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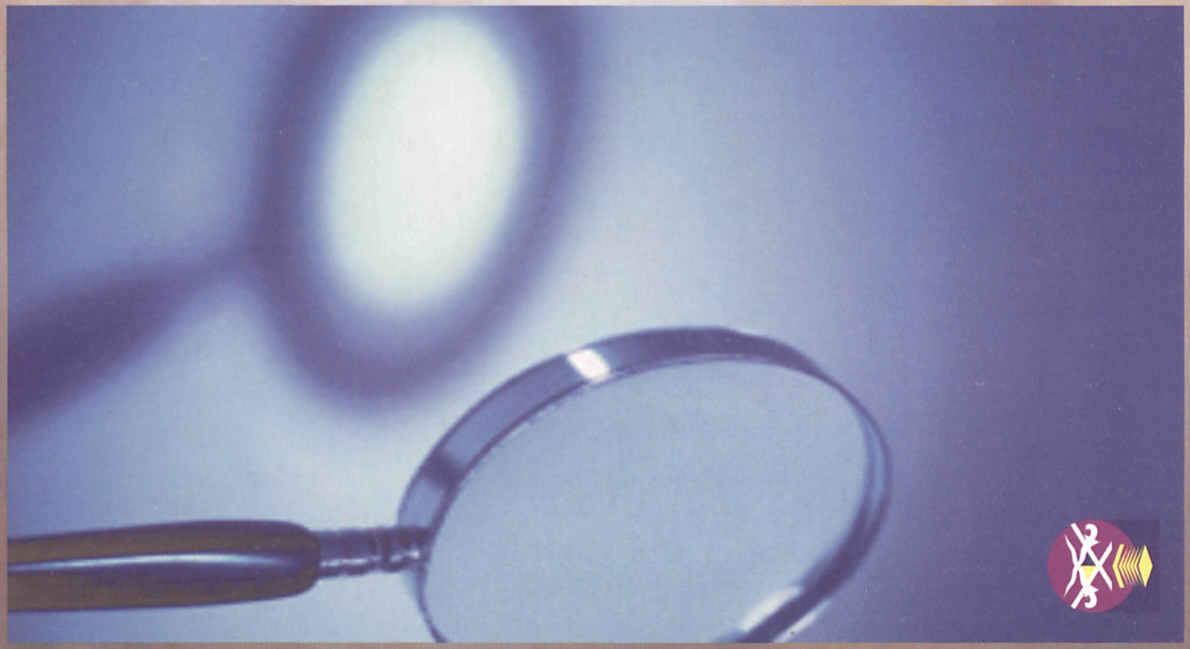

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KANDUNGAN

KANDUNGAN

13

TARGET COSTING: AN APPROACH TO COMPETITIVE ADVANTAGE

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ABSTRACT

In the quest to meet competitive challenges in today's business landscape, managers often find various options of positioning company's strategy. Regardless of their choices, differentiated or not, managers need tools and approaches that serve as an avenue to becoming better off than other companies. The writer envisages the use of target costing as one of the path to becoming competitive. Having determined the opportunities available in the market, overcome possible threats, identify the resources, capabilities and core competencies that the company possesses, craft the appropriate strategies, and then the implementation of the chosen alternative that requires basic tools, concepts and operational techniques that would lead to attaining competitiveness. And the writer believes target costing is one of those many avenues.

INTRODUCTION

This paper encompasses a 3-tier blend of strategic planning, management, and accounting in the quest of the author to adopt target costing, a management accounting concept, to be a strategically feasible concept in beating competitive challenges in the industry. The quest to becoming an industry leader is unending. But managers find that the harder they work to take the challenge, the more elusive the competition becomes. Innovative marketing strategies sometimes do not translate into competitive gains for the whole company as customers becomes powerful, as choices of products become aplenty. Thus loyalty of customers towards company's product reduces. When customers are powerful, they then can dictate the kind of product the company produces. Coupled with synergistic moves of other high players in the industry to gain added strength, companies have no alternative but to go back to basics i.e. initiating strategic competitiveness as early as initial product development. Yes, many large companies start competitive strategy at this early stage of the business chain of activities – initial product development and customer driven product.

Target costing is not new in developed and emerging countries. In Japan, target costing have three decades of history Kato (1993). In a research by Sakurai (1980), he discovers that 80% of major companies in assembly type industries of Japan have successfully adopted target costing. In a research conducted by the author in 2003, Malaysia's target costing adoption rate is low, that is, 29% of companies in manufacturing industries and 33 % amongst automotive manufacturers and assemblers. Target costing is adopted in all part of the world. They include assembly line industries such as, automobile, electronics, computer, furniture, and home appliances products. Other industries such as printing and publication also patronize target-costing system. Some of the users of this system include Isuzu Motors, Toyota, Nissan, Alps Electronics, Caterpillar, Daimler Chrysler, Boeing, Kodak, Sony and Komatsu Ltd of Japan.

