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The relationship between target costing and value-based pricing and presenting an aggregate model based on customers' expectations

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Abstract:

Competition is the outstanding characteristic of today's business environment. The struggle to win more customers is increasing. There is not any manufacturing, service and business which can survive without satisfied customers. The thing that is more important is that wants, demands and expectations of the customers are increasing daily and this trend will be accompanied with great developments. This fact has forced the businesses consider the customers' expectations as an approach which is very important in keeping the long-term relationship with customers. Meanwhile, some approaches such as target costing and value-based pricing have been applied mostly as a result of considering these long-term relationships in industries. As a principle and efficient tool in management, target costing is considered as a multi-dimensional approach for designing the products to manage the price and reduce cost. In this method, based on surveys in the market, the sale price for the products is anticipated before production processes start and then the business try to design and produce the product based on the predetermined cost to achieve the profit intended by the management and at the same time entail desired quality and competitive conditions in a way that it can result in customers' satisfaction as they deserve. In value-based pricing, the customers' cognition is used as the key criterion in pricing and it should be noted here that the value for customer does not mean low prices for the product or the service. In this article, we will focus on the most important relationships between these two approaches. Customer orientation is the distribution of data related to the customers in the whole organization, devising strategies and tactics to meet the needs of the market practically and by all parts in an organization and achieving general commitment by all personnel regarding the programs devised. Finally, an integrated model based on the expectations of the customers will be presented in which the quality and the cost expected by the customers is considered as the principal factors.

Keywords: Customer Orientation, Target Costing, Value-based Pricing, Customer Relationship Management, Customers' Satisfaction

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1. Introduction:

Today most companies and industries need the two principle factors of better quality and lower price in order to survive and keep their competitive capabilities. Also they should take into consideration some other factors such as better services, performance reliability, in time flexibility, consistency and homogeneity [1]. These days, the reasonable price is noticed by customers and the companies as a norm. Customers like to have a role in price determination for the products. Of course, this price determination is done regarding the quality, graphic shape and desirability because different customers have different expectations towards similar products. On the other hand, industries and companies try to enter a product with reasonable price and high quality by reducing the cost to change their customers into the permanent ones by keeping them satisfied. Thus, they need to consider the expectations of the customers of the price and quality of the product. Value-based pricing which considers customers' expectations especially by the help of target costing which is a price management system tries to manufacture a product which considers the expectations of most customers.

Those suppliers which can present products with similar quality and performance but with lower prices can win the competition with their rivals and increase their share of the market. Besides, the limitations of the resources lead the management towards using price management approaches because the management desires more efficiency of the resources. The efficiency means to manufacture goods and services, expected by the customers with the least resources consumed, in a way that it increases the value and reduces the price.

2. Literature Review:

2.1. The Origin of Target Costing

A retrograde approach for determining product costs, which is one of the most important features of target costing, can be found as early as the beginning of the last century at Ford in the United States and in the development of the Volkswagen Beetle in Germany in the 1930s. At Volkswagen, in order to meet the price goal of DM 990, alternative technical solutions were weighed on the basis of cost considerations [3]. Yet a full-fledged target costing approach began during the period of scarce resources after World War II. During this time, Americans created a concept of maximizing desirable product attributes while at the same time minimizing product costs [4]. The technique became known as “value engineering” and was subsequently adopted by Japanese companies in order to withstand stiff competition within Japan. In the 1960s, value engineering was combined with the idea of influencing and reducing product costs as early as possible during the planning and development stages of a product [5].

