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CUSTOMERS ARE THE KING OF THE MARKET: A PRICING APPROACH BASED ON THEIR OPINION - TARGET COSTING

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ABSTRACT

It is well recognized throughout the world that customers are the kings of the today's market. Their opinions are very vital at the time of designing of the products, features of the products and also at the time of fixing the price of the products. This is more applicable in the case of luxurious products. In target costing customers opinions are first taken to know how much price they are willing to provide for a product and based on this price, costs are determined and final decision are taken for the products. Customer's views play very vital role in decision-making process in target costing. At present the supply of products are more than the actual needs of the consumers in the business world and for this reason gradually manufacturer are going under the control of customers. Target costing is the way to win this situation.

KEYWORDS

Target costing, Pricing, Customers, Products, King of the Market.

I. INTRODUCTION

The world market is going to change from producer market to consumer market or from sellers market to buyers market. This drastic change is witnessing through the last two decades and it is increasing day by day. Earlier producer produced the products as per his own choice, preference and customers had to depend totally upon producer about new style, new design, price of the products etc. In the era of globalization and with the increasing of number of manufacturer/ producers/sellers, customer's choice gets high priority rather than sellers. Competitions among the sellers are very keen with the increasing of number of sellers for the same product. For example in colours television market there are number of manufacturers, like Samsung, Philips, Videocon, Sansui, Sony, Hyundai, Sanyo, Akai, Panasonic, Panorama, LG, Oscar, Santosh, Salaro, Peacon, etc. Some are of national wide business and some are of international wide business. Everyone wants to reach to the customers. To reach to the customers it is must to know what they want about quality, features, size and the price and they also want to pay for all of these. Hence price is the most considerable marketing mix to reach to the customers. From this view point target costing emerged.

Target costing emerged in Japan in 1960s as the responses of different market situation. Since the 1980s, target costing was widely recognized as a major factor for the superior competitive position of Japanese companies, extensive efforts have been made to convey target costing to Western companies. Many large companies in North America and Europe have tried to adopt target costing to enhance their cost management and, thus, increase their competitiveness. Consequently, many variations of target costing have been developed and are being used in different countries. It became popular when market changed from producer to buyers market, where buyers opinion about the products and obviously the price which they desire to pay for a packet of features of a product.

II. OBJECTIVES OF STUDY

Objectives of study are to provide an overview of the target costing and provide information about how target costing can help the businessman in today's competitive market.

III. TARGET COSTING AND TARGET COST: MEANING

Target costing is a method to decide how much maximum cost can be allowed for a particular product or service by taking market driven various considerations. It is a disciplined process that uses data and information in a logical series of steps to determine and achieve a target cost for the product. Target costing is a structured approach to determine the cost at which a proposed product with specified functionality and quality must be produced in order to generate the desired level of profitability at the product's anticipated sales price [Cooper, (1995)].

In addition, the price and cost are for specified product functionality, which is determined from understanding the needs of the customer and the willingness of the customer to pay for each function. To determine such maximum cost, at first market research is required to know how much maximum price is affordable by the customers. After knowing such price, the required rate of return is deducted from such prices to know target cost. So, it is clear that target cost is set-up by taking customers opinion about the price.

Therefore

Target cost = Target sale price --- Target profit/Required rate of return

For example, if target sale price is Rs.20 and if required rate of return is 20% on sale price then Target cost would be = Rs.20 --- 20% of Rs.20 = Rs.16

But this is not very easy task to know the target sale price, for this purpose a detail market research is required.

"Target cost is a product cost estimate derived by subtracting a desired profit margin from a competitive market price. This may be less than planned initial product cost, but will be expected to be achieved by the time the product reaches the mature production stage" – CIMA-London.

A target price is the estimated price for a product or service that potential customers will pay. The estimate is based on an understanding of customers' perceived value for a product or service and how competitors will price competing products or services [Horngren et al (2009)].

Another interesting aspect of Target Costing is its inherent recognition that there are important variables in the process that are essentially beyond the control of the design group or even the company. For example, the selling price is determined by the market place-- the global collection of customers, competitors and the general economic conditions at the time the product is being sold. The desired profit is another variable that is beyond the control of the organization. It may be set at the corporate level. It is influenced by the expectation of the stockholders and the financial markets. And, the desired profit is benchmarked against others in the same industry and against all businesses. In this complicated environment, it is the role of Target Costing to balance these external

variables and help to develop a product at a cost that is within the constraints imposed. In short, traditional approaches, such as simple "cost-plus" is a recipe for market failure, and giving the customers more than they are willing to pay for is a recipe for insolvency.

