

Decision on Margins and Sourcing

- The company receives a Request for Quote from a customer who wishes to buy 3000 per month of their product XJ2 for the next 9-12 months. The customer's target price is \$45.
- The company uses standard costing and has a policy requiring a minimum 15% margin on all orders. The standard cost for an XJ2 is \$42.44.
- The margin is \$2.56 per unit that makes a 5.7% margin. The company turns down the order.

Not so fast 

Source it Overseas

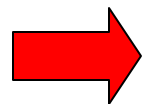
- The sales person does some investigation and finds that they can source XJ2's in these volumes from the Far East at a landed cost of \$30. The company has a standard 7.5% overhead rate for outsourced items making the total cost \$32.25.
- This represents a sales margin of \$12.75 giving a margin of 28.3%. This is clearly a winner.

Not so fast 

Make It In-House

- The production plant does not have capacity to make this additional quantity of XJ2's.... But the value stream manager works out that - with the addition of 2 people and 2 more machines – the additional capacity can be made available.
- From this the value stream manager can calculate the financial impact on the value stream of purchasing the product from the Far East or making it in-house.

**The Summary Value Stream Cost & Profitability
is shown on the following table**



Summary of the Alternatives

	Using Standard Costs	Outsource to China	Value Stream Costing
Revenue	\$1,042,631	\$1,177,631	\$1,177,631
Materials	\$424,763	\$521,513	\$491,753
Conversion	\$392,089	\$392,089	\$400,756
Profit	\$225,779	\$264,029	\$285,122
Return	21.65%	22.42%	24.21%

When you take account of the total value stream cost & profitability – rather than looking at margins for an individual product – you get a more accurate assessment of the financial impact of a decision.

In this case the most financially advantageous course is to make the product in-house.

Of course, these decisions are not made on a purely financial basis; there are many other business issues to be taken into account. But these decisions should be made by assessing the impact on the value stream as a whole and not based on the individual product.

This can be calculated quickly and easily; and gives the accurate economic impact of each course of action..