Target Costing in Service Organizations – A Case Study of Hotel Kohinoor Continental, Mumbai and Emerging Strategies

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1. Introduction

- **Overview of Hospitality & Hotel Industry in India**

Indian Hospitality & Hotel Industry contributes 9.2 % of India's GDP .This industry has been a major contributor to employment, foreign exchange and growth of infrastructure. Several factors like infrastructure improvements, increased purchasing power of the middle class and youth, active support & participation by the Corporate & Industry have helped to spur growth in the Hospitality and Hotel Industry. Indian Hospitality industry has bounced back since 2014-15 with rising trends in occupancy and sales revenue all over India from the long slowdown since 2009. The sustained growth of this industry can be attributed to the changes in attitudes and tastes of rising middle class and youth, infrastructural reforms of the Government, increase in international tourist arrivals and tourism friendly visa policies such as the extension of e-Tourist Visa to 150 countries. In the recent period since financial years 2016-17, hotels across all segments recorded occupancy of over 65 % for the first time in eight years since 2008. Hotel room supply in India grew at 7-8 % over 2013-14 and is expected to be the same till 2018-19. Demand for hotel occupancy is growing at the rate of 11-14 % annually, indicating a rise in the growth and overall progress for the industry at the macro level in the economy.

Historically, building a good hotel has always been a huge task, but in these times of 21st century it is gigantic due to manifolds increase in the prices of nearly each and everything that is required to make a hotel of the best standards. Hotels usually are a spectacular display of architecture combined with luxury at its best and conventionally are built in accord with the contemporary and futuristic designs with distinction for not only the exterior outlook but at the same time interiors are also given a flavour of classic and ethnic styles with an intricate eye for details on every aspect. New and cost effective concepts like Boutique Hotels, Green Hotels, and Healthy Hotels have emerged in the market with time, leading to the evolution and growth of new trends in the hotel industry. Hotel industry caters to the travellers /guests /executives/youth who are away from their home places and are willing to pay for the price of the services provided by the hotel.

2. Review of Literature –Target Costing

Target costing was originally introduced into Japanese companies as a way to integrate the use of other tools such as Just in Time (JIT) and TQC (Total Quality Control) and promote their use (Sakurai, 1989).Target costing is, by nature, market-driven. It therefore stimulates behaviour which is customer-focused and encourages all functions within the company to respond to market demand and competitive trends rather than internal performance indicators. In addition the Marketing department is free to make product decisions without the costs being a given (Gagne and Discenza, 1995). As previously mentioned, it is being increasingly recognised that the major proportion of product costs, around 70 to 80% (Cooper and Chew, 1996) are effectively fixed during the design stage. Target costing provides a means to manage costs from the design stage to maximise the potential for cost reduction. Target costing focuses on the customer. Customer requirements for quality cost and time are incorporated into the product decisions and guide the analysis of costs. Indeed target costing forces companies to be specific about what customers want and the prices they are prepared to pay (Cooper and Chew, 1996). Swenson et al (2003) identify as a feature of best practice in target costing that companies actively solicit input from their customers on design issues to examine whether or not customers are willing to pay for the design innovation and to ascertain whether the cost exceeds the value to the customer, in which case the innovation is abandoned. The process may also involve discussions with customers of different design options, making trade-offs between cost and value. Target costing is a tool which can be used to control decisions such as design specifications and production techniques. For this reason it tends to be oriented more towards management and engineering than accounting, and to be successful requires the use of cost engineering techniques such as value engineering (Sakurai, 1989) The discipline of target costing and the detailed review of costs can reveal more general managerial problems. Chen and Chung (2002) cite a company which uncovered corrupt practices in the purchasing department as a result of the detailed examination of component prices. Target costing focuses on the customer. Customer requirements for quality cost and time are incorporated into the product decisions and guide the analysis of costs. A characteristic mentioned in all literature on target costing is the multidisciplinary nature of the process and the importance of the involvement of all functions in the analysis and decision-making. Responsibility for achieving targets must also be shared across functions. In a study of Toyota Australia's target costing system, the International Federation of Accountants' (IFAC) Financial and Management Accounting Committee (now Professional Accountants in Business) highlighted the multi-disciplinary involvement in the cost management process and the vital roles played by different functions

