Target Costing as an **Effective Tool for Retail Pricing** An Exploratory Research

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Abstract:

Retail Pricing is a key issue of concern to Retailers. In order to sustain the existing market share and to face the new emerging challenges, which is inevitable. This paper tries to find out the effectiveness of Target Pricing Techniques in the arena of Indian Retail Industry. An attempt is made to work backwards from traditional cost plus method of pricing to Target Pricing Technique. This paper is based on what the customer is willing to pay on his perceived product attributes. An attempt is made to study the cost structure by the process of Value Engineering and a model is suggested to work upon minimising or eliminating the non value added costs in the overall Retail Pricing System.

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Source: 1. Presentation to FICCI by MBN Rao (Chairman, Indian Bank): "Strategy for Financing Service Sector" Sept.15, 2004.
2. Ganguly, Saby, Retailing Industry in India, www.indiaonestop.com

INTRODUCTION

Retailing is an interface between the producer and the individual consumer buying for personal and non business use. Retailing is a process involving selling of goods and services by manufacturer himself or wholesaler or retailer to consumers for personal consumption. Retailing can be in person, through telephone, vending machine, Internet, etc and it can be through stores or non stores means.

Indian Retailing Industry:

The growth in Indian Retailing is phenomenal. At Kearney, the well-known international management consultancy, India is identified as the 'Second most attractive retail destination' globally from among thirty emerging markets. Trade or Retailing is the single largest component of the services sector in terms of contribution to GDP1. The Retail Industry in India is dominated by Un-organised sector in comparison to Organised Sector. Organised Retailing refers to trading activities done by licensed retailers, who are registered for sales tax, income tax etc. These include the corporate backed super markets and retail chains and also the privately owned large retail businesses. Un-organised Retailing on the other hand refers to the traditional kirani shops; Proprietor managed general stores, convenience stores, Pan beedi shops, Pavement vendors, Hand cart shops etc. Un-organised Retailing is by far the prevalent form of trade in India constituting 98% of total trade while the remaining 2% is occupied by Organised Retail sector 2. The employment opportunities whether taken by chance or by choice in Retail sector are growing at an alarming rate. About 4%-6% of total population is dependent here for their lively hood.

Retail Pricing:

Retail Pricing plays a predominant role in the determination of market size and share for a product or service. Demand and supply forces exert great influence on the determination of Retail Price levels. Demand and supply factors are influenced by 3C's namely; Customers, Competitors and Costs.

a) Customers:

Customers influence prices through their effect on demand. Too high a price may cause customers to reject a company's product and may them shift to substitute product or service.

b) Competitors:

No business can operate in vacuum. Companies must therefore always have an eye on their competitors pricing strategy. At one extreme, competitors affect demand forces through alternative and substitute products and at the other extreme, business without rival in a given environment can be the price setter instead of price seeker.

c) Costs:

Costs influence prices because they affect the supply side. The lower the cost relative to the price, the greater the quantity of product the company is willing to supply. Understanding the cost structure and its classification is very important as it makes companies to set prices that make the product attractive to customers while maximizing companies operating profits.

Time Horizon of Pricing Decisions:

Most of the pricing decisions are either short run or for long run. Short run decisions typically have a time horizon of less than a year and include decisions such as pricing a one time special order with no long run implications, and adjusting product mix and output volume in a competitive market. Long run decisions involve a time horizon of a year or longer and include pricing a product in major market where there is considerable leeway in price setting.

Target Costing For Target Pricing:

Target pricing is an important form of Market-based Pricing, which allows the forces of demand and supply to determine the true price. A Target Price is the estimated price for a product or service that a potential customer will be willing to pay.

Target price is generally estimated based on an understanding of customer's perceived value for a product and competitors responses. A company's sales and marketing organization, through a close contact and interactions with their customers, will be in a better position to identify customer needs and their perceived value of the product or service. Based on the above interactions, Target Prices are fixed.

Target Costing technique is an indirect method of costing when compared to traditional method of Cost Plus Pricing. Under traditional method of Cost Plus Pricing, Retailers determine the selling price of the product based on its Total Cost and a certain percentages of markup added to it. It is a cost driven approach and retailer is the Price maker. Under the Target Costing approach, Selling price is determined based on the prospective customers willingness to pay for the perceived product attributes and deducting the expected profit margin, Target cost is worked backwards. It is popularly called as Target costing technique since Cost is the main target which a retailer should shoot for. It is a Sales or Market driven

Source: [3]. A study adapted from Management Accounting research group, "Investigation"; Blaynay and Yokoyama, "Comparative Analysis"; Grant Thornton,"Survey"; "Cornick, Cooper, and Wilson, "How do Companies"; Mills and Sweeting, "Pricing Decisions"; and Drury, Braund, Osborne, and Tayles, "A Survey"

Table A

Method	US	INDIA	JAPAN	IRELAND	UK
Market based 2	2	1	1	1	1
Cost based	1	1	2	2	2

approach where retailer is a Price Seeker.

