

Target costing

Business



Introduction Target costing, is a type of management technique that have come to be known as contemporary management techniques. Other contemporary management techniques are, value chain, life costing and the balanced score card analysis. Whichever technique a company wishes and chooses to use, the objective is to maximize the profits.

For this reason, in a nutshell, target costing is a management technique implemented by a firm, with the aim of maximizing profits. This paper seeks look into this management technique through the scope of one major pharmaceutical company. Merck is a leading pharmaceutical company with global business operations in over twenty countries. As such, it is a medium-sized pharmaceutical firm that prides its self as a leading drugs producer created from the 0 phase, signifying that each drug produced in this company is solely researched and developed all the way through research and development (Merck, 2009). The firm's operations focus on the treatments and medication development for both Human and Animal health.

One of the major segments of the firm is the “ Vaccines Segment” which specializes on human vaccine products aimed at joint ventures with hospitals and research labs throughout the world (Merck, 2009). Not a lot is mentioned concerning the firm's financial position and the profits generated by the firm. This paper will address the issue concerning target costing and its benefits with relation to this, Merck, pharmaceutical company. The paper will briefly but conclusively look at the rationale/relevance of this contemporary management technique (target costing), an in-depth analysis of the technique. In this section, the technique will be fully described, the technique's implementation process, its application by other organizations,

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its applicability to Merck Pharmaceuticals and finally how it can be implemented in the company.

Rationale of Target Costing The word rationale refers to the fundamental reasons or the basis of taking a course of action. In this light, this section aims at looking at the basis or the carefully thought out reasons why a company/firm would employ this contemporary management technique as one of the management tools. According to Cooper and Slagmulder (1997) Target costing is a pricing method used by firms. Defined as “ a cost management tool for reducing the overall cost of a product over its entire life-cycle with the help of production, engineering, research and design” (Cooper and Slagmulder; 1997), the method entails coming up with a target cost by looking at the competitive market price and then reducing (Lessing) the desired profit margin from it. A target cost is then basically, the maximum amount of cost that can be incurred on a product and with it the firm can still earn the required profit margin from that product at a particular selling price (Cooper and Slagmulder; 1997).

Kenneth Crow (2002) asserted that as an industry becomes mature, the basis of competition typically moves to price. For this reason, the profit margins shrink. Companies and firms then are forced to focus on cost reduction with the intention of maximizing profits. As Adam Smith (1776) had noted in the wealth of nations that it is the objective of the firm to maximize profits while at the same time minimize the cost of production. Modern times have; however, changed hence contemporary management techniques have been developed.

The cost structure for existing products is largely locked in and cost reduction activities have limited impact (Crow; 2002). Crow further asserts that “ as companies begin to realize that the majority of a product’s costs are committed based on decisions made during the development of a product, the focus shifts to actions that can be taken during the product development phase” (2002). What then is the relevance of target costing? For starters, as mentioned, the objective behind target costing is to ensure profit maximization and cost minimization. All firms strive to be in this position. A well thought out and implemented target costing technique will see to it that a firm attains its required objective which in most cases is profit maximization and cost minimization.

Apart from maximizing the profits and minimizing the costs, the technique also optimizes the whole product. Problems concerning transparency in the firm with regards to the revenue collected by the firm are reduced. In addition, communication grievances in the firm are also curtailed since everything is in paper and has been thought out before by a group of people. This technique, target costing, integrates economic objectives and technological knowledge. The economic objective of all firms, as put forward by Adam Smith, and as mentioned earlier, is the maximization of profits and the minimization of costs (1776).

However, Adam Smith greatly considered technological development/advancement as key in the growth and development of an economy, hence he is considered the father of modern economics. Through target costing, the technological requirements by a firm are put into account and are considered in the technique. In-depth Analysis of Target Costing <https://assignbuster.com/target-costing-essay-samples/>

Crow (2002) attempted to give an in-depth and detailed analysis of target costing. According to Crow, the technique is based on three premises: 1.) orienting products to customer affordability or market-driven pricing, 2.) treating product cost as an independent variable during the definition of a product's requirements, and 3.) proactively working to achieve target cost during product and process development (Crow; 2002). The three premises above are all economic premises. By orienting products to customer affordability or market-driven pricing, the firm tries to make the products affordable to the customers while at the same time ensuring that the cost of production does not exceed the revenues generated. It is thought of as being similar to the break even point in economics.

