Beyond ABC: Targeting costing for profit enhancement
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Beyond ABC: Target Costing for Profit Enhancement

Mark Green/FPG

A textile manufacturer aims to reduce costs before they are incurred.

BY JOHN M. BRAUSCH, CMA

Lybrand Bronze Medal Winner, 1993-94

Target costing is a strategic management tool that seeks to reduce a product's cost over its lifetime. Target costing presumes interaction between cost accounting and the rest of the firm; well-executed, long-range profit planning; and a commitment to continuous cost reduction. Its application in Japan has been well documented, but American firms also can use it to understand costs better and to enhance long-term profitability. One American firm recently implemented target costing, and the results have exceeded the firm's expectations.

Culp, Inc., a $260-million textile manufacturer for the home furnishings industry, has just completed the final stages of implementation of its newly designed costing system. We began the project in 1988 when we realized the need for better cost management and have worked tirelessly since then in an ongoing cost management evolution. Our journey has led us to a realization that cost management is different from other accounting efforts, and we have undertaken a target costing program to help us build profits and decrease the cost of our products at the design stage.

We implemented this system by using a team approach to cost management and by bringing together the divergent groups in the company—accounting, finance, engineering, and operations—to make our cost system as up-to-the-minute as possible.

The target cost is the price customers are willing to pay for a product less the profit we must receive for making that same product. The difference between the two becomes our product cost. It is the cost at which we must produce an item in the long run. Typically, American manufacturers have said: Here is my cost. I have to receive a certain profit contribution rate above that, so consequently I must sell my product for this price (cost/(1-needed profit margin). Target costing reverses several decades of American pricing strategy by taking into account that our customers do not care about our costs—only about their own. Our selling price is their cost, and there the customer's concern ends.

CHANGING THE CORPORATE MINDSET

Our philosophy was simple: that cost management is one of the most strategically imperative areas of the firm. It combines the efforts of marketing, operations, and accounting and presumes a relationship with and working knowledge of each to be successful. This relationship and working knowledge were achieved by integrating cost management with the other activities of the firm and no longer treating cost accountants as after-the-fact scorekeepers.

Our No. 1 maxim of cost management is: Unless cost management is treated as a viable part of the firm's strategic direction, ongoing cost management efforts are doomed to failure. In most cases, including our own, cost management efforts are preset for failure if the cost accountants are treated as bean counters destined to crunch a lot of numbers without any input or explanation as to why the numbers are the way they are.

THREE STRATEGIES

In an article in the August 1993 issue of MANAGEMENT ACCOUNTING®, "Strategic Management Accounting—How and Why," authors Johnson and Kawada posit that two schools of management accounting thought have emerged: the accuracy school and the strategy school. These schools of thought are said to have one thing in common: disdain for traditional financial accounting and an awareness that management accounting sys-

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Author John Brausch (l.) greets Nathan Garrett, chairman of the National Association of State Boards of Accountancy, at a recent Piedmont High Point Chapter meeting.

tems must be separate from financial accounting systems.

At Culp we recognized the importance of breaking down the attitudinal barriers of the firm toward cost management. As our cost management system evolved we began, first, to recognize the distinction between managerial and financial accounting. Second, we joined the accuracy school, and, last, we saw the viewpoint of the strategy school and the importance of strategic cost management to our firm's corporate direction.

Strategy No. 1: Recognizing the differences between managerial and financial accounting. Although most readers of MANAGEMENT ACCOUNTING® are well versed in the differences between financial and managerial accounting, most business leaders are not. Most of them feel that accounting figures can be massaged to produce any output for any particular application. Because most firms' accounting efforts have been designed to meet the needs of financial accounting, managerial accounting, if it is considered at all, is thought of only as a subset of financial accounting.

Even among accountants, cost accounting has received scant attention. Few CFOs and even fewer CEOs have any type of background in cost management. Typically, CFOs come from public accounting firms. They are well versed in financial accounting but have little knowledge of the intricacies inherent to cost management. Auditing, tax, and financial management have been seen as the glamour fields within accounting. The evolving attitude is toward an obsession to manage by the numbers, whereas cost management relies more on an operation's processes and much less on GAAP.

Financial accounting's edicts result in a lack of interest in both the processes and the people involved and a corporate dictum to make the numbers look good. The people who are managing by the numbers rarely visit the shop floors, have no concept of the manufacturing or service processes, and do not have the patience to allow for the implementation of long-term corrections rather than short-term fixes. Today's profit and loss statement rather than tomorrow's competitive position is what drives management by the numbers.

This attitude affects cost management in two ways. First, cost management, to be successful, requires understanding the business processes. Second, proper cost management cannot be achieved in the short run by a quick fix. What is necessary is a long-term commitment to learning the business and building a managerial accounting system to fit the operational cycles of the firm.