The first use of value engineering in Japan—known as “genkakikaku”—occurred at Toyota in 1963, though it wasn’t mentioned in Japanese literature until 1978 [6]. Later “genkakikaku” was translated into “target costing,” the term now used throughout the world. Rössler (1996) did etymological research to clarify the derivation of the term “target costing” from Japanese language, which is described in Figure 1. Even though Kato (1993) criticizes the use of “target costing” as a translation of “genkakikaku,” the term has been generally accepted in the Western world. At the annual meeting of the Japan Cost Society in 1995, the official name was made “target cost management” on the grounds that “target costing” was too vague and did not convey the true meaning of “genkakikaku” [7].
2.2. **Pricing:** Among marketing mixture (price, product, distribution, advancement), price is the only factor which creates income. Also price is the most flexible factor in marketing because we can change it rapidly. Although competition over price is the main concern which companies encounter, most firms can not solve this problem properly. When the product quality of different companies are equal and the competition is more severe, the price factor changes into one of the most important factors which maintains and absorbs the customers and their loyalty and satisfaction. This is better felt these days because of extraordinary spread of internet [5]. Pricing is simply price identification for goods and services. Pricing is an activity which should be repeated and it is a permanent and continuous process. This permanence is derived from the environmental changes and inconsistency of market conditions which creates the necessity to repeat this process [5].

3. **THE DEFINITIONS OF TARGET COSTING**

Apparently many Japanese scholars do not themselves agree on the exact meaning of “genkakikaku.” There are a number of different concepts and definitions [9]. As Hiromoto (1988) states, “They don’t simply design products to make better use of technologies and work flows; they design and build products that will meet the price required for market success—whether or not that price is supported by current manufacturing practices. Their management accounting systems incorporate this commitment”[10]. Similarly, Sakurai (1989) writes that “…target costing can be defined as a cost management tool for reducing the overall cost of a product over its entire life cycle with the help of production, engineering, R&D, marketing and accounting departments.” Later, “genkakikaku” was viewed as a tool of profit management [11]. As Monden (1995), for example, states: “Target costing is defined as a companywide profit management activity during the new product development stage that includes: (1) planning products that have customer-pleasing quality, (2) determining target costs (including target investment costs) for the new product to yield the target profit required over the medium to long term given the current market conditions, and (3) devising ways to make the product design achieve target costs while also satisfying customer needs for quality and prompt delivery”[12].
A detailed discussion of the various definitions by Japanese scholars can be found in the work of Seidenscharwz which classifies the definitions into three different (1993), categories:

- Market-oriented (Hiromoto).
- Engineering-oriented (Sakurai and Monden).
- Product function-oriented (Tanaka and Yoshikawa) [13].

As the variety of definitions indicates, “genkakikaku” was not developed whole from an established theory but piecemeal and in practice from competitive pressure in Japan (which will be described in detail in the next section). This is also evidence of the breadthness of the concept. For example, target costing has been tied closely to total quality management (TQM) efforts and factory automation programs in many companies [11]. The broadness of target costing extends beyond technical aspects, thus raising significant behavioral implications. For example, Kato et al. (1995) consider target costing an integrating mechanism that ties the various functional units in a company together into one coherent system. Implementing target costing effectively removes internal barriers of communication among the employees [7]. Hiromoto (1989) emphasizes the motivating effect of target costing and the resulting innovative energy. He believes that the goal of management accounting is to motivate employees and provide instruments that enable employees to think and act in the right way [11].

4. THE PROCESS OF TARGET COSTING

The uniqueness of Japanese target costing comes into play when strategic product positioning is completed in coordination with the company’s general strategy. This is also the point in time when the product-market mix has been determined and information about what product attributes and what related prices consumers desire are collected through a market analysis. Up to that point, the Japanese way is similar to the traditional Western cost management. However, there are important differences between these two approaches in the way the market information is gathered and converted into an actual product [14]. A more detailed comparison is presented in Figure 2.

![Figure 2: Western and Japanese Cost Management](image)

The Japanese approach is highly beneficial, because it works to actively control costs before or during product development. Under the traditional approach, a company waited until much later in a product’s life cycle, by which time a significant part of the costs had become fixed. Consequently, the company had little ability to change or control costs. Target costing begins with the question: “What should a product’s cost be?” In theory, this question can be answered by the following well-known equation:

Sales Price – Target Profit = Target Cost

5. Value-based pricing

Value based pricing, or Value optimized pricing is a business strategy. It sets selling prices primarily, but not exclusively, on the perceived value to the customer, rather than on the actual cost of the product, the market price, competitors prices, or the historical price.

