TARGET COSTING

Target Costing

- Target costing is the process of determining the maximum allowable cost for a new product and then developing a prototype that can be made for that maximum target cost figure. The equation for determining a target price is shown below:

- ***Target cost = Anticipated selling price – Desired profit***

- Once the target cost is determined, the product development team is given the responsibility of designing the product so that it can be made for no more than the target cost.

Reasons for Using Target Costing

- Two characteristics of prices and product costs include:

1. The market (i.e., supply and demand) determines price.
2. Most of the cost of a product is determined in the design stage.

Reasons for Using Target Costing

- Target costing was developed in recognition of the two characteristics summarized on the previous screen.
- Target costing begins the product development process by recognizing and responding to existing market prices. Other approaches allow engineers to design products without considering market prices.

Reasons for Using Target Costing

- Target costing focuses a company's cost reduction efforts in the product design stage of production.
- Other approaches attempt to squeeze costs out of the manufacturing process after they come to the realization that the cost of a manufactured product does not bear a profitable relationship to the existing market price.

Target Costing

- Handy Appliance feels there is a niche for a hand mixer with special features. The marketing department believes that a price of $30 would be about right and that about 40,000 mixers could be sold. An investment of $2 million is required to gear up for production. The company requires a 15% ROI on invested funds.

- Let's see how we determine the target cost.

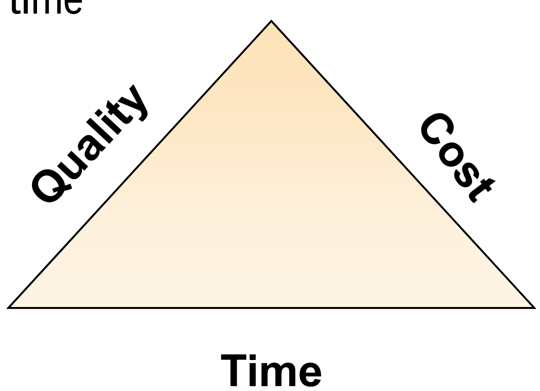
Target Costing

Projected sales (40,000 units × \$30)	\$ 1,200,000
Desired profit (\$2,000,000 × 15%)	300,000
Target cost for 40,000 mixers	\$ 900,000
Target cost per mixer (\$900,000 ÷ 40,000)	\$ 22.50

- Each functional area within Handy Appliance would be responsible for keeping its actual costs within the target established for that area.

TARGET COSTING ... The new competitive environment

- Global competitiveness requires balancing quality, cost, and time



- Target costing focuses on all three dimensions of the strategic triangle

TARGET COSTING...
State of the Art in the U.S.

US Companies	Japanese Companies
67% use cost plus pricing	100% used price minus profit
Cost estimates need great improvements	Achieve 80% accuracy of cost estimates at product concept stage
Estimate of sales volume provided to suppliers are overstated between 11-25%	Estimate of sales volume provided to suppliers are within +/-5%
No tight monitoring of profits, costs, capital investment, quality, development budget, and performance.	Tight monitoring of profits, costs, capital investment, quality, development budget, and performance.

TARGET COSTING...
What Is It?

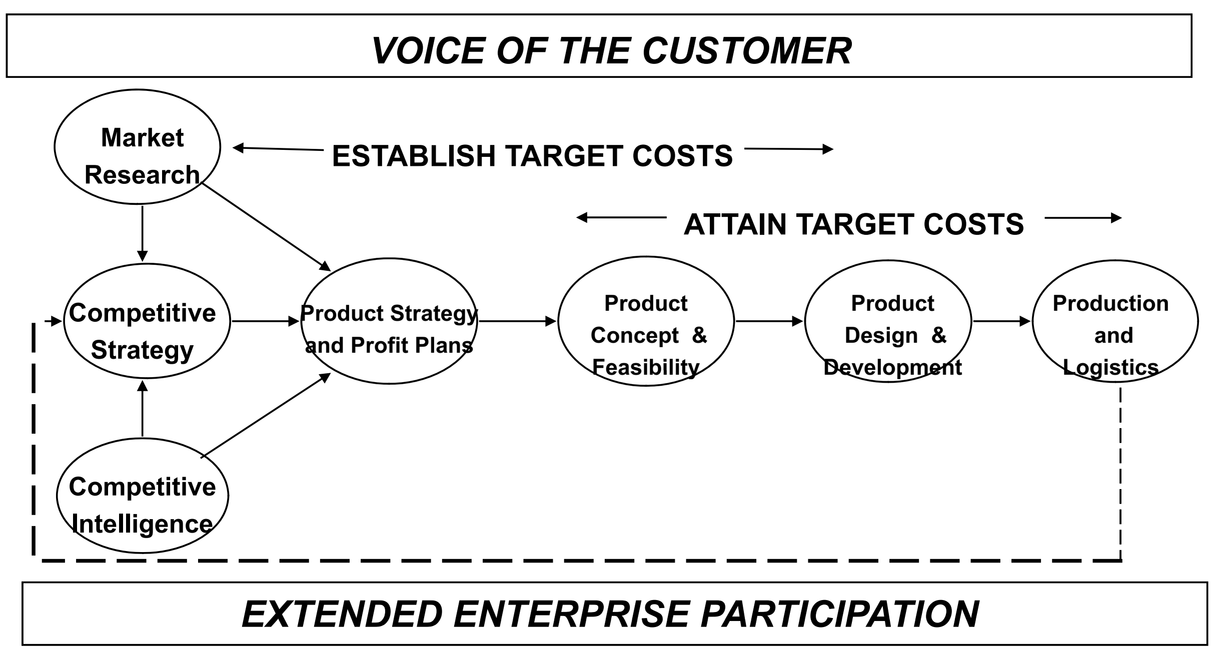
- A target cost is the allowable amount of cost that can be incurred on a product and still earn the required profit from that product
- A strategic profit and cost management process
  - Price-led
  - Customer-focused
  - Design-centered
  - Cross-functional
  - Life cycle oriented
  - Value Chain-based