Unfortunately, cost management is competing against other areas for the firm's scarce resources. Its advocates are left at a huge disadvantage because top financial management generally doesn't understand cost management or the processes that cost management seeks to address. A recent study by the Controller's Council of the Institute of Management Accountants indicated that cost accounting ranked dead last in terms of resources consumed by accounting functions. To quote that study: "Many firms of all sizes do no cost accounting or managerial accounting whatsoever. Even in manufacturing, cost and managerial accounting receive meager support."

The second difficulty management accountants must overcome has to do with financial accounting numbers. The case has been well made by numerous academicians and practitioners that the outputs of financial accounting simply are not sufficient for management's needs. The information is both too late and too aggregated to be of much good to anyone other than the IRS and the SEC. Unfortunately, most firms are not willing to invest the time and money necessary to develop separate managerial accounting systems. Instead, they ask the management accountants to provide internal financial information based on externally derived systems.

At Culp, our first goal was to separate the functions of managerial and financial accounting so that each could serve its customers to the best advantage. This separation is important to any management accounting system evolution. We do not ask salespeople to present the same proposals to every customer, yet we ask accountants to use the same information and make it work for management, the investment community, the IRS and SEC, and all of the other groups our information affects. As management accounting practitioners, we must realize that these groups need different information just as the firm's customers need to know about different aspects of what our firm can provide.

Strategy No. 2: Accurate product costing. The accuracy school of cost management obviously is concerned with accurate product costs. We began our cost effort firmly in this camp. In the words of our CEO, our mission from the project's beginning was to "get product costs as close to actual as possible." Although this goal may sound simplistic, achieving it was not easy.

We knew that in most of our divisions our costs were accurate in the aggregate. That is, our budgeted costs and actual costs were closely related. Unfortunately, as in so many companies, our individual product costs were terribly misstated. Our system worked on a modified welfare basis, penalizing profitable products with unwarranted costs and subsidizing losing products by channeling their costs elsewhere. At the same time we reported all product costs to the fourth decimal place, intimating a level of accuracy that the cost department (and almost everyone else) knew was not there. Unfortunately, many of the users of the information

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in design, marketing, and manufacturing derived a false sense of comfort from it, which inevitably led them to poor decisions about the products. Many of these decisions could have been avoided by involving the management accountants in the decision-making processes and by changing the role of the cost group from team statistician to team player.

To involve management accountants in the process required an admission that our product costs were not accurate and that the decision makers should not rely on them. This admission then forced a decision: either the costs were worth knowing or they were not. If so, we had better improve their accuracy. If not, then why cost products at all? If costing were used only to value inventory, we could devise a much simpler system to do it. GAAP requires nothing as sophisticated as our previous cost system for inventory valuation, and said sophistication was too expensive to maintain if it were of no further value to us internally.

Inevitably, we concluded that these product costs were important and that we had better make them as accurate as possible. This decision in turn led to representatives from all areas of the company working together, first, to understand what makes up a given product's costs and, second, to do whatever was necessary to reflect those costs accurately in our cost management system. Over time, as the entire company began to regain faith in the system's output, these decision makers concluded that each of their actions played a large part in determining and then lowering product costs. This revelation led us in turn to the third strategy.

Strategy No. 3: Going from the accuracy school to target costing. Costing products accurately is a worthy goal. Accurate product costing, however, in and of itself does little to improve the firm's strategic position and does nothing to reduce costs. We concluded that reporting the same costs accurately was not as important to us as using cost management to make more money for our firm. The strategy school suggests that cost management can be used to meet predefined strategic goals extrinsic to cost management. After gaining a level of comfort with the information provided by cost management, we decided to change the thrust of what we were trying to accomplish. As we learned more about the activities that consumed costs we realized that we could do much to limit them. One of the premises of activity-based costing is not just to learn more about costs but to make the decisions that will bear directly on them.

One of the ways we have decreased costs is by implementing target costing at the design stage. As we worked on our cost management systems, we soon realized that well over four-fifths of our costs were built into the product at the design stage. In our previous cost reduction efforts we spent 100% of our time in reducing the 20% of the costs not necessarily designed into the product and left the 80% of costs to do as they pleased.

Understanding the nature of cost buildup was an important lesson for us. We discovered that our manufacturing costs were incurred as a result of the product and process characteristics. The processes in turn were driven by what we were producing at any given time. Through our cost management implementation efforts, we became aware that the overwhelming majority of costs were created and built into our products before we ever began the manufacturing process. Our previous efforts to reduce costs had been little more than after-the-fact tinkering,

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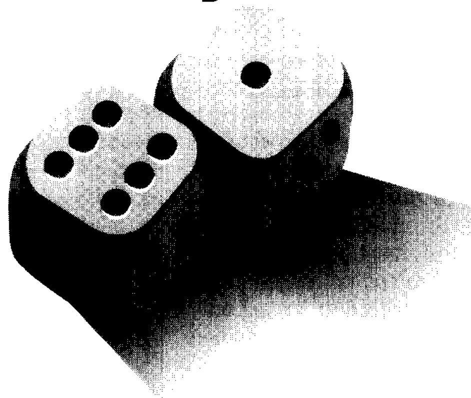
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while our current efforts address reducing còsts before they are incurred.