According to Gagne and Discenza (1995), the target costing teams which are the most successful are those whose members have a basic understanding of how their work is translated into numbers which represent the firm's performance, using indicators which are meaningful to them. In addition, the best team members are those who have rotated through several departments, including design, purchasing and marketing before being assigned to a cost-planning project, as broad backgrounds give team members a unique ability to spot and implement ways to improve costs. A number of writers describe the importance of working with the company's supply chain to identify opportunities for cost savings. This is particularly important where a high proportion of the total cost of a product is in purchased raw materials and components, and target costing goals would be impossible to achieve without supplier involvement. Some companies view their supply chains as part of an 'extended enterprise' where design and cost information is shared and inter-company teams are established to meet cost reduction goals (Swenson et al, 2003). Banham (2000) identifies getting suppliers to buy in to target costing as probably the most difficult aspect of target costing as experienced by US companies implementing the process. Amongst the methods used to achieve this are joint classes and team-building and promises of shared savings. Target costing is not an exact science and depends on credible data and sometimes difficult judgements. It is also an iterative process where targets evolve as teams seek to balance functionality, price, volumes, capital investment and costs (Cooper and Chew, 1996). However, it is important the overall top-level target cost is regarded as an unalterable commitment and if this cannot be met, the product cannot be launched. Although the cost targets for individual components or processes evolve, once they are set, they should not be changed. Also, as Cooper and Chew (1996) point out, targets must be more than hypothetical, so that managers have an imperative to meet them in order to ensure the launch of products. They should also be attainable, but require effort to meet them (Sakurai, 1989).

Research Gap

Target costing is equally relevant to both the service and the manufacturing sector. This Case Research aims at identify ways in which target costing can be applied to service-oriented businesses, which is of particular interest when looking at its applicability to the Hotel Kohinoor Continental (KC) .For process businesses, the focus of target costing shifts from the product to the process, and for service businesses the focus is the service delivery system. Although, the key issues – understanding the needs of the market, customers and users, and ensuring satisfactory financial performance at a given cost or price which does not exceed the target cost is maintained in a market driven context.

3. Objectives of the Study

1. To understand the present cost system and operation processes of the KC and to analyse the cost drivers, resource drivers and operation drivers of expenditures in the context of reducing costs.
2. To analyze the importance of ' fixed cost ' in the operations of the KC
3. To compare the differences between the present cost system and the TC system in the case Hotel KC
4. To develop the ' TC system' in the Hotel KC
5. To create an enterprise advantage and to maintain a competitive edge for the case Hotel KC.

This case study is borne out of the synergy among the Hotel Kohinoor Continental and Kohinoor Business School (KBS) which belong to Kohinoor Group. Kohinoor Group was founded by Dr. Manohar Joshi , a well-known statesman and Educationist (formerly Chief Minister of Maharashtra and Honourable Speaker , Lok Sabha) .Since its inception from a humble educational venture in 1961, the Kohinoor Group has grown progressively in various business activities including Real Estate, Hospitality, Healthcare, Power and Education.

- **Hotel Kohinoor Continental – A Brief Profile**

KC has commenced its activities in 1986, as a private limited company initially as a 3-star hotel with the name "Hotel Airport Private Limited" at the present location near Chatrapati Shivaji International Airport, Mumbai with 50 rooms. By 1998, another 70 rooms and other facilities were added to get a 4-star accreditation. In 2008, premium facilities for 17 rooms have been included to reach a total of 137 rooms. Its Banquet halls can be rented as separate / interconnected as per the needs of customers. KC also has a swimming pool (55 ft. 9" in length, 26 ft. 3" in width and depth 4 ft. 3"), health club/gymnasium and steam& sauna facility. KC has utilities for garbage segregation, fire & security systems, clean & filtered water, sewage treatment plants (STP), rain water harvesting and other facilities for differently- abled persons.

