Target costing: market-oriented target costs for products and purchased parts

Target costing is a market-oriented method of cost planning in which the permissible price of a product is dictated by the market and the permissible costs are derived backwards from it. In industrial procurement, the method is used to define target requirements for purchased parts and development costs at an early stage and to achieve them jointly with suppliers. This shifts the focus from retrospective cost control to the forward-looking design of the product, bill of materials and supply chain.

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Key facts at a glance

01 Target costing derives the permissible costs backwards from the marketable selling price and the required profit margin.

02 In procurement, target costs are frequently broken down into assemblies and individual parts in order to give suppliers concrete price targets.

03 The central control variable is the gap between allowed and estimated costs, the so-called cost gap.

04 The method is particularly effective in the development and quotation phases, as this is typically where the majority of later lifecycle costs are determined.

05 Success presupposes that functions and costs are transparently allocated, for example through function and cost analyses.

06 Value engineering and design to cost are the most important levers for achieving target costs without loss of quality.

Definition: target costing

Target costing is a management-oriented cost steering concept that starts from the price achievable on the market and derives the maximum permissible costs of a product from it. Unlike classic markup

costing, the price is not calculated from the costs incurred; instead, costs are adapted to the market-based price.

Basic formula and principle

The calculation typically follows the logic: allowed costs = target price minus target profit. The target price results from market prices, customer willingness to pay and competitor comparison, the target profit from strategic requirements such as the required return on investment. If the calculation yields a difference from the forecast actual costs, a cost gap arises which must be actively closed.

- Target price: determined on a market basis, not calculated
- Target profit: specified by corporate planning
- Cost gap: difference between allowed and estimated costs

Distinction from classic product costing

Classic product costing follows the principle of costs plus profit margin and sets the price afterwards. Target costing reverses this logic and forces development, procurement and manufacturing to align with the earnings target. Classic costing nevertheless remains important in order to reliably estimate should-costs of variants, assemblies and parts and to make the cost gap measurable.

Positioning in product lifecycle management

Target costing should ideally start in product lifecycle management before the design freeze, because a considerable proportion of later unit and lifecycle costs is fixed during the design phase. Later cost reduction projects (cost down), by contrast, apply to products already launched and often follow the logic of lean procurement, for example through standardisation and volume consolidation.

Methods and procedure in the procurement process

In procurement, target costing is organised as a structured process across the procurement phases, from early alignment through sourcing award to series production. The central building blocks are the target cost breakdown, function analysis and joint cost development with suppliers.

Target cost breakdown into assemblies and parts

The product target costs are distributed across modules, assemblies and individual parts according to value shares, functions or benchmark values. For catalogue and standard parts, market prices and parts catalogue analyses provide realistic upper limits; for in-house developments, should-cost estimates serve as the reference. The breakdown gives procurement negotiable price targets per item.

Function and value analysis

Each function of a component is examined for the customer benefit it provides and the costs it causes. Functions with a high cost share but low benefit are simplified, substituted or eliminated. This system is closely related to design to cost and value engineering and requires early, cross-disciplinary

collaboration between design, procurement and supplier.

Supplier integration and contractual implementation

Suppliers are involved early in the cost development process, for example through surveys during the quotation phase, joint workshops or cooperation models such as joint development manufacturing (JDM). Target requirements and price paths are anchored in contract management, for example with price adjustment clauses, call-off volumes or agreed cost reduction curves. A proper supplier qualification assessment ensures in advance that suppliers are capable of achieving the target costs.

Key KPIs for steering target costs

Target costing is easy to measure because target and actual values can be compared at every stage. Steering is carried out via metrics that reflect the cost scissors, project success and supplier performance.

Cost-related metrics

At the core are the cost gap in absolute terms and target cost achievement in per cent. In addition, target costs per assembly, deviations per unit and the share of items on target are monitored. These figures should be included in spend under management reporting at an early stage, so that target costs are not only defined but also actively steered.

Process and supplier metrics

Process metrics show how quickly and reliably target costs are achieved in the procurement process, for example via the requisition cycle time or the time to price agreement in the sourcing schedule. On the supplier side, cost reduction rates, on-time delivery and service level are combined to check whether low costs are not at the expense of quality or availability.

Risks and controls in target costing

Target costs can be missed if they are set unrealistically, communicated too late or imposed without the involvement of those affected. Controls must therefore cover both the plausibility of the targets and the impact on quality and supplier relationships.

Quality and reputational risks

If suppliers achieve target costs only through material substitution, reduced tolerances or reduced inspection scope, quality problems, complaints and growing reputational risk in procurement loom. Countermeasures are binding inspection instructions, documented change processes and clear approvals for material or process changes.

