COST MANAGEMENT

Implementing Target Costing in Small and Medium Business Units in India: A Market-Back Design and Cost-Gap Closure Case

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Abstract

Indian small and medium business units increasingly face price-sensitive buyers, input-cost volatility and pressure to maintain acceptable quality. Yet many firms continue to set prices by adding a mark-up to accumulated production costs. This paper examines how target costing can reverse that logic: a credible market price and required profit determine an allowable cost before the product or service is finalised. Drawing on established scholarship and newly checked 2025–2026 Indian MSME policy evidence, it develops a transparent, constructed case of a small metal-products manufacturer launching a modular storage rack. The case traces market-price selection, a 15% operating-profit objective, component-level cost gaps, value engineering, supplier negotiation, pilot quality checks and sensitivity testing. With an assumed net realisation of ₹2,400 per rack, target cost is ₹2,040 against an initial estimated cost of ₹2,280, creating a ₹240 gap. A costed improvement package reduces expected cost to ₹2,030 without assuming a quality downgrade. The resulting ₹370 contribution before tax and finance charges is a modelled outcome, not observed company performance. The paper proposes a staged 90-day implementation framework and interprets the managerial implications for resource-constrained Indian firms. The contribution lies in offering a replicable management-accounting decision protocol while clearly separating observed public evidence from scenario assumptions.

Keywords: Target costing; Indian MSMEs; strategic cost management; value engineering; supplier collaboration; cost-gap analysis; affordable product design

1 Introduction

The economics of a small factory often begins with a difficult conversation: the customer has a price in mind, while the owner knows what raw material, labour, electricity and transport actually cost. In a highly competitive market the buyer may simply turn to another producer when the quoted price rises. Target costing treats this situation as a design question rather than a last-minute discounting exercise. Managers ask what the customer will pay, how much profit is required and what production system could deliver the promised function within that limit.

India offers a compelling setting. Official public releases in 2026 report that micro, small and medium enterprises contribute around 31.1% of GDP and 35.4% of manufacturing output, while current registration counts run into several crore enterprises (PIB, 2026a, 2026b). These are sector-wide context figures, not evidence that target costing is widely adopted. For smaller units, the practical challenge is to translate a concept often associated with large automotive companies into a simple spreadsheet, team discussion and documented product launch decision.

2 Conceptual foundations and literature review

Target costing starts with an externally anchored sales price and subtracts a required profit. In contrast, conventional cost-plus pricing begins with estimated or incurred cost and adds a mark-up. The formula is simple, but its managerial significance is profound: purchasing, engineering, sales, production and accounting must reconcile the customer's expectations before costs become locked in.

Kato (1993) described target costing as an early-stage, life-cycle oriented management process rather than merely an accounting formula. Tani et al. (1994) showed that Japanese target-cost management combined cost objectives with quality, delivery, product development and supplier cooperation. Cooper and Slagmulder (1997) foregrounded value engineering and design choices, highlighting the need to manage costs before production routines become fixed.

Dekker and Smidt (2003), in a survey of Dutch listed manufacturing firms, found that 19 of 32 respondents reported practices resembling target costing. Their sample is not representative of Indian MSMEs, yet it demonstrates that target costing can occur outside its Japanese origins. Ellram (2006) observed the importance of purchasing, early supplier involvement and cross-functional activity in 11 US organisational cases. Ibusuki and Kaminski (2007) integrated value engineering into concept, project and validation stages in an automotive development case.

Ansari, Bell and Okano (2006) conceptualised target costing as an important strategic-cost-management approach but emphasised continuing questions about its organisational processes and outcomes. Roffia, Benavides and Carrilero (2024) found persistent barriers to formal cost accounting in SMEs, reinforcing the need for simpler tools and management commitment. These studies support transferability of the principles; they do not establish measured Indian SME adoption rates or causal profit gains. Table 1 summarises how each source informs the present case.

Table 1. Key studies informing the case.