At this point, a firm's total revenues equal the total costs incurred by the firm. Treating product cost as an independent variable during the definition of a product's requirements implies that the product cost is autonomous of all other factors of production in this technique. Proactively working to achieve target cost during product and process development means that all efforts are made to meet the target cost in this technique. The target cost as mentioned is the maximum amount of cost that can be incurred on a product and with it the firm can still earn the required profit margin from that product at a particular selling price (Cooper and Slagmulder; 1997). According to Crow (2002), there exist ten steps to be followed to establish and put into action a comprehensive target costing approach within an organization or a firm. The first and one which is considered most challenging is "to re-orient". Crow asserts that thinking should be shifted and sifted from the basic and conventional technical requirements as a basis for product

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development to the contemporary market-driven pricing and prioritized customer needs (Crow; 2002).

In this step, the cost of production should influence the design. Rather than having the design of the product influence its cost of production, Crow tends to think that a vice-versa approach should be applied. The second step is the establishment of a market driven target price. Before a target price is set, the firm's management needs to go through various market forces and how the market forces are playing in order to come up with a good target price. It is imperative that one notes that there is a difference between target cost and target price.

While a target cost focuses on majorly profits, the target price is the price at which a seller projects that a buyer will buy a product. Factors such as the company position in the market place (market share), business and market penetration strategy, competition and competitive price response, targeted market niche or price point, and elasticity of demand, are key to look at. These are the factors that would determine the perfect target price since in many cases, if not all, a company/firm has its competitors. It is generally thought that the target price for any product should be reviewed often, as market conditions and forces tend to change and fluctuate. It is generally thought, that in the manufacturing industry target pricing is used to calculate the target cost.

This leads to the third step of target costing technique; determination of the target cost. Once the target price is established, a worksheet is used to calculate the target cost by subtracting the standard profit margin, warranty

reserves, and any uncontrollable corporate allocations (Crow; 2002). In many cases, it is stated and mainly thought that there exist three defined and distinct methods of determining cost; “ subtractive” method (also known as the sales based price method), “ adding up” method (estimated cost-based method) and the combination method. In the subtractive method, the target cost is determined by deducting target profit from the target selling price. In the adding up method, the target cost is determined by deducting possible profit improvement target value from the estimated cost.

Both the methods are not as effective as they are required by the firms. This is because they fail to consider a myriad of factors that affect the market forces. It is for this reason that the combination method is introduced into the picture. This method sets the target cost somewhere between the subtractive and the adding up methods. The fourth step is the balancing of target cost with the requirements.

Before the target cost is finalized, it must be considered in conjunction with product requirements (Crow; 2002). Kenneth Crow asserts that the greatest way of controlling a product’s costs is through proper setting of requirements or specifications (2002). Deeper understanding through paying attention to the customers needs is therefore important. For this reason, the use of conjoint analysis to understand the value that customers place on particular product capabilities, and use of techniques such as quality function deployment to help make these tradeoffs among various product requirements including target cost, is put to use. The fifth step is the establishment of a target costing process and a team based organization. A

well-defined process is required that integrates activities and tasks to support target costing (Crow; 2002).

Further, a team-based organization is required that integrates essential disciplines. Responsibilities to support target costing need to be clearly defined. This implies that there should exist specifications and specializations in the organization. Different departments should be charged with different duties and responsibilities so as to attain the perfect target cost. The sixth step involves the brainstorming and the analyzing of alternatives. It is important that the management of the firm looks at other alternatives or the next best choices that they are left with before plunging into the establishment of a target cost.

Many at times, there are better alternatives that could have been taken but since the firm needs a quick recovery strategy, they fail to consider the other options that lay ahead of them. Kenneth Crow points out that the seventh and amongst the most imperative steps is the “ establishment of production cost models that would help in the decision making”. Product cost models and cost tables provide the tools to evaluate the implications of concept and design alternatives (Crow; 2002). It is a common feature, at the initial stages, that these models are based on parametric estimating or parallel techniques. Later into the technique, these models are based on industrial engineering or bottom-up estimating techniques. To ensure that all proposed processes are addressed, it is important that the models are comprehensive.