IV. OBJECTIVES OF TARGET COSTING

The main objective of target costing is to help the management to control the production cost, before the production has actually started. Cost control become more critical if production once started, as most of the cost reduction can do in design stages by altering product design and product features. Once product launched in the market, cost control become typically hard. To capture/win the market if price reduced or features changed after marketing the product, a negative impact may arises among the customers. So, it is better to pre-control the cost by taking the customers opinion regarding price, design etc. Furthermore cost reduction is not an easy task, it involves throughout every levels of the organization. It started at design stage and end at after sale services.

V. TARGET COSTING PRINCIPLES

Target costing can be described as a systematic process of cost management and profit planning. The six key principles of target costing are¹:

- 1. Price-led costing:** Market prices are used to determine allowable or target costs. Target costs are calculated using a formula similar to the following: market price – required profit margin = target cost.
- 2. Focus on customers:** Customer requirements for quality, cost, and time are simultaneously incorporated in product and process decisions and guide cost analysis. The value (to the customer) of any features and functionality built into the product must be greater than the cost of providing those features and functionality.
- 3. Focus on design:** Cost control is emphasized at the product and process design stage. Therefore, engineering changes must occur before production begins, resulting in lower costs and reduced "time-to-market" for new products.
- 4. Cross-functional involvement:** Cross-functional product and process teams are responsible for the entire product from initial concept through final production.
- 5. Value-chain involvement:** All members of the value chain—e.g., suppliers, distributors, service providers, and customers are included in the target costing process.
- 6. A life-cycle orientation:** Total life-cycle costs are minimized for both the producer and the customer. Life-cycle costs include purchase price, operating costs, maintenance, and distribution costs.

VI. IMPLEMENTATION OF TARGET COSTING

The following steps are required to implement target costing:

Step-I Decision about products: At first stage organization / company has to decide about the product, whether a totally new product to be launched or an existing product to be continue by altering its features and price. A right decision is require taking in this stage by considering the market situation and obviously the company's financial background or availability of financial resources for such decision.

Step-II: Market research about products and price: If decision is for new product then company must be cautious about its launching, as launching of new product is more risky than alteration of an existing product. Product may or may not be accepted by the customers, but this is not so in case of an existing product. Research for market demand and price is very vital.

For e.g. a book publisher may plan for production of a calculator based dictionary, i.e. just putting the word in calculator we can know the meaning of the word with the different language option. This dictionary may be named micro-dictionary. For such product plan, demand analysis and price analysis is must by taking demand and price of existing book based dictionary.

For existing product, some alternation is desirable to catch the market. Just for example, a mobile phone manufacturer may plan for adding some extra features in mobile. E.g. a mobile based dictionary or adding a mechanism to inform about the temperature etc. Such additional features will be very attractive to the students. After coming to positive decision, phone manufacturer require to know how much maximum price can be allowable by the customers for such extra features.

Step-III: Decision regarding profit or required rate of return: In this stage company/organization require to take decision regarding rate of return on the fund to be invested for the products. For taking such decision company's financial position, state and country's economic position and obviously the industries position regarding rate of return require to be taken into consideration.

Step-IV: Establishment of target cost: From target price, target profit is required to deduct to find out the target cost. This cost are further broken down in to various cost component like material, labour, overhead, after sales service cost etc or into prime cost, work cost, cost of sales etc to properly analysis and control the cost, so that main object can be achieved i.e. production within the target cost.

Step-V: Analysis of target cost: After getting the target cost, a details analysis is require to know whether such cost is permissible or not for such product. To achieve such target cost a group is required to form by taking the representatives from different departments of the organization. Like representative from purchase department, production department, sales department, market research department, finance department etc.

Product design and engineering department play a very vital role to achieve such target cost. Proper designing is also crucial as cost is varying from one design to another design. Cost determination section of production department regularly reviews the cost and ascertains the different cost sheet for finding out the costs for different design of the product but with the same features. Design, which is able to produce the product within the target cost, is finally selected for production purpose.

Step-VI: Pilot testing or test production: After selection of final design/process a test/samples production is done. That samples are checked mainly from two angle i) Cost of the product and ii) Features of the product.