SWOC Analysis

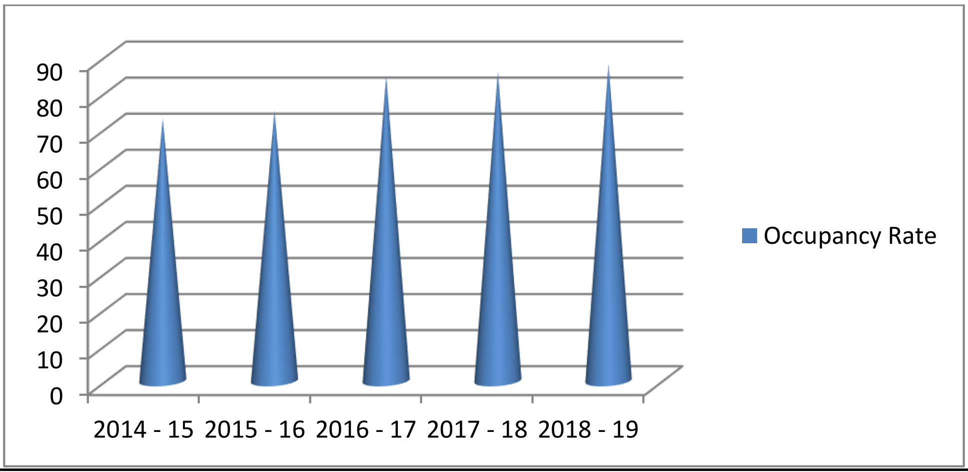
Strengths	Weaknesses
• Located close to International Airport Metro Station and other amenities • Well equipped hospitality assets including interconnected banquet /conference halls, swimming pool furniture, parking facilities • Belongs to Kohinoor Group	• Highly Capital Intensive expenses for setting up and recurring costs • High costs for centralized air conditioning, energy, water and maintenance round the year in line with accreditation guidelines governed by Department of Tourism. • Rising costs of Commodities
Opportunities	**Challenges**

• KC's high growth in occupancy over the last two years since 2014-15 is in line with rise in foreign & domestic tourist arrivals and rise in corporate & leisure travel at the macro level in the economy. • High Growth opportunities due to proximity to Airport, Mumbai Metro station & other logistically favorable urban amenities.	• High Costs of the maintenance in accordance with 4 Star accreditation which are mandatory as per the Guidelines of the Ministry of Tourism , Government of India • Rising Staff costs

4. Main Findings - Present Cost System in KC

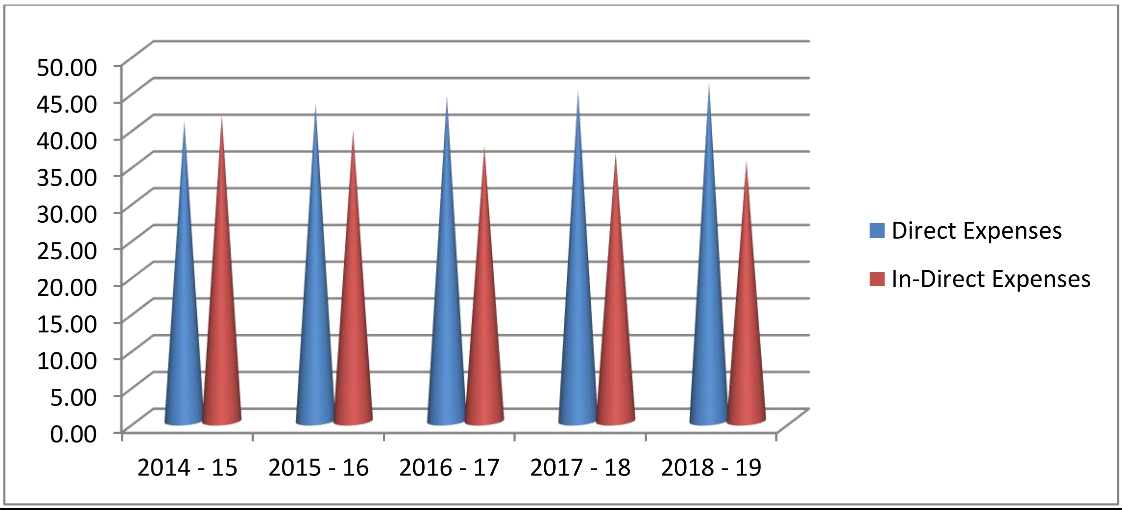
A major part of its recurring expenses are capacity -driven rather than based on occupancy by guests / visitors to restaurants and other amenities. It is generally understood that these expenses are to be incurred on a fixed cost basis rather than variable depending on the occupancy by guests / visitors to restaurants. The maintenance costs are governed by the Guidelines of the Union Ministry of Tourism which certifies for star rating of rooms and utilities. These guidelines are mandatory to be followed by KC and periodically inspected for renewal of the star rating and accreditation as per the Guidelines. Sweeping, dusting and mopping (SDM) expenses in the guest rooms, restaurants and other facilities have to be incurred regularly to indicate a high standard and luxury class as customarily required essential for the Hotel & restaurants. Expenses related to the crockery and cutleries are to be capitalized expenses considering the nature of regular usage and replacement. KC prepares its annual budgets on the basis of the current business scenario in the hospitality expenses industry at macro level in the economy. While setting the targets relating to revenue and budgets, KC has kept in mind the key business objectives such as customer satisfaction, increase in the customer occupancy, improvement in the quality of services to customers, increase in the revenue and profits along with cost control , employee training and skill development, increase in market share in comparison to the actual performance in these indicators. As part of the analysis of Budget and operational costs for the recent period 2014-15 to 2018-19, the following observations are made:

Chart – 1 Occupancy Rate at KC



Source: Primary Data

Chart – 2: Direct and Indirect Expenses in KC



Source: Primary Data

- Increase in the occupancy rate of the hotel from 72.8% in 2014-15 to 74.9% in 2015-16 & 84.6 % in 2018-19. This has also resulted in increase in revenue by 19.59% in 2018-19.
- Direct expenses are around 40% of revenue in all the 5 years during 2014-15 to 2018-19.
- However, in the year 2015-16, there has been increase in direct expenses to 43.18% from 40.81% in 2014-15. This has resulted in decrease in net profit percentage in 2015-16.
- Indirect Expenses have reduced from 41.61% in 2014-15 to 39.59% in 2015-16 & 35.49% in 2018-19. This implies that KC management has attained stability in incurring overheads over last 5 years**.**
- During the period 2014-15 to 2018-19 ,its variable costs are in the range of 30-40 % of the total costs of which 18-20 % are for manpower (about 240 persons) and the balance for the commodities/perishables & consumables . Laundry, energy, gas & water expenses account for 30 % of the total costs. KC exercises stringent cost control measures all round the year, although the nature of the recurring costs indicate high level due to the rise in salaries & related expenses to staff, inflation in the prices of commodities and general rise in communication costs and other costs . Thus KC is able to satisfactorily manage the variable costs, comfortably over the breakeven level year to year.
- Gross operating profit is reasonable to the extent of 30-35 per cent exclusive of financing costs on the loans.

It may be noted here that the Budget and the financial data on the above indicators are not provided on actual terms by KC, due to reasons of confidentiality of the data and privacy nature of the consultancy assignment.

Target Costing Model Suggested by the Case Study of KC

As part of the strategy formulation for the emerging industry scenario, the consultancy team from Kohinoor Business School (KBS) attempts Target Costing for the KC. KC's occupancy trends in recent years indicates a higher rate of occupancy as high as 70-85 % over the last five years since 2014 -15. KC receives lodging reservations to the extent of 60- 70 % from the Corporate sector, 12-15 % through travel agents and 15-20 % from online Portals , relatively a new and increasing source of lodging attractive to youth. The traditional accounting method usually assigns indirect costs like repair & maintenance, communication, advertising & marketing, accounts, general administration by using thumb rules (adhoc values). This means that the direct labour costs, direct material costs, air conditioning /energy consumption costs, etc. are incurred as part of overall facilities and are not assigned to the main activity centres. Since the Direct costs are a substantial portion of the service costs in a hotel industry like Kohinoor Continental and this would distort the costing system and pricing of various activity centres availed by customers are more likely to be misrepresented than being appropriately valued and priced .

To achieve the objectives of target costing, **a team-based set up is required which integrates essential disciplines such as marketing, engineering, kitchen, restaurant, food services, purchasing and finance**. As followed by Budoonoki Co., Ltd in its approach to Costing & Management Control System, we attempt the TC process in KC. As a result, it was shown that upstream Management, cross-functional team activities, value engineering as cost reduction method and follow-up for target costing is effective in restaurant and administration services. While implementing TC in KC, tabulating cost data is suggested as follows:

Preferences of Mini Bar Features

Properties of service	**Very important Less important**					**Scores (preferences)**	**Share in the overall assessment (%)**
	1	**2**	**3**	**4**	**5**		
Wide choice	x						
Design		x					
Dimensions				x			
Economic characteristic					x		
Utilization			x				
Total							

Source: Author's edition based on ***A. Ansari et al. (1997)***

Direct Costs of Mini Bar Components are shown in the following Table

Components	**Function**	**Standard costs (EUR)**	**Share in the overall standard costs (%)**
Box	Storage		
Shelves	Orderliness		
Ice cube tray	Cooling		
Cup holder	Ensure the consumption		
Total			

Source: Author's edition based on ***S. Ansari et.al (1997)***

Calculating the Target Cost

Net Selling Price	
• Estimated Target gain (15%) • Overheads	
Target Cost	
Standard Costs	
Deviation	

