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:

\[
\text{Target cost} = \text{Anticipated selling price} - \text{Desired profit}
\]

- 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.

- 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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected sales (40,000 units × $30)</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Desired profit ($2,000,000 × 15%)</td>
<td>300,000</td>
</tr>
<tr>
<td>Target cost for 40,000 mixers</td>
<td>$900,000</td>
</tr>
<tr>
<td>Target cost per mixer ($900,000 ÷ 40,000)</td>
<td>$22.50</td>
</tr>
</tbody>
</table>

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
  - 67% use cost plus pricing
  - Cost estimates need great improvements
  - Estimate of sales volume provided to suppliers are overstated between 11-25%
  - No tight monitoring of profits, costs, capital investment, quality, development budget, and performance.

- Japanese Companies
  - 100% used price minus profit
  - Achieve 80% accuracy of cost estimates at product concept stage
  - Estimate of sales volume provided to suppliers are within +/-5%
  - 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
- Market considerations not part of cost planning.
- Costs determine price.
- Waste and inefficiency is focus of cost reduction efforts.
- Cost reduction is not customer driven.
- Cost accountants manage costs.
- Suppliers involved after product designed.
- Minimizes initial price paid by customer.
- Little or no involvement of value chain in cost planning.

Target Costing
- Competitive market considerations drive cost planning.
- Price determines costs.
- Cost reduction is achieved by simultaneous product/process design.
- Customer input guides cost reduction.
- Cross-functional teams manage costs.
- Suppliers involved in concept and design of product.
- Minimizes cost of ownership to customer.
- Involves the value chain in cost planning.

TARGET COSTING...
In the Product Development Process

VOICE OF THE CUSTOMER

MARKET RESEARCH

ESTABLISH TARGET COSTS

COMPETITIVE STRATEGY

PRODUCT STRATEGY AND PROFIT PLANS

PRODUCT CONCEPT & FEASIBILITY

PRODUCT DESIGN & DEVELOPMENT

PRODUCTION AND LOGISTICS

ATTAIN TARGET COSTS

EXTENDED ENTERPRISE PARTICIPATION
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

**COMPUTE COST GAP**

- Initial Cost Estimates
- Compare To Target Cost

**DESIGN COSTS OUT**

- Design Products/Processes
- Perform Value Engineering
- Estimate Achievable Cost
- Perform Cost Analysis

**PRODUCE**

- Release Design to Production
- Undertake Continuous Improvement
- ACTUAL COST

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.