Supplier and financial risks

Overly aggressive target requirements can squeeze supplier margins so far that their economic stability

is jeopardised. Regular monitoring of supplier financial health shows at an early stage whether a supplier can meet the target costs without loss of substance. If the relationship is terminated, contractual provisions such as termination for convenience should govern the exit option.

Methodological controls

A coherent should-cost position is important: the sum of the sub-target costs must exactly match the product target costs, otherwise the cost gap remains hidden. Changes during development are tracked through change and contract management, including updated target costs and effects on logistics terms such as the chosen Incoterms CPT or other delivery terms.

Current developments and digitalisation

Target costing is becoming increasingly data-driven in practice: market price data, supplier quotations and historical procurement data flow directly into the determination of target prices. Digital platforms accelerate alignment with suppliers and make target costs transparent along the supply chain.

Digital tools and transparency

E-procurement systems and a central supplier portal make it possible to exchange target requirements, quotation data and deviations in a structured manner. Should-cost libraries and price benchmarks help buyers set target costs more quickly and objectively. Comparison data also helps with supplier discovery in deriving market-based upper limits.

Target costing in the supply chain

Target costs do not end at the first tier of suppliers: tier two and three suppliers also contribute to unit costs. Approaches from supply chain resilience management complement the picture, as cost and risk aspects are increasingly assessed together — for example in multi-site strategies or for components with supply bottlenecks.

Typical metrics

Metric	Typical value
Target cost achievement	commonly 95–105% in practice *Proportion of achieved costs relative to allowed costs; 100% means full target achievement.*
Cost gap closure rate	> 90% by start of production *Proportion of the cost gap closed before start of production; typical benchmark from cost reduction projects.*

Cost reduction rate in series production (year on year)	typically 2–5% p. a. *Usual range for agreed price paths with suppliers, depending on material and market situation.*
Share of items within the target cost band	> 80% *Proportion of procurement items that comply with the broken-down sub-target costs.*

Practical example

A mid-sized mechanical engineering company is developing a new special machinery module and sets a factory cost target for the main assembly that is around 15 per cent below the estimated costs. Procurement breaks the target costs down into modules and individual parts and derives negotiable price targets for each item.

- Workshops with three qualified suppliers for joint cost development of the gearbox assembly
- Value analysis with design engineering: reduction of 14 individual parts and switch to a standardised interface from the parts catalogue
- Contractual anchoring of price paths and annual cost reduction targets within contract management
- Monthly cost gap reporting including quality metrics to demonstrate cost savings without loss of quality

Conclusion

Target costing shifts cost steering to the beginning of the product lifecycle and makes the market the benchmark for costing. For the procurement function, this creates a clear, negotiable target variable for purchased parts and development costs. Prerequisites are reliable should-costs, a consistent target cost breakdown and early involvement of suppliers. Those who integrate quality controls and supplier risks achieve sustainable cost advantages without loss of substance. Combined with lean procurement and value engineering, target costing is thus an effective lever for competitive results and margin.

Frequently asked questions

? What is target costing?

Target costing is a market-oriented method of cost planning in which the permissible price is dictated by the market and the maximum product costs are derived backwards from it. The target price is reduced by the required profit margin; the result is allowed costs that development, procurement and manufacturing must align with. The difference from the estimated costs is the cost gap, which is actively closed.

? How are target costs calculated in target costing?

The basic formula is: allowed costs = target price minus target profit. The target price is derived from market prices, competitor comparisons and customer willingness to pay, the target profit from strategic requirements such as the planned return on investment. In procurement, the product target costs are then broken down into modules, assemblies and individual parts.

? What is the difference between target costing and classic costing?

The classic product costing approach calculates costs plus margin and then sets the price. Target costing reverses the direction: the price comes from the market and costs are adapted to it. Classic costing nevertheless remains an instrument for estimating should-costs of parts and variants and for making deviations measurable.

? What role does procurement play in target costing?

Procurement sets target requirements for purchased parts, reviews their market conformity using benchmarks and should-cost analyses and negotiates binding prices from them. It involves suppliers early in the cost development process and anchors target requirements in contract management. In addition, it safeguards through inspection instructions and quality metrics that cost targets are not achieved at the expense of quality.

? Which KPIs are common in target costing?

Typical metrics are the cost gap in absolute terms, target cost achievement in percent and the share of items on target. These are supplemented by process metrics such as requisition cycle time and supplier metrics such as on-time delivery and service level. The combination of cost and quality metrics is important in order to identify undesirable side effects early.

? When should target costing be used in the product development process?

The ideal point is the early development phase, before the design freeze, because the majority of later lifecycle costs are determined there. Later use is possible, but shifts from shaping costs to reducing costs that have already been fixed. In practice, many companies therefore combine early target costing with later cost-down programmes.

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