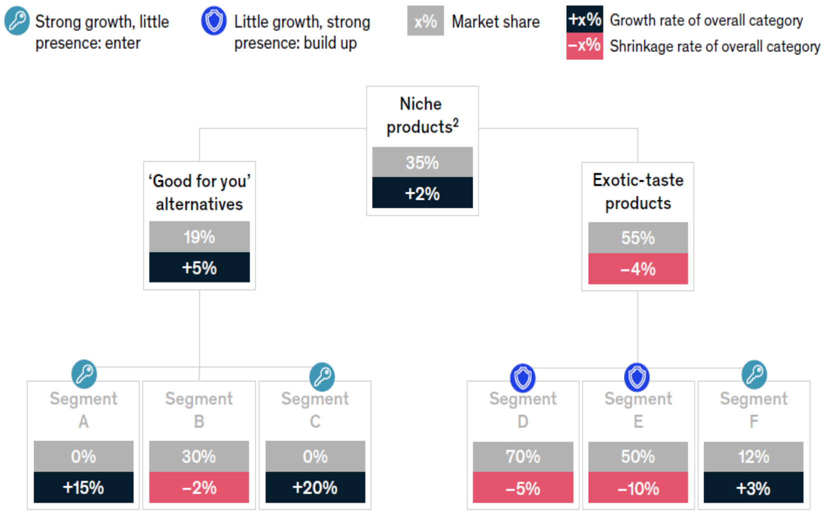
Source: Author's edition based on ***S. Ansari et.al (1997)***

Deviation of Target Cost from Standard cost in the Level of Components

Components of product	Target costs	Standard costs	Deviation of target cost from standard costs
Box			
Shelves			
Ice Cube Tray			
Cup Holder			
Total			

Source: Author's Edition Based on ***S. Ansari et.al (1997)***

A category analysis for KC and its market share in specific segments of customers, by percentages of the variety of food items can be illustrated as follows



Key Features of Target Costing in KC

The price of the product is determined by market conditions. The company is a **price taker** rather than a **price maker.** The minimum required profit margin is already included in the target selling price. It is part of management strategy to focus on cost reduction and effective cost management.

- Product design, specifications, and customer expectations are already built in while formulating the total selling price of KC.
- The difference between the current cost and the target cost is the **"cost reduction,"** which management wants to achieve. A team is formed to integrate activities such as designing, purchasing, manufacturing, marketing, etc. to find and achieve the target cost. It shows management's commitment to process improvements and product innovation to gain competitive advantages. The product is created from the expectation of the customer and hence cost is also based on similar lines. Thus, the customer feels more value is delivered and his satisfaction is enhanced.
- With the passage of time, the KC's operations improve drastically, creating economies of scale. The KC's approach to designing and delivering the various services mentioned above becomes market-driven.
- New market opportunities can be converted into real savings to achieve the best value for money rather than to simply realize the lowest cost.

Importance of Cost Control in KC

Given the strong orientation in a target costing environment, there is obviously a considerable role for the cost accountant on a TC design team. The cost accountant should be able to provide for the other members of the design team a running series of cost estimates based on initial designs sketch, activities based costing reviews of service delivery processes, and **"best guess"** costing information from suppliers based on estimated service delivery volumes.

Essentially in the earliest stages of a TC design, the cost accountant works with vague costing information so that he is able to provide estimates within a high-low range costs, gradually tightening this estimated cost range as more information becomes available. The cost accountant should also be responsible for any capital budgeting requests generated by the design team since he has the knowledge of the capital budgeting process. The cost accountant plays a very important role in the TC design team for answer to any questions from the finance staff regarding issues or uncertainties in the capital budgeting proposal. The cost accountant should work with the design team to help it understand the nature of various costs as well as the cost-benefit trade-offs of using different design or cost operation in the new product. In addition, the cost accountant is responsible for bridging the gap between the current cost of a product development and design and the target cost that is the TC design team's goal' providing an itemization of where cost savings have already been achieved and where there has not been a sufficient degree of progress. Finally, the cost accountant must continue to compare a product's actual cost with the target cost after the design is completed and till the company sells the product. This is a necessary step to keep costs under control. There are particular qualifications that a cost accountant must have to be included in target costing team. He must have a good knowledge of company products as well as their features and components. Also the cost accountant must know how to create a TC system to evaluate related service delivery cost, or at least interpret such costing data developed by someone else.

Further, he must work well in the team environment, productively assisting other members of the team in constantly evaluating the cost of new design concepts. In addition, he should have good analytical and presentation skills, since the on-going costing results must be continually presented not only to other members of the team but also to the other members of the company.

