



Target costing

LECTURE

What is Target costing?

Target Costing is a process of developing costs for a product (or services) based on **market** driven considerations.

A method that allows firms to provide consumers with products that **they want**, at a price **they can afford**, and still earn **desired** financial returns.



Application

- ❑ To **start from the market** and work back to production process, through design and development of product that customer needs at acceptable prices.
- ❑ It is applied in the design and development stage.
- ❑ Target Cost of a product = Target selling price less Target Profit
- ❑ Value Engineering is a key to achieving target costs.
 - ❑ *It is a systematic evaluation of all aspects of production and marketing that starts from R&D, Design of products, and distribution to customers, ending with customer service.*
 - ❑ *Target costing is widely used by Japanese and American Industries in automobiles (Toyota), Electronics (Panasonic), Information Technology (Apple).*



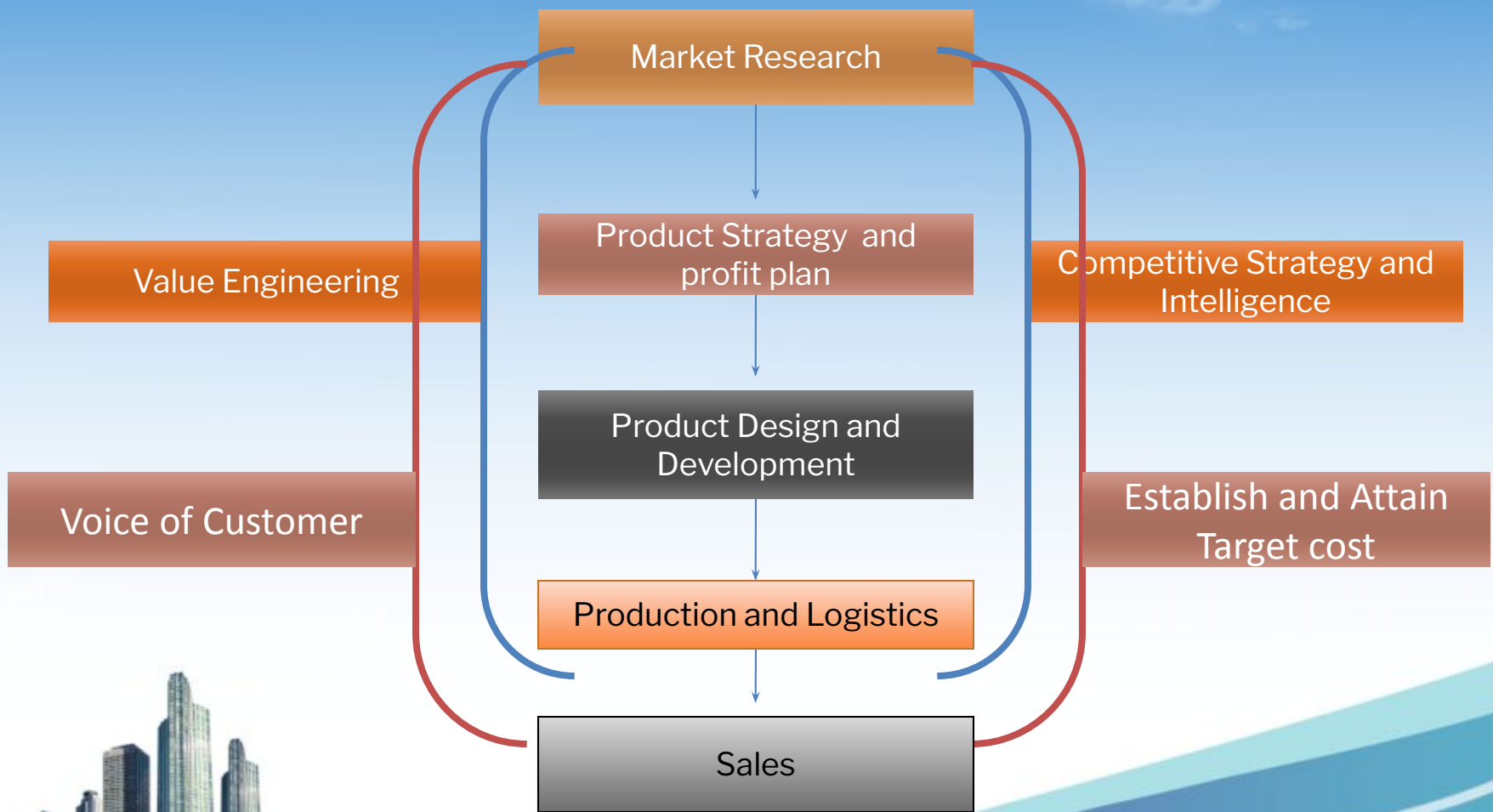
Value engineering

- ❑ **Value Engineering (VE)** is a management technique that seeks the best functional balance between cost , reliability and performance of a product, project and process or service.
- ❑ It is a systematic method to improve the "value" of goods or products and services by using an examination of function. Value, as defined, is the ratio of function to cost. Value can therefore be increased by either improving the function or reducing the cost

For example, the function of a pencil is to "make marks". This then facilitates considering what else can make marks. From a spray can, lipstick, a diamond on glass to a stick in the sand, one can then clearly decide upon which alternative solution is most appropriate.



Target costing process model



Target Costing Process

- Two stage process
 - **Establish** the target cost
 - Market research
 - Product planning, concept development stages
 - **Achieve** the target cost
 - Value engineering, continuous improvement
 - Design stage
 - Continuous improvement in later stages



Establishing the Target Cost

- **Determine the product and its market**
 - Who is the target market?
 - What do they want?
 - What do competitors offer?
- **Introduce concept or prototype**
 - Evolutionary or revolutionary?
 - Refine until it meets customer needs
- **Determine the selling price**
 - Must be acceptable to the customer
 - Must be able to withstand competition
 - Techniques
- **Determine the required profit**
 - Return on sales will fluctuate over the life of the product



Achieving the Target Cost

- **Must include the features the customer wants while maintaining cost at or below target**
 - Want to meet the customers needs, but not exceed them
 - Failing to keep cost at or below target will result in unacceptable profits
- **Rank customer requirements**
 - What does the customer want?
 - What do we and our competitors currently offer?
 - Competitive evaluation
- **Determine the cost gap between current cost and allowable cost**
- **Decompose the cost gap**
 - Life cycle decomposition
 - Value chain decomposition
 - Cost reduction targets are divided among internal and external activities



Achieving the Target Cost

- **Perform value engineering to design out costs without sacrificing needed features**
 - Perform a cost analysis of major components and activities
 - List components or activities and their functions
 - Calculate a cost breakdown
 - Relate the components to customer requirements (exhibit 4)
 - Develop Quality-Function-Deployment matrix
 - Develop a functional ranking
 - Indicates the importance of each component to the customer



Achieving the Target Cost

- Identify components for cost reduction
- Generate cost reduction ideas
 - Eliminate over-engineering
 - Eliminate, replace, combine, rearrange
 - Consider the process as well as the product
- Test the ideas
 - Will they be effective?
 - Are they technologically feasible?
 - Is there a domino effect?
- Estimate the achievable costs
 - Use activity-based costing, cost tables, etc.



Organizational Impact

- **Positives**

- Customer focus
- Cross-functional integration
- Open sharing of information
- Better process understanding

- **Negatives**

- Too much customer focus
- Potential organizational conflict
- Too much pressure to attain targets
- Longer development times





**Thank you for the
attention!**