The goal of value-based pricing is to better align price with value delivered. Price for any individual customer can be customized to reflect the specific value delivered. Examples could include metrics such as number of users and the value per users, number of annual transactions and the value per transaction, size of revenues and the impact on revenues, cost savings, or other measurements. Value based pricing is intended to make companies become more competitive and more profitable than using simpler pricing methods. It can also be used in product development and product management to configure products to maximize value for specific customers.

Value-based pricing is dependent upon an understanding of how customers measure value, through careful evaluation of customer operations. Survey methods are sometimes used to determine the value, and therefore the willingness to pay, a customer attributes to a product or a service.

Here it should be mentioned that the value for customer does not necessarily mean low price for the goods or services [15].

Value-based pricing is based on the customer’s perception of the value of the product, not on product costs (see Figure 3).

Figure 3. Pricing Conflict in the Product Development Process

Value-based pricing strategies are focused on creating long-term value for the customer. From a marketing perspective, the goal of pricing strategy is to assign a price that is the monetary equivalent of the value...
the customer perceives in the product while meeting profit and return on investment goals [16]. This paper posits the view that traditional cost-based approaches to pricing are short-term, tactical in nature, and place the interests of the seller over the interests of the buyer. Conversely, pricing approaches based on customers' perceptions of value are strategic and long-term in nature since they are focused on capturing unique value from each market segment through the pricing mechanism. We will argue that firms need to invest to create “pricing capital” to ensure the long-term benefits of value-based pricing. Firms that invest in a strategic pricing center can make better product decisions throughout the development process by understanding how customers value product alternatives and arrive at prices that they are willing to pay.

6. The relationship between target costing and value-based pricing: there is much relationship between target costing and value-based pricing such as: long-term strategic approach, competition, long-term profitability and customer orientation. But regarding the importance of the customer and customer orientation in current century, we only will explore this issue. Before discussing about the relationship between these two approaches, we will briefly discuss about aspects of this issue related to customer and customer orientation.

7. Aspects related to the customer
First the company should know the definition of the value by the customer. Then, the company should try to supply the satisfaction based on the needs and value standards by the customer. Finally it should try to maintain and be loyal to the customers.
Value: in a business relationship, the value is established for the customer when the customer is interested to purchase. Customers describe value in different ways such as: 1) the thing that a customer wants from a product or a service, 2) low price, 3) the correlation between quality and price and 4) the thing that a person gains in return to something he/she loses.
Satisfaction: it is our judgment of performing the expectations and the sense which helps the customers feel satisfied. The satisfied customers in a long-term relationship are keys to success especially when their satisfaction changes into loyalty.
Maintaining and loyalty: the customers' loyalty is something that is traced after the goals in today's market. There are a lot of evidences that prove profitable customers are those whomaintain a consistent relationship with the company. Loyalty results in customer consistency and satisfaction increase in customers and the relationships between customers and firms. Loyalty can be considered as the individual's feeling regarding the performance of a product or service and how this feeling forms the customers' behavior. Loyalty is related to the performance and also how a correct product or service can be received with a correct price and in time [17].

8. Customer orientation
8.1.During the past four years, customer value has been one of the most important variables (physically and practically) in marketing management [18]. In the related literature of the researches carried out, customer orientation refers to the set of beliefs which leads the person's behavior towards customers and clients. In fact the basics of these beliefs are some beliefs which entail priority over all the other things. In his priority to interests and wants of the customers, the interests and goals of the organization or entity is fully noticed because paying attention to customers will result in fulfilling the long-term benefits of the organization. We can call customer satisfaction as the prerequisite for all subsequent successes of the organization because it is a key factor in forming the future tendencies of the customers for purchase and satisfied customers may talk about their good experiences with the company. Today, paying attention to
the customers' wants has forced a lot of entities to improve and upgrade their relationship with their customers [19].

