

Should-costing: cost transparency as a basis for negotiation

Should-costing refers to the systematic determination of the justified manufacturing costs of a product or service from the buyer's perspective. The aim is to derive a realistic target value for the price and to discuss deviations from the supplier's quotation in a structured way. The approach turns price negotiations into fact-based cost dialogues and sustainably strengthens procurement's negotiating position.

Key facts

- Should-costing breaks a product down into material, manufacturing, logistics and overhead cost components and derives a justified target price from them.
- Material costs typically account for 50 to 70 per cent of the total cost of industrial products and therefore form the focus of the analysis.
- In practice, should-costing frequently achieves savings of 5 to 15 per cent compared with original quotations.
- The approach sometimes uses specialised software, but can also be implemented manually using cost accounting, time studies and market knowledge.
- Should-costing operates along the entire procurement cycle: from market analysis via the enquiry through to the supplier award.
- The effort should be proportionate to the procurement volume – detailed analyses are worthwhile above all for high risk classes and strategic material groups.

Definition: should-costing

Should-costing is a methodology for the bottom-up determination of the costs that a product or service 'should cost' according to realistic market prices, process times and calculation logic.

Distinction from price-costing

In classic price-costing, procurement orientates itself on market behaviour: quotations are compared, discounts negotiated and price developments monitored. Should-costing takes a step back and asks how the price is composed of materials, manufacturing times, machine hour rates, set-up costs, scrap, logistics and profit markup. This turns the price from a take-it-or-leave-it figure into a negotiable construct. This transparency also changes the tone of the supplier dialogue: it is no longer about positional pressure but about joint cost drivers.

Relationship to process cost accounting

Methodologically, should-costing is closely related to process cost accounting, but views this perspective from the buyer's side and under market price considerations. While process cost accounting maps internal cost rates and process times in-house, should-costing transfers this thinking to the supplier's external value creation. The two approaches complement each other: those who know their

own process costs can establish make-or-buy comparisons and should-cost-based target prices on a far more solid footing.

Fields of application in procurement

Should-costing is typically used for strategic material groups, complex contract-manufactured parts, castings, plastic injection-moulded parts, sheet metal formed parts and electronic assemblies. It is also common for development services and tooling procurement. What matters is the fit with the procurement volume: for low annual requirement volumes, the calculation effort quickly exceeds the benefit. In practice, ABC-type prioritisation has proven effective, in which critical volumes and high risk classes are analysed first.

Methods and procedure in should-costing

In practice, the process follows a recurring pattern: break down the product, identify the cost drivers, build the calculation model, reconcile it with quotations.

Break down part structure and cost drivers

The starting point is the bill of materials or the drawing data set. Each component is broken down into its key cost drivers: raw material including cutting and material loss, manufacturing steps with nominal cycle times, set-up times, avoidable and unavoidable scrap, surface treatment, heat treatment, logistics and packaging. In addition, overhead surcharges and a realistic profit margin are factored in. For complex assemblies, clustering by manufacturing process helps to reuse calculation blocks.

Use market data and benchmarks

Reliable should-cost models stand or fall with the data fed into them. Material prices can be determined via exchange quotations, index series and existing framework agreements. Machine hour rates, wage rates and typical surcharges come from market knowledge, supplier discussions and audit results – for example from a structured audit checklist in supplier evaluations. A well-founded market analysis of capacities, demand and regional availability refines the calculation. In addition, previous tenders and cost developments for similar parts provide useful indications.

Tools and manual models

Specialised should-costing software solutions with calculation libraries for manufacturing processes exist on the market. Such tools considerably speed up the work but are not a prerequisite. Many companies start with Excel-based models that have been validated for a narrowly defined material group. What matters is less the tool than the plausibility of the assumptions and the ongoing updating of prices and hourly rates.

Negotiation and target-cost collaboration

In the best case, should-costing does not run as a one-sided diktat but as an open cost dialogue. Those who disclose the model to the supplier and discuss assumptions jointly frequently achieve greater acceptance and uncover untapped optimisation potential such as design changes, material substitution or deviating lot sizes. The results subsequently flow into tenders, target prices and supplier award decisions.

KPIs and benefit assessment of should-costing

Like every investment in procurement, should-costing should also be measurably linked to objectives. The following metrics have proven effective.

