

Target Costing

The meaning of Target Costing can be understood from its title. What does a product cost? And particularly, how much should it cost in the future?

In principle, there are two ways of estimating (calculating) the cost of a product; Bottom-up and Top-down. In the first, the individual cost elements are identified and when added together give the total product cost. Target Costing, however, focuses more from the Top-Down viewpoint. This means that the maximum possible cost of the product is determined by the market price of the product. The actual target cost is the market price less the profit margin.

In order to establish the market price, it may be necessary to undertake various exercises in market research, bench-marketing etc., with the support of other business functions such as business development and marketing. This allows the enterprise to get an overview of the market and allows it to price its product relative to the competition.

Based on the agreed target cost (price minus margin), the individual cost elements (material, investment, wages, fixed costs, etc.) of the product must be established. This involves a coordinated effort between all functions in the organization, which are involved in bringing the product to market. Additionally, a number of strategic decisions must be made, including product specification, manufacturing location and supplier involvement.

With experience the target costing experts are able to give the various functions / departments guidance on where their part of the product cost needs to land.

Specification is particularly important. The product should contain only those features, which the customer requires and for which it is willing to pay. Over-engineering of products quickly catapults the product out of the target cost range.

The target costing team (which can be a department or an activity within the product line), consolidates all of the proposed costs. Several iterations may be necessary before the necessary level of cost commitment is reached, thereby achieving the target cost.

Importantly, once the targets for the individual cost elements are established, and the product development has started, it will be necessary to ensure that the cost situation remains within the target cost range.

Regular reviews and monitoring are necessary to prevent cost creep, which develops due to unexpected events, such as material shortages, development delays and customer change requests.

In these cases, the enterprise must react quickly, and implement corrective action, such as cost savings, design-to-cost or change management activities, in order to bring the product cost back into the target range.

Additionally, particularly in dynamic markets, competitors are probably working away on continuous improvement activities. For this reason, it is important to revisit the benchmarking activities again from time-to-time and where necessary to adjust the target price and therefore the target cost.

Target Costing has been successfully implemented, when the customer receives a product which meets his / her expectations, and is comparable or even better than that of the competitor and most importantly, the enterprise achieves an acceptable level of profit.

Target Costing is an important part of Cost Improvement. To save you the effort and expense of developing your own target costing procedure, for a reasonable fee*, we will provide you with our standard detailed target costing procedure, which can be easily adapted to your organization. Should you need additional support, we can also provide you with a target costing expert to get you up and running. Just let us know how we can help.