Like in the determination of the target cost, a target cost worksheet may alternatively be used to capture the various elements of product cost. The

eight, and most brief step, is the use of tools to reduce costs. Basically, the use of tools entails the guidelines, databases, training procedures and supporting analytic tools to ensure that the perfect target costing technique is established. The ninth step is that of reducing indirect cost application. Indirect costs are those costs that are incurred for common or joint objectives and therefore can not be identified readily and specifically with a particular project.

Many at times firms may not realize that the number of indirect costs in their production lead to heavy losses eventually recorded by the firms. The enterprise must, therefore, examine these costs, re-engineer indirect business processes, and minimize non-value-added costs (Crow; 2002). The final step is that of measuring results and maintaining management focus. This is simply the going through of the targeted costs and the revenues realized. In this stage, the main point is to ensure that everything is in tandem with the projected/targeted works.

Application of Target costing by other organizations Target costing, is generally thought to have originated from Japan in the 1960's and it is therefore no surprise that many organizations in Japan have applied this technique and have benefitted from it. With the increased levels of competition among companies both locally and internationally, it has become imperative that modern day companies reach product-related cost, time, quality and functionality targets at the same time and at the maximum level possible; in order for them to develop sustainable competitive advantage through producing quality and functional products as demanded by the customers over a price determined by the market and to maintain <https://assignbuster.com/target-costing-essay-samples/>

their existence in the ever-changing environment. Toyota is a good example of a company that uses target costing as a method of profit maximization and cost minimization. Target costing, as it has been developed in Japan, was invented by Toyota in 1965. Thus, the use of target costing has a long tradition at Toyota.

At Toyota, they talk about cost planning and cost control, i. e. influencing product costs during the design phase and keeping the running costs as low as possible. Reducing cost through continuous improvement, “cost kaizen”, is becoming relatively less important, because the efforts made throughout the company will inevitably lead to fewer opportunities to cut costs. (Tanaka T 1993.) In 2005, Toyota moved past General Motors Company to become the largest auto manufacturer in the world.

Target costing in the Toyota case was put into effect in this manner, it was reported that Toyota’s approach to entering the U. S. market was a stealthy one by first being steadfast in achieving a certain net profit margin. Just like in the steps by Kenneth Crow, Toyota then had to determine what suitable price they had to set for them to convince a wide majority of the American population to buy the Japanese products. Third, since the difference was the cost of the car they could offer, Toyota designed the solution accordingly (Weeks; 2006). Essentially, it is many Japanese companies that have applied this technique.

The technique seems to have been more beneficial than of a liability. Nissan also applied this technique recorded profits in the automobile industry for many years. It is still recording profits though not as highly as expected.

Applicability of Target Costing to Merck Every company aims at maximizing profits and minimizing costs. This is difficult to attain with the ever increasing number of competitors in the various fields of business. For Merck, in the last 3-4 years the company has recorded a steady increase in the profit margins.

However, the cost of production has also increased rapidly. The number of competitors in the field has also been on the steady increase. For this reason, there is a general projection that the profit margin may start to decline in the near future. It is therefore imperative that this company puts into play this technique of management. Through this method, the company might be able to effectively compete with the increasing number of competitors while at the same time optimizing its profit and minimizing the costs.

How can this technique be implemented in Merck? Today, it is important that companies begin to manage costs of production way before production of the product begins. Merck is no exception to this, the company is faced by major cost minimization problems and therefore implementation of this technique requires that a company follows the right channels of implementation. In the book “ Hitting the Target” implementation of the target costing technique has been broken down into three stages; knowing about a new technique, putting the new technique to practice, and then being or institutionalizing the practice so it becomes a part of the organizational fabric. Merck requires following these steps in order to attain the full benefits of this technique. Knowing/learning more about the technique should be no problem to a company such as Merck.

Once the acquisition of the knowledge is gained putting it into practice and following it up are the steps that follow. However, for this technique, a change of management may be necessary at Merck. This kind of technique requires that people of the same ideas (contemporary ideas) be present in the same boardroom. Conflict in this kind of matter might not be the best of ideas. The management needs to look at their pricing policies and what dictates the prices charged by the company. In my view, it is the customer base that should be the greatest determinant of the price set.

All in all, target costing is a great management technique that has been used in many developed economies by companies that have a major impact in the world. Merck pharmaceuticals should put this technique to practice in order to maintain its increasing profit trend and to minimize the costs production.