

Target Costing

Castout Ltd

Target Costing

In the August issue of the ICB Members' Newsletter I considered the technique of Overhead Recovery and Full Cost Pricing. Here we continue with the Castout Ltd case study series and this month focus on Target Costing as an alternative to Full Cost Pricing. I hope that you find this useful, recognising its potential and practical application.

- Target Costing

Much literature cites Japanese companies developing and using target costing; Toyota, Honda and Nissan are such examples. In the US Caterpillar and Chrysler are examples where economic benefits of the technique have been noteworthy.

- Traditional Pricing and Costing

Full cost pricing has been the model used by many businesses in the past. Standards and standard costing technique was used to determine a product's cost of labour and material, overhead was absorbed, a share of selling distribution and administration cost was added to achieve a product's total cost. Price was then set by adding a desired profit margin.

This additive model worked well and was appropriate when markets were less efficient and responsive as they are today.

If the price was acceptable in the market it was only experienced when the product was actually introduced to potential customers. This could result in the price being either too high or too low and therefore technique was developed that prevents pricing error and aids faster more focused product development.

- Target Costing

'Target costing describes a process of first assessing a target price and then designing a product to meet this price' (Hergeth).

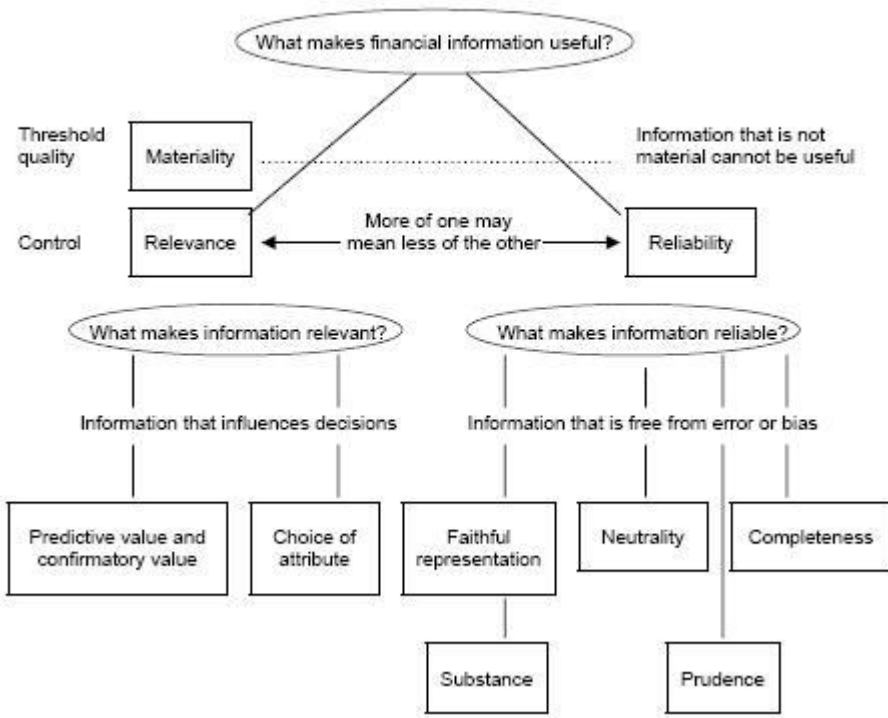
It is part of a total cost management system which moves away from traditional accounting to managerial accounting and moves decision making from an accountants perspective to the market place.

It is a top down process:

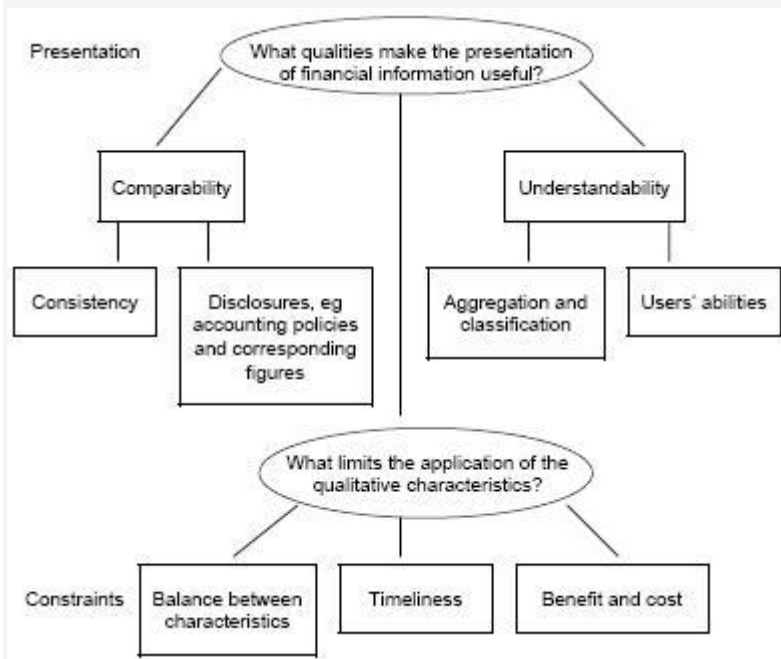
- Setting Price
- Setting Profit
- Setting Cost

The process is interactive and comprises three phases: market level, product level and component level (Cooper and Slagmulder 1999):

The following diagrams illustrate more clearly the concepts in content and presentation:



This can also be viewed as:



Target costing therefore builds upon a design to cost approach where the focus is a market driven price as a basis for establishing target costs.

Hergeth states:

"The key element in target costing is the market orientation of the entire costing and product development process. By introducing the market price as the focal point of the analysis, target costing avoids problems of other costing approaches:

- Costing becomes a managerial tool to achieve successful product design rather than documenting historical data.
- An economically relevant variable (price) becomes the driver of the product development process rather than its output. This results in a market and profit driven product development process rather.
- Due to its market orientation target costing can consider long-term corporate strategies in the market. Variable costing and activity based costing tend to focus more on short term goals.
- Due to its specific purpose target costing tends to provide decision relevant data, while traditional absorption costing models tend to document all cost, independent of the decision making relevance. "

• **Application of Technique to Castout**

We would need to compare our original estimated cost of a product to target cost.

If this was greater than target we would need to reconsider design and possibly reduce associated expenses or examine our decision to offer the product.

This could involve re-examining processes to introduce cost reducing efficiencies.

• **Target Cost Profile**

Product: Castout ACE H5

Price Cost Element	% Factor	Per Unit Factor £
Target Price		90.00
Profit Margin	20%	<u>18.00</u>
		72.00
Selling, distrobution and admin	10%	<u>7.20</u>
		64.80
Overheads	30%	<u>19.44</u>
Target Costs (Direct)*		<u>£45.36</u>
*Labour and material		

The target costing process integrates many activities and tasks. The target costing team needs to be drawn from disciplines within the company to include: finance, manufacturing, purchasing and marketing. We need, as with our budgetary control mechanism, a participative approach to target cost management. • Conclusion Although the technique in its simplest form is merely a model – target price minus profit margin = target cost, todays highly competitive market place and external environment can make the technique a strategic management tool. It can be incorporated into our management accounting portfolio and provide the company with economic value added and strategic benefit. It will allow us to focus on the use of limited resources to maximise opportunity to achieve target return on investment.

Readers are also referred to A Practical Guide to Target Costing by Frank Robinson (a CIMA publication)