Target Costing - A Competitive Move

Target costing is a strategic process of determining the maximum allowable cost of producing a customer driven product that can simultaneously achieve the companies desired above average profit.

The strategic process of launching a new product or even modifying and innovating existing products begins with the understanding and learning of various concepts. This includes:

1. The kind of product that fits the target market
2. Perceived value of the customers
3. Resources available (tangible and intangible)
4. Capabilities of the company
5. Core competencies
6. Industry attributes

Conceptually, managers should know-why these issues are significant before a new product is initiated. To put it in another way, linking the cause and effect relationship of designing a product to each of the aforementioned issues will yield the know-why concept. The team of managers needs to understand why the organization wants to produce, innovate or launch a new product at a given phase and production throughput is proven to be more effective in achieving a desired strategic goals rather than just enforcing workers to work for the day without knowing the 'why' factor. By making each team member and the whole organization aware of a new concept to be implemented or that the product is to be manufactured based on a predetermined maximum allowable cost (target cost) then everyone and even the lowest of the rank and file employees will be motivated to act in accordance with the set targets.

In target costing, first and foremost prior to preliminary designing of product, the team should identify the many faceted product attributes that fit the customer's needs. This requires the manager's deep understanding of consumers' needs. For instance in the case of automobiles, customers may have preference on style from the many functions of a car. They may be style, comfort, operationability, quality, color and attractiveness. With the customers' liking, companies eventually are expected to focus on producing a product that suits their taste. Unfortunately, many large companies produce products of the company's choice e.g. branded arm wristwatches. Keeping track of the customers changing culture and taste, a thorough investigative and scanning process is being undertaken to know the preferences of prospective buyers. Most competitive companies maintain information intelligence program to cipher out the changing and idiosyncratic needs of customers.

Customers perceived value of the product is relevant in establishing the kind of product that customers are willing to pay. Would the product be a truly unique and differentiated? Or would it be just for a smaller untapped segment? Or should the product be produced for a broad market segment with spice of uniqueness? These issues are significant in determining the target-selling price of the product. To arrive at the target-selling price a market research is conducted. Once the

selling price is obtained, the management would then compute the cost for which the product must be manufactured in order to provide the firm with an acceptable profit margin. Managers ought to benchmark the target selling price with its nearest rivals or probably if possible the entire industry.

Subsequently, another complimenting factor is a multidiscipline team so that the company can use leverage to grab the opportunities available. A team of both technical and professionals is required to initiate the preliminary planning (design) of the product. The team comprised of individuals from different disciplines i.e. product designer, draftsman, production expert, marketing manager, management and cost accountant, purchasing manager and packaging experts (if need be) whose main task is to formulate the design that is responsive to the customers' needs. In addition to skills and competencies, they need the tangible assets or facilities to facilitate designing process, monitoring inadequacies and implementing changes on prototype models to meet the required cost on every stage of the product life cycle.

The product life cycle begins at preliminary design stage, detailed design specification, prototyping, testing, production, growth, and maturity. The target costs are derived basically from these life stages. Envisaging the various costs consideration in each stage induces top management to strategically focus to zero out product and operational defects, as it affords no time for corrective measures in the future.

When conceptual issues are in place, the next phase of target costing is the implementation. This incorporates setting target cost in each of the stage mentioned earlier. For example, in detailed design and testing, material specifications, labor, production processes are identified so that costs can be ascertained. For the sake of right costing, various value chain activities are given equal consideration such as logistics, selling and distributions, customer service, human resources, and technology.

Hand-made prototype is assembled to exactly assess the product competitiveness. The team of managers would analyze the product in terms of materials composition, parts and materials used, processes used to manufacture and the total costs incurred at a given stage. Evaluation of current product attributes and its costs as projected enables the team to make design changes including the possibility of alternative material usage to suit the maximum allowable costs. For instance, if the projected actual costs were above the targeted cost the team would adopt to improving the production processes, efficiency and shorter production throughput to reach the target cost.

Target Pricing

One of the critical steps in target costing system is setting the target price. Companies normally have little or no control over the price of their products. At one end, companies are price takers as products prices are set by the customers and in another end are companies that control and dictate the price. Recognizing that a wide range of market forces influences prices, managers determine prices strictly on the basis of costs. In assembly industries, one major element is to

keep cost down by eliminating costs during the planning and design stages, set target cost for suppliers and uses cost reduction techniques when necessary.

Setting target price can be based on various market forces such customer's perceived value or how much they are prepared to pay for the product? Or what satisfaction customers get from it? Price charge by existing rivals is also considered in addition to the desired level of target profit of the company. The company can calculate target price of a new product based on the existing product's price plus the value of added functions recognized by customers. Other strategic options in pricing new products are: skimming and penetration pricing. The former would set high initial price for a new product in order to reap short- term profitability and gradually reduces the price over time while the latter sets low initial price in order to penetrate the market deeply and gain a large and broad market share.

