Supply management’s involvement in the target costing process

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Abstract

This article investigates the role of purchasing/supply management in the target costing process. It is based on case studies of eleven firms that use target costing. In addition to exploring the role of purchasing, purchasing’s interface with suppliers was investigated.

Research results indicate that supply management plays a substantial role throughout the target costing process. Its contribution is particularly critical at the initial stages, when developing component level target costs, and when activities/modifications are occurring to achieve target costs. Supply management also plays a lead role in managing, monitoring and improving costs.

Importantly, there is no single function that is more important than others in target costing. A cross-functional team approach, including suppliers, is critical to the long-term success of target costing efforts.

Keywords: Target costing; Supply management; Case study

Target costing has been recognized as an important tool for lowering costs and increasing competitiveness for over a decade. A 1991 Fortune Magazine article touted target costing as “Japan’s smart secret weapon” (Worthy, 1991). Target costing is a process whereby an organization determines the “estimated selling price” for its product or service, less the “desired profit,” with the remainder equaling the “target cost.” The target cost amount must cover all of the firm’s expenses for producing/procuring the product or service: purchased-in costs, costs of production and other operating costs such as marketing, sales and research expenses. Given that external purchases constitute approximately 60 percent of the cost of sales for most manufacturers and around 25 percent of the cost of sales for service providers, external suppliers have a significant impact on a firm’s ability to achieve desired target costs.

The purpose of this research is to explore the role of the purchasing function and its relationship to suppliers as it affects the target costing process in western-economy, primarily US-based, companies. While the role of suppliers in target costing has been emphasized in previous studies (Cooper and Slagmulder, 1997), how suppliers interface with the buying organization has been less well understood (Ellram, 1999). Thus, this paper explores the interaction between purchasing, which is generally the primary interface with suppliers, and suppliers in the target costing process.

After a brief explanation of target costing and a review of the literature related to target costing, this paper presents the results of an in-depth study of eleven organizations involved in target costing. The research questions explored here are:

Research Question 1: What is the level of supply management’s involvement in the target costing process of the organization?

Research Question 2: What is the nature of supply management’s involvement in the target costing process?

Research Question 3: What is the level of supplier involvement in target costing, and how does supply management support supplier involvement in target costing?

Research Question 4: What is the general accountability, and specifically supply management’s accountability, in the target costing process?

The purpose is to gain an appreciation of the nature and level of supply management’s involvement in and accountability for the target costing process of an organization.
1. What is target costing?

As demonstrated in Fig. 1, target costing encompasses a whole range of activities and inputs that are internal and external to the organization. This paper takes the perspective followed in Fig. 1, that the target costing process is being used for a new product or service. The target costing process begins with developing an understanding of unmet needs in the marketplace, and then determining what customers would pay to have their needs met, the “target price.” Internal goals and pressures determine the profit margin desired. Calculating the allowable target cost is the next step, where:

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\text{Target cost allowed} = \frac{\text{estimated selling price}}{\text{desired profit}}.
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During the next step, the target cost is apportioned among the key cost elements, and further broken down to the materials or component level. This is the level at which the organization actually tries to manage the cost elements. Based on the component level goals or targets, the next step involves undertaking various cost management activities to achieve the target component/materials prices. This aspect of the target costing process is presented in more depth below. Once the target costs are achieved, the item goes into production, and continuous improvement measures are implemented. The activities that make up the target costing process cut across functional boundaries within the firm and organizational boundaries in the supply chain.

2. Context of the study

Much of prior target costing research focuses on a single case study of an automotive or electronics company, explaining how target costing is performed in one or two firms. Many of these articles take an accounting perspective, providing insights into the accounting implications of target costing, or its general usefulness (Brausch, 1995; Fisher, 1995; Kato et al., 1995; Morgan, 1993; Baker, 1995). Most research, even two entire books dedicated to target costing (Cooper and Slagmulder, 1997; Ansari and Bell, 1997) fail to
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