MEETING THE TARGET COSTING CHALLENGE
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Target costing is a market sensitive approach to the pricing decision whereby, in direct contrast to cost plus pricing, the initial approach is to carry out market research to determine the:

- specification of product/service is expected from prospective customers,
- price prospective customers are willing to pay for the product/service specified, and
- volume of product/service is likely to be demanded if the price that is acceptable is charged and the specification expected is delivered.

If the above information can be determined with sufficient certainty then the next stage in the target costing process is for the organisation to deduct from the forecast market price the level of margin that is required in order to contribute to attaining the financial objectives of the organisation. Once this has been deducted the target cost can be determined. Thereafter, the target costing challenge is to ensure that the forecast volume of the product/service can be delivered within the indicative target cost.

The target costing challenge will ideally be met by the following parties working in unison:

- Product Designers
- Production Engineers
- Cost Accountants
- Logistics Professionals
- Marketing Professionals

The premise is that cost improvements are ‘engineered in’ to the product and production process rather than an approach which involves the stripping out of the product attributes. Examples of actions that could be taken to help meet the target costing challenge may include the:

- re-design of the product to incorporate input savings. This value-engineering will assist in meeting the specification required at a lower cost,
- introduction of new production methods and technologies to achieve cost efficiencies,
- sourcing of cheaper production inputs wherever possible,
- rigid control of production costs,
- increasing of batch sizes in a batch costing environment to drive down batch related unit costs, and
- reduction of unit delivery costs by increasing delivery quantities.

TARGET COSTING EXAMPLE

D Limited produces and sells leather car seats for the luxury car market segment and it currently manufactures 50,000 car seats per annum for an Italian customer, Bologna SPA. D Limited currently charges Bologna Spa €400 per seat which includes a mark-up of 15%.

Recently, Bologna SPA signalled to D Limited that for the next two years it wishes to double its annual order size from the 50,000 seats it currently orders. However, before placing this order, it is expecting D Limited to reduce the cost per seat to €300.

In order to continue to supply this key client D Limited's management team asked you to calculate the sales margin required to ensure that the current level of profitability is maintained. The management team has also requested your assistance to determine whether or not the resulting indicative cost can be achieved given the changes that D Limited's management have considered. The proposed changes are listed below.

Management of D Limited has provided you with the following information.

Standard Cost of producing car seat:

- Leather – 3 metres at €10 per metre.
- Cushion – 10 metres at €4 per metre.
- Labour – 6 hours costing €12 per hour.
- Production Set-Up Cost - €200 per batch of 20 seats.
- Transportation - €3,000 per delivery of 20 seats.

Proposed Changes

1. D Limited plans to invest €5,000,000 in improved technology (which would be written off evenly over 2 years). This investment should reduce wastage levels of both materials by 20%. In addition, 45 minutes of labour time per seat could be saved.

2. D Limited's contract transportation partner has agreed to deliver 40 seats per delivery at an increase in price of €1,000 per delivery. To accord with this delivery schedule D Limited's production engineers have reconfigured the production schedule so that the current production batch size will be doubled.

3. D Limited's leather supplier has agreed to reduce the price charged by 5% if D Limited can sign up an annual contract to purchase a guaranteed minimum of 200,000 metres per annum.

BRIEFING

TO: MANAGEMENT TEAM D LIMITED

FROM: JAYNE DOE, MANAGEMENT CONSULTANT

SUBJECT: TARGET COSTING CHALLENGE – BOLOGNA SPA PROJECT

DATE: 01 FEBRUARY 20XX

I am pleased to advise that based on your proposed investment and production plans that the Bologna Spa target cost challenge can be met. The basis for this follows.

Given the proposal from Bologna SPA the target cost for the seat can be calculated at €270 per the following schedule:

TARGET COST CALCULATION	
CURRENT GROSS PROFIT (50,000*€400*15%)	€3,000,000
PROPOSED GROSS SALES (100,000*€300)	€30,000,000
REQUISITE SALES MARGIN (preserves profit)	10%
TARGET COST PER UNIT (€300-10%)	€270

If this target cost can be achieved the absolute level of net profit of €3,000,000 can be preserved whilst enabling D Limited to meet Bologna SPA's price and volume expectations for the next two years.

The indicative cost of producing each seat is €247.80, calculated as follows:

INDICATIVE COST PER SEAT	
	€
LEATHER (3 metres*80%* (€10 * 95%))	22.8
CUSHION (10 metres * 80% * €4)	32
LABOUR (5.25 HOURS * €12)	63
PRODUCTION BATCH SET UP (200/40)	5
DEPRECIATION (5,000,000/2/100,000)	25
TRANSPORT (4,000/40)	100
INDICATIVE COST OF EACH SEAT	**247.8**

I will be pleased to assist if you require any clarification of the above or additional information.

Jayne Doe
Certified Public Accountant.