Source	Contribution to this case	Caution for transfer
Kato (1993)	Early design and life-cycle cost discipline	Different industrial setting
Tani et al. (1994)	Joint cost/quality/delivery goals	Predominantly Japanese firms
Dekker & Smidt (2003)	Adoption beyond Japan	Listed Dutch manufacturers
Ellram (2006)	Purchasing and supplier participation	11 US cases
Ibusuki & Kaminski (2007)	Value engineering as closing mechanism	Automotive product case
Roffia et al. (2024)	SME cost-accounting constraints	Not India-specific

2.1 Strategic cost management linkage

Target costing works best alongside activity-based cost identification for overhead drivers, lean process improvement to remove waste, kaizen for continued savings after launch and life-cycle costing for warranty and disposal obligations. No technique should be presented as a substitute for engineering validation, labour safety or regulatory compliance.

3 Research problem, objectives and design

3.1 Problem statement

Small businesses often know their purchase prices but lack reliable product-level profit visibility. Indirect expenses may be allocated roughly; desired profit margins may not be stated; suppliers may be consulted only after a design is fixed. The central problem is whether an accessible, market-back target-costing routine can improve the quality of product launch decisions in this setting.

3.2 Research objectives

1. To synthesise established research on target costing and the constraints of smaller firms.
2. To document the recent macro context of India's MSME sector with traceable official figures.
3. To build an auditable component-level target-cost model for a representative small manufacturing business.
4. To evaluate the sensitivity of the proposed design to selling-price, input-price and volume changes.
5. To formulate an implementation roadmap and measurable pilot indicators.

3.3 Design and evidentiary boundaries

This is a structured analytical or teaching case, not a field survey, action-research study or account of a named factory. The fictitious organisation, product specifications, quotations, cost sheets, volumes, timings and improvement outcomes below are explicit modelling assumptions created to demonstrate the method. They are not primary observations, interviews, audited accounts or verified current market quotations. External 2025–2026 MSME figures and published academic findings are secondary evidence. Table 2 sets out how each category of evidence should be interpreted. No hypothesis test, interview count, correlation coefficient or causal effect is claimed.

Table 2. Evidence categories used in the case and their interpretation.

Evidence category	What is included	How it should be interpreted
Verified secondary evidence	Official MSME releases and scholarly studies	Context / theory, not unit outcomes
Illustrative assumptions	Rack price, bill of materials, cost gap and redesign	Decision simulation only
Analytical results	Arithmetic, scenario margins, breakeven-like checks	Conditional on assumptions
Not available	Actual SME field data, customer interviews, pilots	No real-world effectiveness claim

3.4 Contribution and publication positioning

The manuscript offers an implementation framework and worked case anchored in recent official context. A journal that requires novel empirical data should classify this as a conceptual/analytical case, or the author should subsequently collect real purchase orders, process times, customer feedback and pre/post cost records before submitting it as an empirical case study.

4 Recent Indian MSME evidence and relevance

As of June 2026, Udyam Registration and Udyam Assist registrations together had crossed 8.7 crore, according to a Press Information Bureau release on the MSME sector (PIB, 2026c). A separate 2026 parliamentary briefing cites the Economic Survey's approximate MSME share of 31.1% of GDP, 35.4% of manufacturing output, 48.58% of exports and employment around 32.82 crore (PIB, 2026a). These figures refer to different administrative and statistical constructs; counts should not be treated as equivalent estimates of active, independent production factories. The main indicators are summarised in Table 3.

Table 3. Recent Indian MSME indicators.

Indicator	Reported value / date	Source and interpretation
GDP contribution	31.1% (latest cited survey estimate)	PIB 2026a, sectoral share
Manufacturing output	35.4%	PIB 2026a, sectoral share
Exports	48.58%	PIB 2026a, sectoral share
Employment	~32.82 crore	PIB 2026a, estimate
Registrations	>8.7 crore by June 2026	PIB 2026c, combined registration platforms
Revised small category	Investment ≤₹25 crore; turnover ≤₹100 crore	PIB 2025; effective April 2025
Revised medium category	Investment ≤₹125 crore; turnover ≤₹500 crore	PIB 2025; effective April 2025

The post-April 2025 classification changes matter for management research: a "small" unit may now represent a wider range of investment and revenue than in earlier studies. Any future sampling protocol should clearly identify manufacturing/services, employee count, product type, ownership and regional cluster rather than relying on an undifferentiated MSME label.