Target/actual variance and savings

The key metric is the percentage deviation between the quoted price and the should-cost target price. In practice, target prices are frequently 5 to 15 per cent below initial quotations; how much of this is actually realised depends on negotiating strength, the market situation and the supplier's willingness to switch. In addition, it is advisable to record realised savings against the baseline – analogous to classic ROI analysis in procurement – in order to demonstrate the cost-effectiveness of the should-costing team.

Cost transparency and model coverage

Further useful metrics are the number of validated should-cost models per material group, the coverage of procurement volume with models, and forecast quality, measured as the average deviation between the model result and the actual landed cost. A deviation of under 5 per cent is typically regarded as good model quality. These metrics make the maturity of the approach visible and help prioritise future analyses.

Benefits beyond savings

Not every effect shows up directly in the price. Should-costing also improves the suitability assessment of new suppliers, because cost drivers and process requirements become clearer. It supports risk class classification and promotes understanding of sole-source dependencies. Those who disclose cost drivers jointly with suppliers also build trust – a benefit that cannot be directly measured but is real in supplier management.

Risks, limitations and controls

Should-costing is not a walk in the park. Faulty assumptions or excessive target prices can strain relationships and distort decisions.

Faulty assumptions and model risk

The biggest risk lies in outdated or inaccurate parameters: material indices, hourly rates, shift models, scrap rates. A model based on assumptions that are several years old produces target prices that miss the market. Countermeasures are regular update cycles, sensitivity analyses and validation against genuine supplier data. Sample checks of model results against prices actually received have proven an effective control instrument here.

Relationship dynamics and loss of trust

Those who use should-costing purely as a lever of pressure risk defiance reactions: suppliers then price more cautiously, discriminate during capacity bottlenecks or only offer undifferentiated terms. The use of should-costing is particularly delicate in single-source situations. A cautious approach is required here – ideally models developed jointly with the supplier rather than confrontational target price dictates. Single-source management also benefits from well-founded cost dialogues, as long as the tone remains partnership-based.

Effort, competence and governance

Serious should-costing requires technical depth: knowledge of manufacturing processes, tooling costs, calculation logic and market structures. Not every procurement team possesses this competence. Clear responsibilities – for example along the lines of a RACI matrix for procurement roles – prevent models from being used unchecked or inconsistently. A short review chain is advisable, in which owners are defined for model assumptions, data maintenance and negotiation management.

Fields of integration: where should-costing strikes home in the procurement process

Should-costing does not unfold its effect in isolation, but in interplay with established procurement processes and steering instruments.

Tender, material groups and supplier award

In the ideal case, the should-cost target price already flows into the enquiry or tender as a benchmark. It helps to identify outlier quotations and to uncover ambiguities in the scope of services. Within supplier management, the model subsequently serves to evaluate supplier award decisions: who delivers closest to the target value, with what justification, at what quality level? In this way, the cost perspective is combined with technical suitability and delivery reliability into a holistic assessment.

Planning and demand-side integration

Should-costing becomes even more valid when requirements data is robust. Material requirements planning (MRP) provides quantities and dates needed for lot size considerations, set-up cost optimisation and capacity-based arguments in the calculation. Conversely, should-cost findings can influence the demand generation process – for example when a design change or material substitution shows recognisable cost advantages in the model. The model also provides arguments for safety capacity considerations: what price premium for smaller lot sizes is justified in order to secure flexibility?

Supply chain, sustainability and resilience

Should-costing can also map sustainability aspects. Where energy prices, carbon prices or regional effects are maintained in the model, Scope 2 emissions of upstream stages, for example, can be incorporated into the calculation at least approximately. For material substitution in the ESG context, should-costing provides the economic counter-calculation to ecological advantages. In nearshoring considerations, the model also helps to make logistics costs, tariffs, risk premia and differences in labour costs comparable – and thus to put location decisions on a rational footing.

Crisis preparedness and supplier failure

In crisis scenarios, should-costing helps to assess emergency prices realistically. Those who know the cost drivers can recognise whether price demands in shortage situations are market-logical or exploitative. In addition, the model supports emergency procurement team planning: cost drivers based on specific upstream products or scarce raw materials point early to dependencies that should be considered in risk analysis and in the strategy for risk classes.

Current developments and outlook

Should-costing is evolving from a craft discipline to a data-driven process with growing automation.

Automation and AI support

Newer approaches use AI-supported drawing evaluation and automated calculation proposals derived from geometry data. Such tools significantly shorten modelling time but do not replace expert review by experienced cost engineers. Practice shows: automation provides good starting points, quality emerges through validation against real market data and supplier feedback.