Because we are in the decorative fabric business, design is a major part of the firm's manufacturing process. Our design staff constantly is developing new products with new applications for new markets. The design staff is good, but it never purposely designed for profitability. Because cost management is now considered such an integral part of our corporate efforts it seemed only natural that the cost management and design teams would work closely together to develop a mechanism to design more effectively for profitability. The result is that target costing goals have been developed for each of our product lines and are being built into all our new products as they are introduced.

APPLYING TARGET COSTING

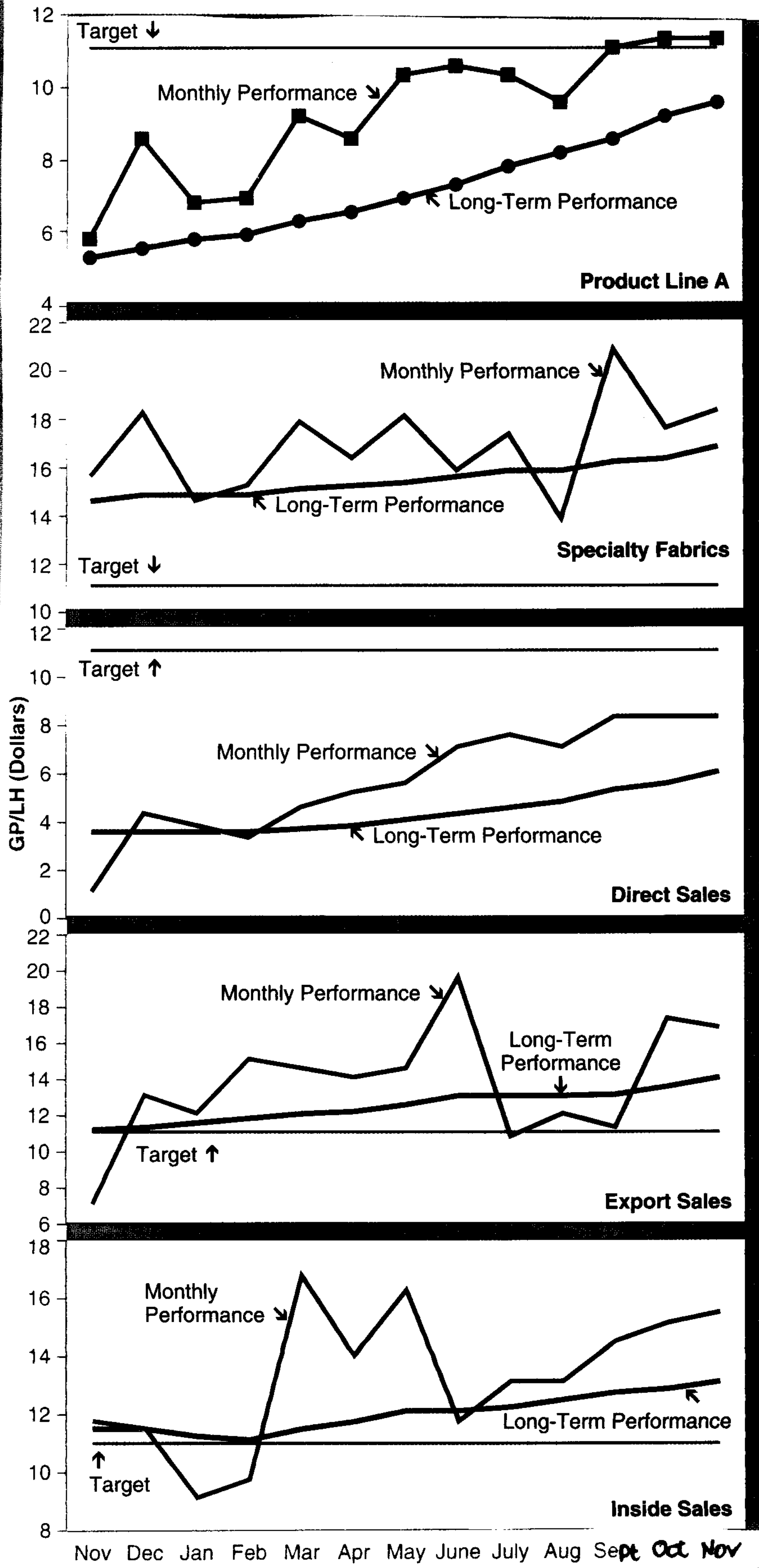
With target costing, the pricing decision becomes the focal point of our efforts, not the product's cost. In our case this information was readily available because our product's perceived value (selling price) is easily determined based on the "look" of the product. In many industries this information may not be so easy to obtain, but it is the genesis of any target costing effort. The focus is much more external in lowering costs to meet customer demands as opposed to an internal focus of meeting internal standards.