If cost is seen within the allowable cost then it selected for mass production but if not then a details cost analysis is require to reduce the cost. Different cost reduction technique like "Kaizen analysis" may be adopted. But here cost reduction should understood as per CIMA's definition of cost reduction ---" cost reduction is to understood as the achievement of real and permanent reduction in the unit costs of goods manufactured or services rendered *without impairing their suitability for the use intended.*"

In an organization cost reduction are normally done throughout the different departments of the organization. It involves the following areas – design stage, factory organization and production stage, marketing stage, administration stage, finance stage etc. For this reason, representatives come from different departments. If features of the product are designed as per our requirement, then it becomes acceptable but if not then again redesign is required.

Step-VII: Mass productions and continuous cost analysis to reach far below than the target cost: If target cost is achieved then mass production is started. But continuous cost analysis is must to reduce the price of the product, as at any time new competitors may come with low price. This cost analysis or value engineering normally is done throughout the product life cycle to capture more and more market. But today's customers never compromise with the quality (particularly in developed country) that must be kept in mind at the time of implementing the target costing.

So in very brief the process of target costing requires the following steps:

- Determine the target price that customers are willing to pay for the products/ services for a bundle of features.
- Determine the target profit margin by taking into account the cost of funds and other related factors.
- Determine the target cost by deducting the target profit from the target price.

¹ These principles are adopted from S. Ansari, J. Bell, and the CAM-I Target Cost Core Group, *Target Costing, The Next Frontier in Strategic Cost Management*, Irwin, Chicago, 1997.

- Establish a cross functional team by taking persons from various departments that to be involved in every stages of the production, starting from design stage.
- Determine the probable actual cost of the product.
- If the probable actual cost is higher than the target cost then investigate to find out the way to reduce the probable cost within the maximum limit of the target cost.
- Continuously pursue the cost reduction process to reduce further cost to win the market competition.

VII. COMPANIES OR AREAS WHERE TARGET COSTING IS APPLICABLE

- If company desiring to introduced any new product to the market, customers opinion relating to price is must to get success.
- If company go to alter the features of a product i.e. addition or deletion of features of an existing product.
- Where the market is a totally customer oriented.
- Where the number of sellers is relatively higher comparing to the number of customers.
- In case to supply to the wholesale markets or company buyers.
- For export order supply.

The following companies are usually following the target costing pricing: Motorola, General Motors, Ford, Toyota, Nissan, Honda, Mitsubishi and General Electric etc. Most of the cars manufacturing companies are also follow the target costing pricing.

VIII. MAJOR ADVANTAGES OF TARGET COSTING

- Proactive approaches to cost control.
- Customers oriented technique, so customers are benefited.
- Departmental unity increases, as every department work together to achieve target cost or helps to break down the departmental barriers.
- Helps to eliminate non-value added activities.
- Its implementation increases awareness among the employees.
- Leads to improve the relationship between customers and suppliers.
- Easy to achieve financial target if it implemented in proper way.
- Increases the awareness to improve the product features.
- Future product planning became easy.
- Always make awareness about customers, market, and competitors.

IX. MAJOR DRAWBACKS OF TARGET COSTING

- Co-operation among the different departments is must; otherwise it cannot be success.
- To reduce the cost, inferior components may be used. It can reduce the quality of product.
- Details of cost data are require maintaining for properly implementation of target costing.
- Production decision may delay due to not achieving the target cost.
- Once target achieved it cannot be fixed, again new target come.
- It involves lot of research and development cost.
- Success of target costing depends upon proper market information, if information is not proper then target also to be wrong.

X. EXAMPLE OF TARGET COSTING:

Light and Battery India Ltd find a market niche for emergency light with certain new features --- like a mobile charging point and small two blades fan with emergency light. The marketing department believes as per marketing information that a price of Rs. 850 would be right for the emergency light. At that price, marketing department estimates that 5,000 emergency lights could be sold annually. To design, develop and produce this emergency light an investment of Rs. 85,00,000 would be required. The company desire 12.5% return on investment (ROI).