4.1 Why target costing may be useful—but not automatic

A small fabricator, garment maker, food processor or packaging supplier may have relatively little power to change market prices. Waste, rejected units, over-specification, purchasing terms, changeovers and product variety are therefore natural places to scrutinise. The National Productivity Council also implements the MSME Competitive (Lean) Scheme, suggesting an institutional route through which process improvement can be explored. However, registration totals and scheme availability do not measure actual target-costing adoption, and business feasibility depends on product quality requirements and local supply conditions.

4.2 Boundary between target cost and ethical cost reduction

A lower-cost design is acceptable only if safety margins, product function, durability, labour standards, and mandated compliance remain intact. Redesign proposals in the case are screened for load capacity and corrosion resistance; lower material weight is not counted as an achievement unless an engineer approves it. A firm should record all test expenses, warranty risk and any new equipment cost alongside apparent unit savings.

5 The constructed Indian small-unit case

5.1 Business situation

Shakti Fabrications operates in a tier-two Indian manufacturing cluster and supplies powder-coated storage fixtures to distributors. Management sees demand for a modular rack with an easy-assembly design. Two competing regional offers suggest a feasible trade selling-price band of ₹2,300–₹2,500; for the case, ₹2,400 is chosen as assumed net realisation. No live retailer quotation or customer field survey was obtained for this paper.

The owner intends to earn 15% operating surplus on sales to fund tools, future upgrades and working-capital shocks. The sales team worries that a cost-plus quote will exceed buyers' budgets. The production supervisor favours thicker steel and higher finishing allowance for reliability; the accountant points to high scrap and setup expense; the buyer believes the design could be simplified and the steel supplier involved earlier. These competing views make the case appropriate for target costing rather than a unilateral cost-cutting instruction.

5.2 Calculation of allowable cost

Target selling price = ₹2,400; required operating surplus = 15% × ₹2,400 = ₹360; target product cost = ₹2,400 − ₹360 = ₹2,040. The initial engineering estimate is ₹2,280, so the cost gap is ₹240 per rack, or 10.53% of estimated cost. The firm should not approve the launch on the assumed margin until it can show a technically acceptable path to close the gap.

Table 4 presents the initial estimated cost structure of the modular rack.

Table 4. Initial estimated cost structure of the modular rack.

Initial cost element	₹ / rack	Cost share
Steel tube, sheet and brackets	1,140	50.0%
Fasteners and fittings	190	8.3%
Powder coating and consumables	245	10.7%
Direct assembly labour	265	11.6%
Power, setup, scrap and rework	205	9.0%
Assigned production overhead	235	10.3%
Total estimated cost	2,280	100.0%

5.3 Management challenge

If management simply adds a 15% mark-up on cost, a selling price of ₹2,622 is implied (₹2,280 × 1.15), even though a 15% mark-up is not identical to a 15% margin on sales. At ₹2,400 the initial surplus is only ₹120, equal to 5.0% of sales. The decision is not merely to ask suppliers for a ₹240 discount; it is to identify functions worth paying for, prevent unnecessary production effort and validate any proposed changes before orders are accepted.

6 Closing the cost gap through value engineering

A three-person working group—owner/finance, production, and purchasing/sales—ranks the largest cost drivers, maps each to the customer function served, and tests potential reductions. The trial

below assumes that identical load capacity and corrosion criteria are met after prototype testing. For real deployment, each proposed reduction requires supplier evidence, a time study, a first-article inspection and sign-off.

Table 5 presents the modelled value-engineering interventions and assumed savings.

Table 5. Modelled value-engineering interventions and assumed savings.

Proposed intervention	Cost driver changed	Assumed saving ₹/rack
Optimise tube cuts and nesting	Steel waste reduction	85
Standardise brackets / fitting sizes	Fasteners and assembly simplification	42
Revise coating batch and hanging density	Powder and energy utilisation	31
Assembly jig and sequence redesign	Labour minutes	38
Prevent setup scrap and rework	Setup / reject allowance	39
Reallocate validated production overhead	Absorption after stable batch scheduling	15
Total modelled saving		250

New modelled unit cost = ₹2,280 − ₹250 = ₹2,030. Modelled operating surplus = ₹2,400 − ₹2,030 = ₹370, or 15.42% of sales. This clears the ₹2,040 allowable-cost target by ₹10. The slender buffer suggests that management should not view the result as robust without sensitivity analysis.

Table 6 presents the target-cost control card: initial versus redesigned model.