8-2. **Customer orientation in value-based pricing:** in this method, the needs of different groups such as present and new customers will be taken into consideration and the customers are placed in the first rank regarding the categorization of key elements in value-based pricing. Value-based pricing considers the customers' expectations of the goods and services value and the price is determined based on their expectations of the goods and the goods cost is placed in a lower rank compared with the customers. Each customer has different expectations from others and the firms are trying to keep the present customers and add new ones. Thus, this system is a long-term strategy which results in profitability for different industries. Here we should note that customer value-based pricing does not mean the low prices for customers as it was mentioned in previous section.

8-3. **Customer orientation in target pricing:** in this system which emphasizes on price management, different viewpoints of customers are incorporated in programming and designing the product. Thus, the managers in firms ask for the viewpoints of the customers about quality and price for manufacturing better products to supply a product for the market which gets customers' satisfaction. The managers determine the price for goods regarding the market conditions and the competitions and the customer does not interfere in the prices practically and this system may satisfy many customers. Although this system takes into consideration the different viewpoints of the customers, the thing which is important for customers is the price of goods.

8-4. **The similarity and difference of value-based pricing and target costing:** these two methods have many similarities. We can consider value-based pricing as a complete pattern of considering the customers' expectations because making decisions is carried out by the customers. In both systems, goods' quality and price management are somehow applied. Both systems the profitability is highly valued. But the main difference of these two systems lies in the decisions of pricing. It is an advantage for value-based pricing and a defect for target costing.

8-5. **The new integrated model based on customer orientation:** one of the most important issues studied in firms and financial entities is customer satisfaction. On the other hand the theorists are permanently trying to find new methods and models to achieve customer satisfaction. They do not agree on a concise and global definition for satisfaction but mostly they emphasize on a definition posed by Oliver (1995). Oliver believes that: satisfaction or dissatisfaction of the customer is his/her judgment of the successes or disabilities of the company to meet the expectations of the customers according to the expectations which results in customer satisfaction and the lack of meeting those needs will result in dissatisfaction of the customer [20].

In this new model the scholars have tried to consider the real needs of the customers. The quality and reasonable price are two important issues which are interesting for the customers. Thus, these two issues were considerably noticed in this model. Not only customers make decisions about the quality of the goods and services, they benefit from a considerable share in decisions related to pricing. Unlike target costing in which the price is determined by the market because of the competitions and thus creativity in entity's profit is avoided, in this model the price is determined based on the customers' reaction to the price. Thus the price is determined regarding the interests and tastes and preferences of the customers.
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9. *Customer relationship management:* it is the total business and marketing strategy which unifies the processes' technology and all business activities for the benefit of the customer. Thus, we can conclude that customer relationship management is a business strategy in order to optimize the profitability, increasing the incomes and customer satisfaction which is designed based on the organization of service deliveries regarding the customer needs and increasing the satisfaction level of the customers based on customer value principles and performing customer value processes [21].

9-1. the goals of customer relationship management:
1. Income increase: a) identifying new opportunities  b) reducing lost opportunities  c) reducing customer avoidance

2. Loyalty creation in customers: a) improving services to the customers  b) improving appearance for the customers

3. Expenditures reduction: a) saving organization's data  b) reducing marketing re-administration [22].

10. Conclusions:

Serious attention to the customers is a necessity to continue the activity in today's competitive markets. Organizations can reduce their expenditures and increase their income through satisfying their customers. These days the companies and organizations should consider a special importance for customer orientation in order to develop and survive in economic competition fields and increase their communications with their goods purchasers more and more. In the recent business approaches absorbing the customer satisfaction has an important and crucial position in company goals and top managers know that their success to achieve macro-goals is related to their customer satisfaction. On the other hand we can not claim that all customers have the same roles in company success. Thus, absorbing the key customers' satisfaction will be more serious. So we should devise and implement a system to absorb and keep customers that can manage the relationship between the organization and customers well. The new model presented tries to remove the defect of those systems such as target costing which ignores the customers in decision makings related to the pricing with the help of customer relationship management. Regarding the importance of customer value in present century, the companies are forced to use this approach in order to survive in the markets. Finally it is suggested that different industries should notice systems in which the customer and customer value is considerably observed because our customers need more care and services compared with the customers in the past.

References:


