Marketing costs (Ksh.)	100,000	75,000	50,000	10,000
Production cost per unit (Ksh.)	500	450	400	450
Customer service cost per unit (Ksh.)	50	40	40	40
Disposal of specialist	-	-	-	300,000

equipment (Ksh.)				
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Additional Information

- The Marketing Director believes customers will be prepared to pay Ksh.500 for a solar panel.
- The Financial Director believes this price will not cover all costs throughout the lifecycle.

Requirement

Calculate the cost per unit looking at the whole life cycle and comment on the suggested price.

Solution

Cost Build-Up by Year

Year	Units	R&D (Ksh.)	Marketing (Ksh.)	Production (Ksh.)	Customer Service (Ksh.)	Disposal (Ksh.)
Year 1	2,000	1,900,000	100,000	1,000,000	100,000	–
Year 2	15,000	100,000	75,000	6,750,000	600,000	–
Year 3	20,000	0	50,000	8,000,000	800,000	–
Year 4	5,000	0	10,000	2,250,000	200,000	300,000

Total units over life cycle: 42,000

Total R&D: Ksh.2,000,000

Total Marketing: Ksh.235,000

Total Production: Ksh.18,000,000

Total Customer Service: Ksh.1,700,000

Total Disposal: Ksh.300,000

Total Life Cycle Cost: Ksh.22,235,000

Life Cycle Cost per Unit

Life cycle cost per unit = Total life cycle cost ÷ Total units = $\text{Ksh.}22,235,000 \div 42,000 = \text{Ksh.}529.40$ per panel.

Evaluation of Suggested Price (Ksh.500)

Unit margin at Ksh.500 = $\text{Ksh.}500 - \text{Ksh.}529.40 = \text{Ksh.}-29.40$ per panel.

Total margin over all 42,000 units = $\text{Ksh.}-29.40 \times 42,000 = \text{Ksh.}-1,235,000$.

Conclusion: The suggested price of Ksh.500 is below the life-cycle cost and would result in a total loss across the product life of approximately Ksh.1,235,000. Solaris should either raise the price above Ksh.529.40, reduce costs, or a combination of both.

Notes & Options

- Target price to break even on a life-cycle basis $\approx \text{Ksh.}529.40$ per panel.
- Cost-reduction opportunities: supplier negotiations, process efficiency, design-to-cost, phased marketing, and after-sales optimization.
- Consider learning-curve effects in production costs if plausible; they could reduce the life-cycle cost.

b) Target Costing

A proactive technique where the selling price and desired profit are set first, and allowable cost is derived. Formula: Target Cost = Target Selling Price – Desired Profit. It focuses on cost reduction during the design and planning stage.

Example: Target Costing and the Target Cost Gap

Great Games, a manufacturer of computer games, is developing a new game. Market research determined a target selling price of Ksh.60, which is the price required to achieve the desired sales volume.

Manufacturing Costs

Cost Component	Amount (Ksh.)
Direct Material	3.21
Direct Labour	24.03
Direct Machinery Costs	1.12
Ordering and Receiving	0.23
Quality Assurance	4.60
Total Manufacturing Costs	33.19

Non-Manufacturing Costs

Cost Component	Amount (Ksh.)
Marketing	8.15
Distribution	3.25
After-Sales Service	1.30
Total Non-Manufacturing Costs	12.70

Target Profit Margin

30% of target selling price = $30\% \times \text{Ksh.60} = \text{Ksh.18.00}$

Solution

Item	Formula	Amount (Ksh.)
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Target Cost	Selling Price – Target Profit	$60 - 18 = 42.00$
Estimated Total Cost	Total manufacturing and non manufacturing	45.89
Target Cost Gap	Est.cost – Target Cost	$45.89 - 42.00 = 3.89$

How to reduce the cost gap?

The company must reduce total costs by Ksh.3.89 per unit to achieve the desired 30% profit margin at the target selling price of Ksh.60. Possible actions include reviewing product design for cost efficiency, negotiating lower supplier prices, streamlining production processes, and reducing non-value-adding activities.

c) Kaizen Costing

A continuous improvement approach used during the production phase. It aims at small, ongoing cost reductions without sacrificing quality, involving all employees. It complements target costing by ensuring continuous efficiency after production starts.