Traditionally, KC would make use of **the cost-plus approach** to estimate the product price. A starting point for them would be to conduct market research to determine its market segment's preferences and hence its product's characteristics that will meet the customer's needs. This will be followed by the design of the product. Next KC's service process is determined.

Vendors will then be contacted to identify the total costs of the components which are required by the design and service delivery departments in KC described above. Finally, cost components are summed up and a selling price is set based on the costs.

If the KC management and the marketing department think that the price and cost are too high, the product design and engineering process will be repeated till an acceptable cost is reached, after which, delivery of various services in KC will be operated in consonance with the main principles of TC already discussed.

Is Tax a Cost to Reckon while Arriving at Profitability Data for KC?

India is facing a slump in the Hotel Industries for approximately five years since 2014-15 now. It is facing low occupancy and declining Rev-par over these years. "The general slowdown in the economy has hit the hotel industry. Over the last two years, average room rates have definitely reduced and occupancy has been stagnant," said SM Shervani, President of the Federation of Hotels and Restaurant Associations of India (FHRAI) as reported by Khosla & Sathyanarayanan in 2014. In India, hotels are taxed anywhere between 20% and 25% depending on the state that they are operating in, when other Asian countries are levying 8-10%. In addition to this, different tax structures in different states are difficult for tourists to comprehend. The on-going economic slowdown has further hurt the sector as it affected both business and leisure travel. In fiscal 2012-13, occupancy rates in the sector dropped to a decade low of 58.3% and the average room rates fell to the lowest in six years at Rs 6,214, according to HVS in 2013. After the government unveiled its budget for fiscal 2013-14, the FHRAI had said that industries such as hospitality, which are particularly sensitive to volatility in economic cycles, should have been offered support in the form of tax relief and other fiscal incentives (Khosla & Sathyanarayan, 2014). Not to mention that taxes ultimately are levied through the customer's pocket, whereas, if some tax relaxations are given to the hospitality industry it will provide a boost to the hotels in terms that they will have more operational cost to run their business and financial support to reduce the risk of failures and give endurance to sustain through the slack times. The saved money could find a place in annual budget of the hotel's operations to increase the ADR and Rev-par through the customer retention strategies opted by the hotels.

Normally, many hotels and travel aggregators announce special packages for vacations and long weekends and offer special rates if booking is made in advance. Since, old rates of GST were applicable till September 30 2019; anyone booking by that date for stay in October 2019 onwards had to pay higher tax. Technically speaking, if rates have been lowered, then goods/service providers need to pass on the benefit, otherwise the matter could go to the Anti-profiteering Authority. There have been such instances with goods providers, when many companies were asked to reduce the prices, return the profiteered amount along with interest at the rate of 18 per cent or deposit profiteered amount along with penalty. Same rules apply to the services also. Now, to avoid action by **National Anti-profiteering Authority** (NAA), companies can *suo motu* initiate the process of lowering the price or refund the difference in case of advance booking. Design of the GST is based on self-assessment and self-monitoring instead of a tax officer policing the companies. "It is the system that works on the principle of self-policing where the input tax credit gets determined by the supply invoices uploaded by the suppliers and that is why we say that the system doesn't require any manual intervention or manual audit. We will further strengthen it and minimise manual intervention by tax officials" according to Ajay B Pandey, Revenue Secretary, Government of India. Further, data provided by KC with regard to GST revisions are inadequate and the time periods since revisions in GST are made and hence not discussed here.

5. Conclusion: Emerging Strategies

- We attempt formulating sustainability strategies in the uncertain world as prevailing in Indian economy which is prone to difficulties and limitations. To quote Nobel Laureate economist Frank Knight, "Uncertainty must be taken in a sense radically distinct familiar notion of Risk, from which it has never been separated ".Target Costing has been found to be suitable, because it copes with the existing environment of uncertainties and uncontrollable factors / both direct and indirect costs.
- Target costing approach integrates the method of illustrating reliable method for managing and reducing the costs in the world of strategic variables of intense competition and profitability constraints. Maintaining costs is important in the services industry as it is vital for manufacturing sector. Our study is pioneering contribution to presenting a strong method for the Hospitality & Hotel Industry as in KC.
- Implementation of TC would involve patience and creating awareness with the Top Management, administration and operational and maintenance services. The proactive role of the cost accountant is also realized in the internal control and external environment which is full of uncertainties and risks.

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