TARGET COSTING...
Managing committed costs

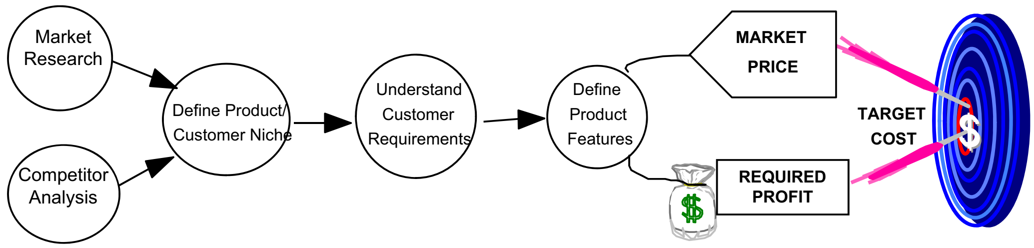
TARGET COSTING...
A Different Profit Planning Approach

❖ Cost Plus	❖ Target Costing
Market considerations not part of cost planning.	Competitive market considerations drive cost planning.
Costs determine price.	Price determines costs.
Waste and inefficiency is focus of cost reduction efforts.	Cost reduction is achieved by simultaneous product/process design.
Cost reduction is not customer driven.	Customer input guides cost reduction.
Cost accountants manage costs.	Cross-functional teams manage costs.
Suppliers involved after product designed.	Suppliers involved in concept and design of product.
Minimizes initial price paid by customer.	Minimizes cost of ownership to customer.
Little or no involvement of value chain in cost planning.	Involves the value chain in cost planning.

TARGET COSTING...
In the Product Development Process



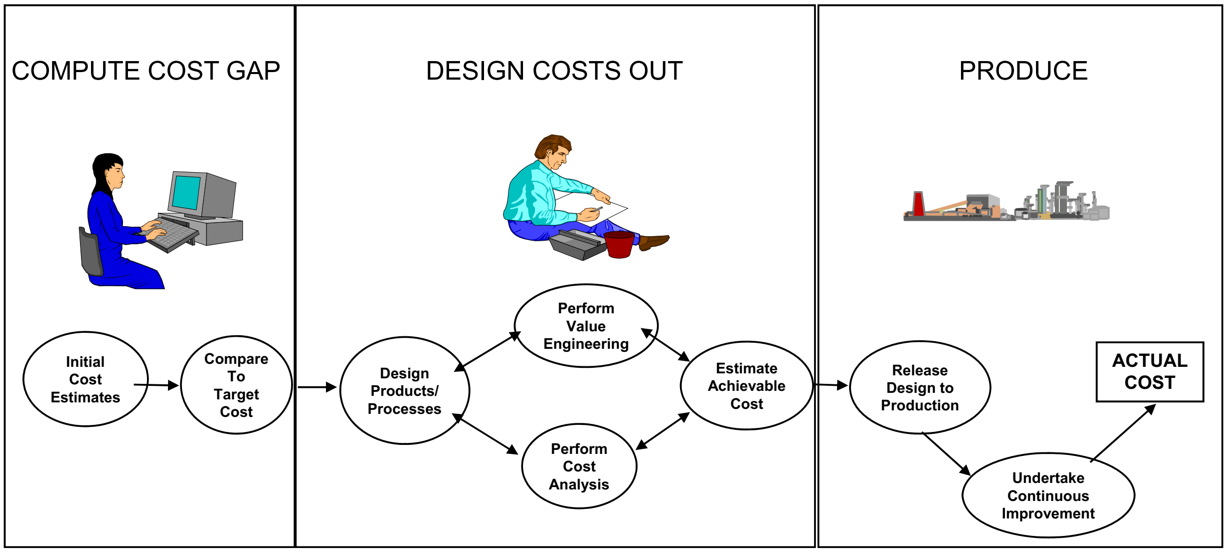
TARGET COSTING...
Setting Target Costs



TARGET COSTING...
Voice of the Customer

- Develop a market-focused mindset
  - Open-minded, inquisitive, take nothing for granted, share what you learn
- Solicit customer information
  - Panels, focus groups, interviews, surveys
- Analyze customer feedback
  - Profiles, charts, maps, tables
- Understand completely what the customer truly values
  - Features and cost determine value

TARGET COSTING...
Achieving Target Costs



TARGET COSTING...
Does It Work?

CHRYSLER'S RESULTS – Mid 1990s

- **Meets customer requirements for safety and driveability**
- **Neon named "Auto of the Year"**
- **Short development time (concept to market 31 months)**
- **Below projected development and investment budget**
- **Neon one of few small cars that earns a positive return**

TARGET COSTING...
Does It Work?

CHRYSLER'S RESULTS

- **Chrysler's share price \$10 to \$54 in 6 years**
- **Revenue increase 70%**
- **Market share increase by 2.1%**
- **Profits and cash flows increase 400%**
- **Profit margin ratio up from 0.33% to 7.1%**
- **Chrysler's Truck Line (including Jeeps and Minivans) number one among US carmakers in "Power Survey."**
- **Industry benchmark study finds Chrysler the low cost producer in North America for second straight year.**
- **Standard & Poors and Duff & Phelps raised credit ratings - first time to "A" level.**