Our second focus is on our profit plan. Medium to long-term profit planning must be in place to incorporate target costing. This longer-run (as opposed to very near-term) profitability assessment is crucial because the target cost may not be achievable immediately but rather may be reached over time. Without forward thinking about longer-term profit positioning, management may exert pressure to lower costs unrealistically because of a short-term profit squeeze. Too much of this short-term profit pressure has a couple of results:

- Rejecting perfectly profitable products, or
- Lowering "standard" costs to appear profitable when in reality said costs cannot be achieved even in the long run.

It is crucial therefore to be forward looking in our target costing efforts and to position a product realistically over its life span. This philosophy is

FIGURE 1 / PRODUCT LINE A GP/LH — ACTUAL VS. TARGET



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similar to previous attitudes about standards being both challenging and attainable. We are attempting constantly to achieve better results but are careful not to set unrealistic goals that might destroy morale.

Target costing is not a costing issue. In fact, our target costing program hasn't had an impact on how we cost products but rather has affected the way in which we use the costing information already available to us through our cost management efforts. The information has altered our fundamental approach to products and their profitability. New product introductions must meet certain profit targets. If targets are not met, then the products are continually redesigned until they meet said goals. This continual redesigning process presumes that the target cost can be reached while attaining the same selling price through the perceived value in the product.

The single largest change in our thinking has been to stop reporting what products *should* cost and instead to report what products *will* cost. We have focused our attention on getting costs out of the product during the design stage. This proactive concentration on the product's cost allows us to prevent costs rather than reduce them after the fact. This concentrated effort in turn pushes us to constant improvement in our design for manufacturability, the number of components used in the process, and the flow of products through the manufacturing pipeline. Now we are concentrating on reducing costs continuously rather than going on periodic cost reduction binges or reporting the costs we have incurred even more accurately.

Please realize that our goal is not so much cost reduction as it is profit enhancement. The long-running intracompany comment is that we were becoming a world-class company in every area but one—making money. We are using target costing to help us become world class in this area as well.

In setting and meeting our target costing goals we also have focused less on single products and more on product groups. At any given time there will be several products within a group that do not meet our goals for a variety of reasons. Our efforts are expended on assuring that the entire group is above goal and that the group's compensation and standing are based on the entire portfolio's standing. The key to any single product is to achieve the targets over the product's lifetime through improvements in the way we manufacture it.

Figure 1 illustrates one product line's performance measured against goal for the last 13 months. Our profit goals are measured on a gross profit (before salary, general, and administrative expenses) contribution per machine hour basis as opposed to a straight profit margin basis. We measure profits this way because machine hours are much more restricted than output based on our manufacturing process—our products vary greatly in the manufacturing time needed to complete them. This time constraint makes profit turnover more important than profit margin. Figure 1 measures each month individually and also provides a longer-term rolling average performance measurement to mark our progress better over time.

This product line's performance then is measured by each of our four marketing groups (see Figure 1) to find out whether goals are being met through each specific marketing channel. Products we once considered homogeneous in terms of marketing behave very differently from a profit standpoint, depending on the marketing channel used. Although we do not yet understand all of the differences involved, we are trying to discover how and why the varied channel characteristics affect company profitability.

We believe that target costing can play a major role in many firms. Although it is used primarily in Japan, American companies can adopt the practice and accrue the benefits resulting from this application of strategic cost management. Cost management can play a major part in any firm's strategic efforts. Management accountants must become involved in the strategic decision-making processes of their firms. They have a wealth of information about the firm and its operating conditions. It is up to each of us, as management accountants, to make our knowledge more accessible to the firm's decision makers. ■

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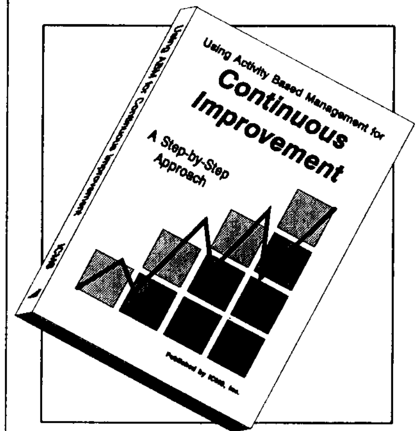

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