Assigning of Target Costs to Product Functions

Prior to assignment of costs to function, managers are to evaluate the functions according to the customers' point of view of, as stated earlier that customers are the one who decides the market requirement. The total functional cost of the product is regarded as 100% and is to be apportioned to each function based on the customer's preference. A simplified example is shown below:

An automobile manufacturer wants to determine the cost to be allocated for the various functions of newly designed prototype, which will be launched at the end of the first quarter of the year. The team estimates the inbound logistics and processing activities will have an estimated target cost of RM 28,000 for a unit produced. Customer's preferences have been drawn from the company's product and market information system as indicated in the table. The assignment of target costs for a unit of car is shown below:

Figure 1: Allocation of Target Cost of a New Product (Automobile)

Functional Area	Customer Preference	Assigned Process Target Cost RM 28,000
Air-conditioning, Electrical & Tire	10 %	2,800
Body Design & Chassis	40%	11,200
Interior & Seats	15 %	4,200
Engine	20%	5,600
Durability	10%	2,800

In this instance, an automobile manufacturer is expected to focus on two functional areas of greater customers' preferences i.e. body design and engine.

Assigning Allowable Target Cost on Product Life Cycle

Assignment of target cost can also be made based on the entire product life cycle. Shown on Figure 2 is an example of the assignment process of a new automobile project. This hypothetical illustration of target cost's assignment would enable managers to come up with some logical reasoning to justify product's introduction. Ideally, revenues over its entire life cycle must be sufficient

to cover all the life cycle's costs to make firms achieve both short and long term financial objectives. Planning for and estimating that these life cycle costs are crucial steps prior to casting economic decisions, most especially when the products have short life cycles i.e. computers and electronic. For computers, electronic and other industries where products have shorter life i.e. a year or two, companies do not have the time to adjust its pricing or correct production process to ensure that products turns profit.

Figure 2: Target Cost Estimates Based on Product's Life Cycle (RM 000)

Life cycle Phase/Year	2004	2005	2006	2007
Product Planning & Concept Design	40			
Preliminary Designing	60			
Detailed Design & Testing	70			
Production & Environmental	900	4000	5000	1000
Distribution & Customer Service	100	450	600	100
Maturity			200	
Decline				90
Total	1170	4450	5800	1190
Sales	1800	8000	10000	1750
Margin	630	3550	4200	560
Percent	35	42	42	32

Strategy Support Services

Target costing is not a stand-alone tool. It requires infrastructure support to make it a success. Use of computerized system i.e. computer aided design software that is interconnected with the computerized costing system, is necessary to make alternations convenient.

Top management is expected to build multidiscipline team around and to give full support on the strategy to motivate the team and the whole organization to excel on its implementation activities thus achieve strategic goals – becoming competitive.

The use of Activity Based Costing (ABC) is appropriate as it induces the team to identify the activities that drives costs most in all the activity chains and possible cost reduction could be worthwhile to reach target cost.

Kaizen Costing could be used to monitor the costs from one point of activity to another over a given period. By maintaining cost statistics and tables in every stage enables the team to quickly tailor material specifications, labor and the whole chain of activities to meet the target cost in manufacturing a customer driven product.

Economic incentive to the team of target costing implementers is another issue: the ability of the team to steadily improve their skills and performance is an added value to the company which in

later years become its competence or a source of strength. Developing a product that matches the customer's needs at the unique company standards at allowable target costs establishes the company competitive success and becomes a platform for continuous growth and development.

Target Costing – A Big Shot

Target costing offers considerable benefits to those who understand the process. The salient of which are economic. It magnifies the power of the company to generate sales growth, cash and value of assets as the products turn to be more valuable to customers thus capturing the added value on its profit margin. The company is offering products at a price that is in harmony with the value paid by customers – competitive advantage.

The flexibility of target costing enables the company to orchestrate the product thus reduces market risk. With the team ever ready to reconfigure the product design and material specifications and processes based on its existing base of assets, the company would be able to respond quickly to new demands as they arise in the market. It does not need to wait and see what is going on in the industry. With this the company can continuously innovate its products based on the customers needs

However, there is a danger in target costing. The team and the whole organization can be tempted to go too far and convert the company to be totally engrossed into target cost without considering issues on environmental, community, other business and corporate strategies i.e. diversification. For instance, the company can establish a chain of geographical branches or strategic business units (SBU) in order to mobilize the accumulated assets to greater heights.

Conclusion

Many large and small companies use simple or sophisticated target costing system in the context of either new product introduction or modifying existing ones. Most of them conduct consumer analysis and component costs analysis to determine whether a new model can be profitably manufactured. In addition, cost reduction measures are pursued by these companies to ensure that the product can be produced to the target costs. Target costing system users can benefit in today's fierce competition by expanding sales and market growth, globalization and diversification – thus making them globally competitive. The use of target costing system rests upon the competence of the management to beating others in the industry.

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