Business Growth Hub

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Factsheet

Target Cost and Market Pricing Model

You would use this approach to ensure that new and existing products and services meet customer price expectations and also deliver sufficient profit to your company.

Projected performance gains

New

- Products or services that can be sold at an acceptable price and profit level.

What investment is needed to understand the concept?

DIFFICULTY

Medium

Requires some reading around the subject and use of standard handouts.

ACTIVITY

Team and Individual

This approach can be used by a team or individual.

EQUIPMENT

Microsoft Excel

This software will help you to work through this approach and keep track of figures.

Explanation of the concept

Developing new products and services can be costly and time consuming. Unfortunately some companies end up with products and services which are too expensive or have to be sold below target profit levels to get customers interested.

Market Pricing is a concept that proposes that Customers will only pay what they believe to be a reasonable price for a product or service. This means that whatever new product or service a company develops, it needs to meet the Customers price expectations.

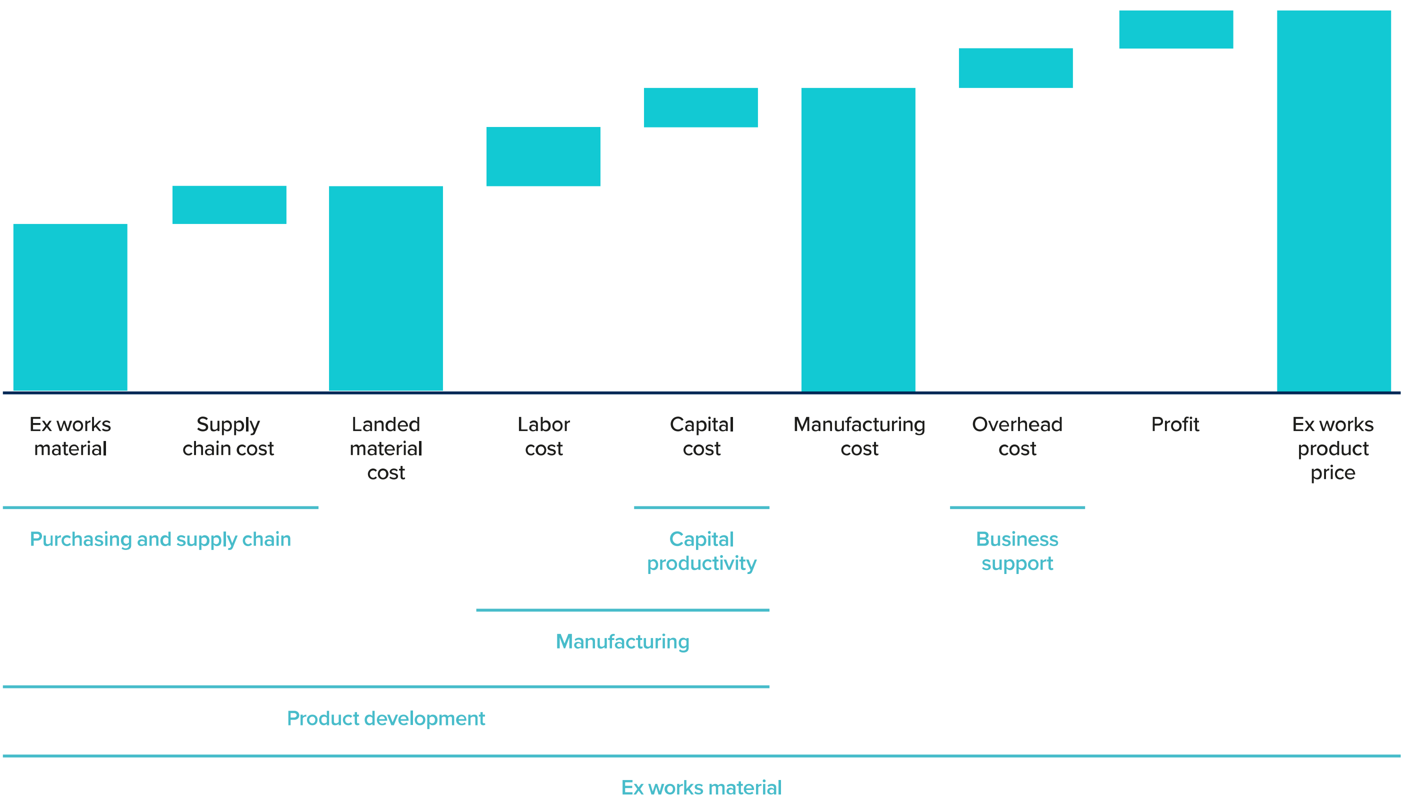
Target Pricing is a concept that proposes that from the very outset of new product/service development, the potential

Market Price needs to be the target. Target pricing also gives us a simple calculation:

Manufacturing Cost + Profit = Market Price

Practically what this means is that all elements of the Manufacturing Cost need to be carefully managed through the development cycle. Major elements such as the costed BOM (Bill Of Materials), labour, machine depreciation, overhead and energy costs all need to have their own individual targets that are carefully managed through the development process. For existing products and services, starting with the Market Price and working backwards to protect the Profit margin will tell you how much the maximum Manufacturing Cost can be.

Diagram to show cost build up



Activity Based Costing (ABC) is an alternative method which is commonly used in manufacturing as it accounts for the true cost of production by including overheads and indirect costs like salaries. This can be a useful starting point, and there is value is learning more about this method.

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What action should I take?

1. Set the Target Price (generally the Market Price in reality)

2. Calculate the required Profit and use this to calculate the maximum Manufacturing Cost

3. Identify cost reduction opportunities in the costed BOM (Bill Of Materials), labour, machine depreciation, overhead and energy costs

4. Put together a plan of action to reduce costs

Recommended resources

Cooper. R., & Slagmulder. R. (1997). Target Costing and Value Engineering. Productivity Press. ISBN: 978-1563271724

Monden. Y. (1997). Toyota Management System - Linking the Seven Key Functional Areas. Routledge. ISBN: 978-0203735350

What is Activity-Based Costing (ABC)?: https://www.investopedia.com/terms/a/abc.asp

Glossary

Market Price: What the customer/market is prepared to pay

Target Price: The target price for a new product or to cost reduce an existing product to

Profit Margin: Difference between Manufacturing Cost and sales price

Manufacturing Cost: In this case, all of the costs of manufacturing the product including the materials in the costed

BOM (Bill Of Materials): Labour, machine depreciation, overheads and energy costs.

Activity Based Costing (ABC): A costing method that accounts for overheads and indirect costs in production or products and services.