Target Costing: a tool for Strategic performance Management

Article by John Currie – Examiner in Professional 2 Strategic Performance Management

Target costing versus cost-plus pricing

The basic principle of target costing is that the cost of producing and distributing a product must not exceed: (competitively realistic selling price minus acceptable profit margin). For example, if the product can be sold for €20 and a profit margin of €7 is required then the manufacturer cannot afford to spend more than €13 producing and distributing it. The amount of this required profit is likely to depend on how much capital has been invested in production and distribution facilities for the product. The logic behind target costing is essentially the reverse of the logic in cost-plus pricing. The logical error in cost-plus pricing is the idea that cost can be taken as a "given" and that a required profit margin can be added to arrive at a "fair" selling price.
In reality, the issue is not whether a proposed selling price is "fair" but rather whether it is competitively realistic and strategically appropriate. A price derived on a cost-plus basis takes no account of customers' willingness and ability to pay that price. Customers' incomes, price sensitivity of demand, competitors' prices for comparable products of similar functionality, and the market positioning of the product are all important variables which must be consciously considered as part of a strategic approach to pricing. Yet cost-plus pricing recognises none of these factors. Target costing, by contrast, provides a means of taking explicit note of these factors and provides a framework for an integrated strategic approach to pricing and cost management. It is worth noting that, while target costing is often thought of as a cost reduction technique, some of its best-known users are companies which operate in high-cost economies such as Japan and Switzerland. This is partly because cost savings in a target costing framework are typically achieved by eliminating non-value-adding cost driver activities (thus reducing overhead costs) and not by reducing the direct materials content or manufacturing quality of the product. This point is explored further below.

The "target cost gap"

In the example above, it was determined that the cost of producing and selling the product must not exceed €13. The next step is to predict the product cost which is likely given the existing product design, supply chain, and distribution channels. If this predicted cost is (for example) €15 then there is a "target cost gap" of €15 - €13 = €2. Manufacture and distribution of the product cannot take place unless this target costing gap is "closed" by identifying sufficient cost savings. Ways of closing a target costing gap are explored later in this article, but at this stage two points should be made. First, the target costing gap must be closed in full, otherwise the product must not be produced. It might be tempting to say that cost savings of (say) €1.50 would be "good enough" but that would be a mistake because it would mean that the minimum required rate of return on the investment would not be achieved. Second, opportunities for closing the target cost gap are typically greatest when the product is still at the design stage of its product lifecycle, is undergoing a fundamental redesign, or where major changes to the supply chain and/or distribution channels are being contemplated. The reason for this is that it is in these situations that there is maximum flexibility to make the changes necessary in order to achieve cost savings.

Closing the target cost gap by reducing direct costs

One way to close a target cost gap is to reduce direct costs of the product (i.e., direct materials or direct labour). This can best be achieved by elimination of non-value-adding raw materials (such as packaging) or by improving labour productivity (e.g., by investing in training so as to accelerate learning effects). However, care must be exercised if the change involves substituting one type of value-adding raw materials with another:

If the replacement raw material is of obviously inferior quality then the amount which customers would be willing to pay for the product is likely to be reduced, thus cancelling out the profit effects of any cost saving.

However, it is sometimes possible to identify a replacement material which is both cheaper and better for the intended purpose. For example, while customers may prefer natural fabrics such as cotton and wool for major clothing items, synthetic microfibers offer many practical advantages (in terms of durability and cleaning) for smaller items such as socks.

Using activity-based cost management (ABCM) to close the target cost gap

In practice the biggest potential for closing the target costing gap usually lies in applying ABCM so as to achieve savings in overhead costs. This is because ABCM often reveals opportunities for eliminating overhead-causing activities without reducing (and perhaps even increasing) the quality of the product and the customer service experience. Some examples are:

1. The use of common components in several products, so that the total *number* (not *quantity*) of components used in a manufacturing facility is reduced. Toyota is frequently cited as an example of a company which uses common components across several vehicles. This has delivered savings in supply chain costs (as there are fewer supplier relationships to be managed), manufacturing (since there is a less diverse range of operations to be performed) and quality (because the simplicity reduces failure rates).