RESEARCH OBJECTIVES:

The specific objectives of this research are as follows:

1. To examine the effectiveness of Target Pricing as a tool for Retail Pricing.
2. To identify the critical value added and non value added factors in Product Costing.
3. To assess the expected reduction in Selling Price from current levels by minimizing the costs incurred on non value added factors..
4. To examine the sustainability of competition through effectiveness of Target pricing strategies.
5. To assess customer delight and long run relations.

RESEARCH BACKGROUND: (EMANATING FROM LITERATURE REVIEW)

The following literature survey introduces some of the key issues related to this study and will lay the foundation for the proposed Research Model.

Surveys of financial officers of the largest industrial companies in several countries indicate similarities and differences in pricing practices around the globe. The use of cost based pricing appears to be more prevalent in the United States, India, than in Ireland, Japan and the United Kingdom.

Ranking of factors primarily used as a starting point to Price products (1 is most important) (See Table A)

Japanese companies use value engineering more frequently and involve designers more often when estimating costs [3].

The above study indicates the various countries like India and US primarily using Cost Based Pricing whereas countries like Japan, Ireland and UK primarily using Market based (Target Pricing) Pricing.

RESEARCH MODEL

The conceptual research model given below, attempts to study the use of Target Pricing as a tool for Indian Retail Pricing scenario. Target Pricing is a Market Based Pricing technique where Selling Price is determined based on the potential customers willingness to pay. Keeping the expected operating margins constant, Retailers should try to shoot the Costs target set by the market driven Target Price. The following equation is used to arrive at the Estimated Target Cost:

Target Costs = Target Price – Target Operating Margins.

The research model given below shows that Value engineering techniques are used to keep the target cost under control. Value Engineering can be classified into Design and Process engineering.

a) DESIGN ENGINEERING:

It is a process through which a re-look into the Product design is done.

b) PROCESS ENGINEERING:

It is a process of complete re-look into the Production process.

Costs can be further re-looked into Value added costs and Non Value added costs. A Value added cost is that cost, if eliminated, would reduce the value or utility that customers obtain from using the product or service. Examples are Quality of the Product, after sale service, Warranty, Durability, Reliability etc. A Non Value added cost is that cost, if eliminated, would not reduce the value or utility that customers obtain from using the product or service. Examples are Secondary Packing, Fancy display, Air-conditioned shore room etc.

An attempt is made to either minimize or eliminate the non value added cost component in the total cost so as to

RETAIL TARGET PRICING MODEL

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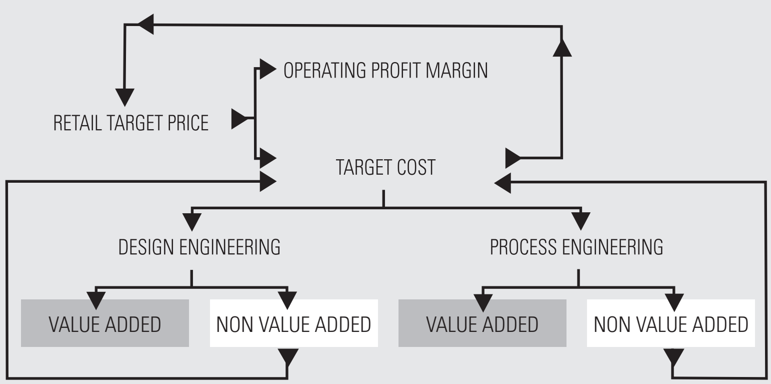

achieve the target costs set above. A Non value added cost is a cost that the customer is unwilling to pay for and if eliminated or minimized, it will result in optimum customer utility for a given level of Target Price.

Even after necessary iterations of reducing the Non value added cost component in the Total cost of the product, if the Retailer is unable to achieve the Target Cost set, operating margins can be sacrificed to the required extent to remain competitive in the market rather than increasing the Selling Price.

SUGGESTIONS

The following points have to be kept in mind for an effective implementation of the Target Pricing Strategies into the Retail Pricing System:

- A deep insight into Potential buyer's attitudes and perceived Product attributes is a key to Target Pricing. A company's sales and marketing organization, through a close contact and interactions with their customers, will be in a better position to identify customer needs and their perceived value for the product or service.
- A close look into competitors pricing strategy is a must as they affect demand forces through alternative and substitute products.
- To also keep in mind the Target Operating Profits expected by the Top Level Management.
- To undertake a deep study of Value Engineering insights of the Product Costs.
- To differentiate costs into Value added and Non Value added costs.
- To minimize or reduce the non value added cost component.
- Reduction of Non Value added cost results in reduction of Actual total costs and helps the organization in meeting its Target Costs.
- If targets costs are still not achieved, it is suggested to cut down the operating profit margins, rather than affecting the Target Prices.
- The above model may help the Retailer to sustain competition, and acquire better market share in comparison with the existing share.

LIMITATION OF THE STUDY

- The above model is an exploratory model and a working paper yet to be tested with market data.
- Difficulties in Identification of Cost structures and its classifications.
- Reduction in Non Value added costs may not be the only factor which contributes for achieving the Targeted costs.
- Adaptability of Target costing techniques in Indian Retail Pricing Situations.

Differences in Retail Buyers perceived Product attributes. Keeping in mind the above limitations, their exists ample scope for further Research into the unforeseen areas.

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