Table 6. Target-cost control card: initial versus redesigned model.

Target-cost control card	Initial	Redesigned model
Net sales realization	₹2,400	₹2,400
Unit production cost	₹2,280	₹2,030
Operating surplus	₹120	₹370
Operating margin on sales	5.00%	15.42%
Gap versus allowable cost	₹240 above target	₹10 below target

6.1 Functional rather than indiscriminate reduction

A shorter tube-cut list is attractive only if it respects the required load and deflection tests. A jig may reduce labour time but must be tested for accuracy and ergonomic safety. Improved batch coating could lower usage but may alter colour consistency. An overhead "saving" is not cash savings unless capacity is redeployed, spend is avoided or throughput truly rises; in a cautious financial forecast, the ₹15 overhead component should therefore be tracked separately as a potentially non-cash improvement. Without it, expected cost is ₹2,045, narrowly missing the ₹2,040 target. This distinction is important for lender and investor credibility.

6.2 Supplier involvement

The purchasing team shares functional requirements rather than imposing an arbitrary percentage price cut. A supplier might offer longer standard tube lengths, consolidated fitting packs or more

consistent surface preparation. The arrangement should protect payment discipline and give the supplier a share of verified efficiency gains where appropriate.

7 Scenario and sensitivity analysis

Financial conclusions should survive reasonable stress testing. Table 7 holds redesigned unit cost at ₹2,030 except where a specific input-cost shock is stated; all cases are assumed rather than observed. Margin is calculated as (selling price – product cost) / selling price.

Table 7. Scenario and sensitivity analysis (illustrative assumptions).

Scenario	Net price ₹	Unit cost ₹	Surplus ₹	Margin
Base redesign	2,400	2,030	370	15.42%
Distributor price pressure −5%	2,280	2,030	250	10.96%
Input-cost rise +8% on material/fittings/coating*	2,400	2,156	244	10.17%
Joint price and material shock	2,280	2,156	124	5.44%
Extra ₹50 quality assurance / warranty reserve	2,400	2,080	320	13.33%
Only verified cash-like savings (₹235)	2,400	2,045	355	14.79%

Note: † For the stress test, the ₹126 cost increment is an explicitly rounded assumption representing an approximately 8% increase on a modelled ₹1,575 cost exposure, not a quoted commodity index. Product mix, GST, credit losses and tax impacts are not modelled.

7.1 Volume and implementation economics

At 1,000 racks a month, the baseline difference between initial and redesigned modelled cost is ₹250,000 per month, but only if all savings genuinely occur and capacity, product mix and sales conditions hold. Assume an upfront jig/prototype/testing spend of ₹90,000, with ₹235 per unit of improvements judged potentially cash-relevant after excluding the ₹15 overhead absorption effect. Under these assumptions a simplistic payback is ₹90,000 / (₹235 × 1,000) = 0.38 months, ignoring ramp-up, downtime and working capital. Such a rapid apparent payback is precisely why the assumptions need field validation; it must not be reported as an achieved return.

Table 8 presents the monthly volume and potential cash-like savings.

Table 8. Monthly volume and potential cash-like savings.

Monthly output	Cash-like saving / rack	Gross monthly benefit	90-day lesson
250 racks	₹235	₹58,750	Higher exposure to setup and low utilisation
500 racks	₹235	₹117,500	Pilot economics may be plausible
1,000 racks	₹235	₹235,000	Needs validated recurring production orders

If sales fall below forecast, overhead absorption and procurement discounts may reverse. Management should therefore maintain a weekly earned-savings register: standard cost, actual purchase price, scrap quantity, minutes per rack, coating usage, rejects, warranty complaints and actual invoiced selling price.

8 A 90-day implementation pathway for Indian SMEs

Table 9 presents the proposed 90-day target-costing implementation pathway.

Table 9. Proposed 90-day target-costing implementation pathway.

Period	Managerial action	Evidence required / control
Days 1–15	Select one product; gather competitor offers and customer needs	Written price assumptions, feature priorities
Days 16–30	Build bill of materials and activity-level cost sheet	Supplier rates, labour-time and scrap baseline
Days 31–45	Set target profit and allocate cost gaps by function	Approved target-cost card and owners
Days 46–60	Co-design changes with shop floor and suppliers	Samples, drawings, supplier confirmations
Days 61–75	Run pilot batches and quality tests	Test logs, actual yield, rework and rejection
Days 76–90	Reconcile true cost, realised price and launch decision	Signed cost-gap dashboard; go/no-go decision

8.1 Minimum viable information system

A unit need not begin with expensive enterprise software. A well-controlled spreadsheet can capture (i) product code and revision, (ii) normalised bill of materials, (iii) purchase rates and validity dates, (iv) standard and actual labour minutes, (v) scrap and return rates, (vi) overhead method, (vii) target margin, and (viii) customer feedback.

One nominated employee should control assumptions; version histories and approval signatures are essential when design choices change.

8.2 Responsibilities and safeguards

The owner defines an acceptable margin and funds trial activity; sales tests price realism; purchasing validates supplier capability; production quantifies operations; and the accountant reconciles cost categories. Where professional engineering review is necessary, external expertise must be obtained. A monthly review should prevent “paper savings” from being counted twice, such as reducing scrap allowance while also crediting the same scrap to lower material consumption.

8.3 Key performance indicators

Five core indicators offer a manageable starting point: target-cost achievement ratio (approved design cost / allowable cost), realised contribution per sale, kilograms of scrap per acceptable rack, direct assembly minutes per rack and first-pass yield. Two complementary indicators—on-time supplier delivery and warranty/returns per 100 units—guard against a false impression of success when apparent costs decline at the expense of reliability.

8.4 Decision rule

A launch proceeds only when an approved product meets all non-negotiable functional requirements, the market-price assumption is supportable, cost calculations are reproducible, and the downside case remains within management’s risk tolerance. If the target cannot be achieved, managers must

reconsider the product specification, customer segment or required profit—not conceal costs or compromise safety.

9 Findings, discussion and implications

9.1 Analytical findings

First, the worked case shows the usefulness of expressing an apparently small commercial disagreement as a measurable cost gap. The initial ₹240 gap is a clear design objective instead of a vague request to "be more economical." Second, most assumed savings arise from process and design coordination rather than a simple supplier price cut. Third, the case illustrates the difference between economically verified reductions and changes in accounting allocation: the ₹15 overhead absorption item matters because it is not necessarily a cash saving. Fourth, the price and input-cost stress tests show that meeting a target in the baseline case does not protect the business from adverse shocks.

The interpretation is consistent with Kato's (1993) early-design emphasis, Tani et al.'s (1994) multiple product goals, Ellram's (2006) supplier focus and Ibusuki and Kaminski's (2007) value-engineering model. Roffia et al. (2024) also helps explain why a simple tool may be more realistic for smaller firms than a technically complex costing system. Consistency with international literature is not proof of Indian effectiveness; it establishes conceptual plausibility.

9.2 Practical implications

For owner-managers, the most valuable change is to treat desired profit as an explicit design constraint. For accountants, the challenge is to improve cost traceability without creating excessive administrative burden. For policymakers and cluster support agencies, training could focus on product-cost cards, small-group engineering workshops and supplier benchmarking, potentially alongside existing lean initiatives. For researchers, the gap is empirical: how often do SMEs use target-costing elements informally, and does documented adoption correlate with verified margins after controlling for product mix and demand?

9.3 Limitations and future research

This analysis uses a fictitious factory, illustrative prices, no interviewed firms and no observed post-implementation results. The model omits financing cost, capital depreciation for new tools, working-capital interest, tax, GST cash-flow timing, market entry costs, warranty probability and competitor response. Consequently, none of the apparent savings can be generalised as an Indian SME industry average. A future multi-cluster study could recruit 60–100 manufacturing SMEs, examine 6–12 months of actual product records, collect customer quality ratings, and estimate within-firm changes or compare matched adopting and non-adopting firms. Such a study would require consent, verified accounts, a pre-registered protocol and proper statistical controls.

10 Conclusion

Target costing is best understood as a shared decision discipline: listen to the market, protect the required customer function, establish an affordable cost and redesign work before committing to production. The constructed Indian rack case demonstrates the calculations and governance steps in a form a small unit could reasonably adapt. Its central claim is procedural rather than causal: a

market-back process makes cost and quality trade-offs explicit. Actual profit improvement remains a proposition for on-site validation.

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