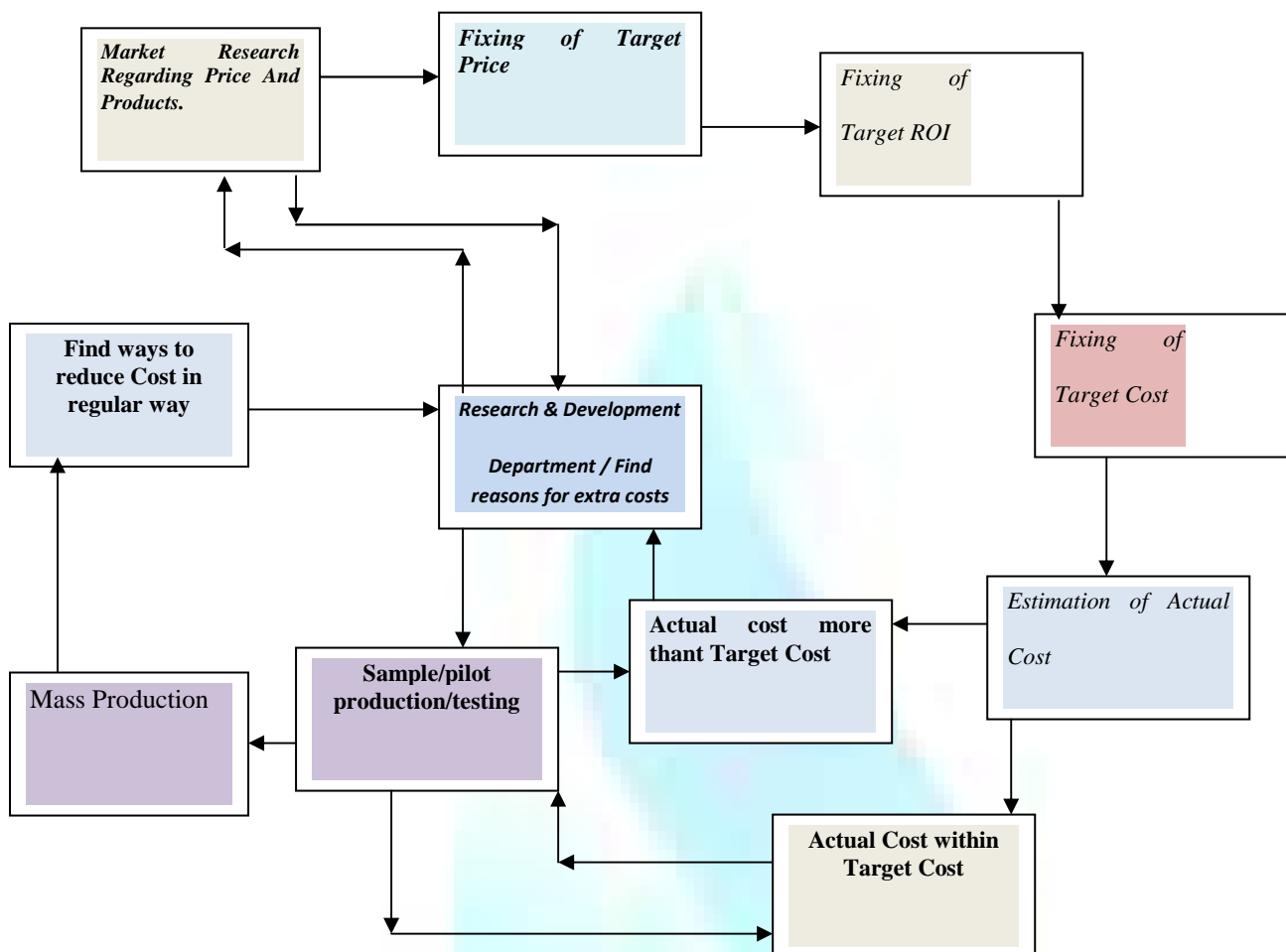
Based on above data the target cost per emergency light would be:

	Rs.
Projected sales	42,50,000
(5,000 emergency light @ Rs.850 per light)	
Less : desired return	10,62,500
(12.5% on Rs.85,00,000)	
Target cost	31,87,500
Target cost per emergency light	637.50
(Rs.31,87,500 / 5,000)	

This target cost of Rs. 637.50 would be broken down into target cost for the various departments like: Manufacturing, Marketing, Distribution, after sale service etc. Each functional department would be responsible for keeping its actual cost within target. The functional cost may be in the ratio of 10:4: 3:1 then the details cost structure would be:

	Rs.
Manufacturing cost	354.17
Marketing cost	141.67
Distribution cost	106.25
After sales service cost	35.41
	637.50

GRAPHICAL PRESENTATION OF TARGET COSTING



XI. CONCLUSION

Customer's opinion plays a very vital role in modern competitive business world. Competition is very keen among the businessman in a single market to win the market place. Customers are very aware about the price of the products and their quality. To reach more close to consumers it is very necessary to give more importance on what are the needs of customers and what price they want to pay for such needs. Pricing play an important role in selection of products by the consumers and today's consumers are highly price sensitive. Here target costing provides proper root to cover/win the market by taking consumer opinion about the pricing and properly set the price of a product. Naturally organization follow target costing at the time of fixing the price of a product is in more advantageous position than the competitors.

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