2. Reduction in the incidence of cost drivers. For example, by eliminating its central warehouse and insisting that all suppliers deliver directly to each of its stores, a supermarkets chain can reduce the number of transport operations. US retailer Wal-Mart was a pioneer of this practice which is now extremely widespread.

3. To the extent that cost drivers cannot be reduced or eliminated, cost savings can be sought through efficiency improvements or outsourcing. In other words, if the activity cannot be eliminated, can it be done more cheaply?

Target costing is only possible if the organisation has in place an activity-based costing (ABC) system. The ABC system provides visibility as to which activities are causing overheads and (by implication) the extent to which proposed changes are likely to contribute to closing the target cost gap. By contrast, if all overheads are allocated on a direct labour hour (DLH) basis then a manager may try to reduce the labour content of his products so as to be allocated less overheads. However, there will be no saving to the organisation in overhead costs, unless DLH is a major activity cost driver.

Value analysis in target costing

Value analysis refers to the organisational processes which a firm uses in order to generate the specific ideas for closing the target costing gap. Value analysis involves a "cross-functional team" subjecting a product (including its components, distribution channels, etc.) to detailed scrutiny to determine the relationship between (1) cost, (2) the practical functionality of the product, and (3) the value of the product to the customer. An example of the difference between (2) and (3) is that (2) may be a list of the technical features of a product (not all of which every customer necessarily desires) while (3) refers to each customer's subjective assessment of what the product is worth to them and therefore what they would be willing to pay for it.

Even a fairly simple change to a product's design characteristics has implications for (1), (2) and (3). A simple example may a proposal to change the type of battery used in a smartphone which is being developed. Such a change clearly has implications for the manufacturing cost of the smartphone, for its technical functionality (e.g., the length of time which the phone can operate without needing to be recharged), and the value of the smartphone to the customer (e.g., if the battery is unusually heavy than customer value is likely to be adversely affected).

The need for the value analysis team to be cross-functional in its composition arises from the need to understand the relationship between (1), (2) and (3) in assessing design changes. For example, the particular expertise of marketing staff is in understanding what product features is actually willing to pay money for. Production staff understand the practical difficulties of producing products with a particular design. (For example, in manufacturing metal-based products, manufacturing the item in a range of colours – rather than just one standard colour – typically slows down production and increases cost). The accountant's particular contribution is typically to keep the score – quantifying (insofar as possible) the cost and revenue implications of possible design modifications and assessing the likelihood that they will lead to the closing of the target cost gap.

Conclusion

The main benefits of target costing can be summarised as follows:

- It provides a reminder that, in competitive markets, firms are typically price-takers and can only achieve profitability by managing costs.

- It gives managers an incentive to control costs since it recognises that costs cannot be passed on at will to customers through higher prices.

- It encourages the use of an activity-based approach to cost management, which in turn has significant potential to deliver cost savings while maintaining (or enhancing) the market value of the product and the customer service experience.

- It encourages innovative thinking (and cross-functional cooperation) in product design and supply chain configuration.

- It recognises the fundamental importance of "what features the customer is willing to pay for" (and not merely "what the customer wants") in product design decisions.

- It can play an important role in product positioning strategies. For example, the outcome of a value engineering exercise may be a decision to add features to a product, increasing both the cost and value of a product, as part of a deliberate strategy of positioning the product in a profitable, upmarket niche where there are few competitors.

Of course, as with any strategic performance management technique, target costing should be used only where appropriate. For example, target costing is less widely used in service industries than in manufacturing, and there appear to be three main reasons for this:
Less intense selling price competition. For example, an airline operating on the Dublin-London route has far fewer competitors than (for example) a manufacturer of tablet computers. Therefore, service firms may feel less need to exercise the kind of rigorous cost control which target costing facilitates.

Less frequent product innovations. For example, a hotel chain may open a new hotel or an airline may open a new route, but the existing business model is typically applied without modification to the new venture. The new venture is not a product innovation in any real sense. Therefore there are few opportunities for target costing, which is best carried out when a product (or service) is still in the process of being designed.

No bought-in components, so there are more limited opportunities for supply chain simplification than in manufacturing firms. Of course, this is not to say that service firms don't actively manage their supply chains for strategic advantage, as the example of Wal-Mart above indicates.