Linking with sustainability and regulation

In the course of growing sustainability requirements, energy costs, the carbon intensity of processes and the origin of raw materials are moving more strongly into the focus of calculation. Should-cost models that map these factors help to connect price and sustainability discussions rather than playing them off against each other. At the same time, accountability pressure in procurement is growing: transparency about calculation assumptions must also be verifiable to the whistleblowing system and internal control bodies.

From individual analysis to cost intelligence

The trend is moving away from individual deep-dive analyses towards continuous cost monitoring: continuously updated models that are automatically readjusted when indices shift or market events occur. This turns should-costing into a tool for ongoing price and value assessment rather than a one-off negotiation building block.

Typical metrics

Target price variance (should vs actual): 5–15 %

Typical difference between initial quotation and should-cost target price; indicates negotiation headroom.

Model forecast accuracy: < 5 %

Average deviation between model result and actual landed cost; a model is considered valid in practice below this threshold.

Realised savings: > 3 % p. a.

Share of the addressed procurement volume actually undercut; analogous to ROI analysis in procurement.

Model coverage: > 80 %

Share of procurement volume in prioritised material groups for which a validated should-cost model exists.

Practical example

A medium-sized mechanical engineering company sourced housing-milled aluminium components from a long-standing contract manufacturer. In the next round of price negotiations, the supplier demanded an increase of 12 per cent, citing rising material, energy and labour costs. Procurement built a should-cost model for the five highest-volume parts and thereby determined a realistic target price that was only 6 per cent above the previous level.

- Material costs were validated against current aluminium index prices and existing framework agreements; part of the material price increase turned out to be already covered by value guarantees.
- Manufacturing times and set-up logic were discussed with the supplier in a joint cost dialogue; an increase in lot size additionally reduced unit costs.
- The result was a realistic price agreement of a 6.5 per cent increase combined with a commitment to process improvements – without changing suppliers.

- The model was subsequently standardised for the entire material group and integrated into future tenders and supplier award decisions.

Conclusion

Should-costing transforms price negotiations into fact-based cost dialogues and creates a common numerical language between procurement and supplier. The approach requires technical understanding, robust market data and credible governance – but it pays off when volume and criticality justify it. Those who understand should-costing not as a lever of pressure but as a joint analysis achieve more sustainable results and simultaneously strengthen supplier management. Combined with market analysis, process cost accounting and a clear allocation of roles in procurement, genuine cost intelligence emerges. For industrial suppliers and buyers, should-costing is therefore not a special project but a load-bearing element of strategic procurement.

Frequently asked questions

What is should-costing in simple terms?

Should-costing is a method in which the buyer independently calculates what a product or service ought really to cost – based on materials, manufacturing time, machine hour rates and a realistic margin. This produces a target price that serves as a benchmark for negotiations. Unlike a pure price comparison, should-costing looks inside the cost drivers.

When is should-costing worthwhile in procurement?

Should-costing is particularly worthwhile for high purchase volumes, strategic importance, complex manufacturing processes or recurring price discussions with the same supplier. In practice, savings potential of typically 5 to 15 per cent is identified compared with initial quotations. For low requirement volumes, the calculation effort often exceeds the benefit.

What data do you need for a should-cost model?

Essential data includes the bill of materials and drawing, manufacturing processes, cycle and set-up times, material prices, machine hour rates, scrap rates, logistics costs, surcharges and margin. This data comes from in-house calculations, market benchmarks, index series and supplier discussions. The more up-to-date the data, the more robust the model.

How does should-costing differ from target costing?

Target costing starts from the market price or target profit and derives permissible costs from it – typically from the customer's perspective. Should-costing starts from the product and its cost drivers and calculates what it should cost under realistic conditions. Target costing is more product- and market-driven, should-costing more procurement- and supplier-side.

What software is available for should-costing?

Specialised calculation tools with manufacturing libraries and AI support for drawing evaluation exist on the market. However, many companies start with Excel-based models validated for a specific material group. The tool matters less than the currency of the assumptions and expert review.

Can should-costing also be used with single-source suppliers?

Yes, but with caution. In single-source situations, the model should ideally be developed and discussed jointly with the supplier rather than acting as a one-sided target price dictation. Otherwise there is a risk

of loss of trust and more cautious pricing by the supplier. Open cost dialogues are usually more successful here than confrontational approaches.