

Target costing: from market price to cost-compliant procurement

Target costing is a method in which the permissible cost frame for a product or component is derived from the price achievable in the market – and not, the other way round, from internal costs. For buyers, this means that supplier prices are not merely negotiated but systematically planned and managed from a given target price. The term describes both the arithmetical breakdown of the target value into cost components and the subsequent process of cost splitting with suppliers. In DACH industry, target costing is a central instrument of early supplier involvement and of procurement strategy.

Key facts

- Target costing derives permissible costs from a marketable sales price minus the target margin.
- The gap between target and actual costs is referred to as the cost gap and is actively closed.
- Typical tools are cost structure breakdown, clean-sheet costing and value engineering.
- The approach works with the strongest levers at the end of product development – manufacturing and procurement then need data from the outset.
- Limitations become apparent in heavily regulated markets, long commitment periods and where design flexibility is lacking.

Definition: target costing

Target costing is an upstream planning calculation that derives the permissible costs of a product from the price borne by the market minus the targeted margin. It is thus the counterpart of classic costing, in which a price is demanded from costs incurred.

Distinction from actual cost accounting

Classic costing asks: what does the product cost us, and what price can we charge for it? Target costing reverses this logic: what costs may be incurred at most for the product to still succeed in the market? For buyers, this yields a benchmark figure per assembly and line item that structures price negotiations and keeps them focused on more than just discounts. The method therefore requires early interaction between engineering, sales, controlling and the procurement organisation, because the key cost drivers are fixed during design.

The cost gap as a central concept

When the target costs derived from the market price are compared with the planned actual costs, a gap frequently arises. This cost gap is the true unit of work in target costing: it is broken down into shares per function, assembly or supplier portion and closed through design changes, material selection, manufacturing process or supplier integration. In practice, the gap is often reduced in stages over several design and procurement revision rounds until the target collision costs equal zero.

Methods and procedure of target costing

Target costing follows a recurring sequence: set the market price and target margin, break down the cost structure, identify the gap, derive measures and monitor regularly. In practice, a team goes through these steps several times per project phase.

Cost breakdown and component approach

The starting point is the breakdown of the target value into material costs, manufacturing costs, overheads, logistics costs and assembly. The more granular the breakdown, the more concrete the mandates for buyers and suppliers. This often works via quantity structures: bill-of-materials items are linked to designated material prices and value-added surcharges, and manufacturing times to machine cost rates. This foundation then forms the basis for target cost mandates to suppliers within material approval and the technical approval processes.

Clean-sheet costing as a tool

Clean-sheet costing reconstructs the true manufacturing costs of a part from scratch: raw material, machining times, set-up times, capital commitment, overhead surcharges and an appropriate supplier margin. It reveals how far the submitted offer is from the technically justifiable price. In combination with target costing, it provides a factual basis for negotiation and replaces pure discount discussions. Transparency of the assumptions is crucial here – otherwise suppliers perceive the costing as control without dialogue.

Value engineering and design-to-cost

Where the cost gap cannot be closed through negotiation but only through design or process changes, value engineering comes into play: functions are analysed, parts simplified, materials substituted, tolerances questioned. Design-to-cost deploys target costing already as a design mandate. For procurement, this opens the opportunity to bring suppliers with process know-how into the solution early – often with measurable material savings without sacrificing function or quality.

Key KPIs and metrics in the target costing process

Target costing thrives on measurable quantities: target price per component, size of the gap, achievement of growth targets and unit cost development over the product life cycle.

Core metrics for steering

Key performance indicators are target cost achievement (percentage of assemblies meeting their target costs), the absolute cost gap in euro or as a percentage of actual costs, and the development of unit costs across defined milestones. In addition, material cost reduction per period is often tracked across all commodity groups to evidence the overall effect. Without robust controlling, target costing remains a snapshot – the KPIs turn it into a manageable process.

Include quality and delivery reliability

Target costs must not be viewed in isolation from quality and delivery reliability. Metrics such as on-time delivery (OTD) and delivery lead time variance show whether savings come at the expense of supply security. Scrap and rework rates per supplier also belong in the analysis, since hidden quality costs can quickly erode the nominal saving. The combination of cost, quality and delivery metrics corresponds to the logic of a supplier rating and prevents one-sided price optimisation.

Risks and controls in target costing

The method is effective but not without pitfalls: unrealistic targets, lack of transparency or one-sided cost pressure can damage supplier relationships and quality. Clear rules and controls are therefore part of any sound implementation.

Unrealistic targets and supplier relationships

Where target costs are imposed without regard to technical feasibility or market conditions, two reactions threaten: either suppliers refrain from bidding, or they accept and later compensate through quality deterioration, delivery delays or renegotiation. In practice, this shows up in increasing delivery lead time variance, falling OTD or refused delivery commitments on rush orders. Target mandates must therefore be aligned with the clean-sheet costing and technical estimates – otherwise paper gains arise that have negative effects along the supply chain.

Contractual and process controls

Anyone working with suppliers in target cost dialogues shares confidential information on cost structures, volumes and pricing. A non-disclosure agreement (NDA) is standard here and protects both sides. In addition, agreements on the obligation to pass on cost reductions ('give-get'), on the validity period of offers and on adjustment in the event of material price changes should be documented in writing. The quality agreement with suppliers also belongs here, so that savings do not come at the expense of the specification. Legal frameworks such as the Supply Chain Due Diligence Act impose additional requirements on supplier selection and review that must be considered in the process.

Internal resistance and data quality

Target costing frequently collides with established costing habits and with resistance from engineering and sales, who see their design latitude restricted. Without management support and without robust cost and quantity structures, the method remains an exercise. A clean data foundation is decisive: current material prices, plausibly documented overhead rates, consistent bills of materials. In practice, the greatest implementation errors prove to lie less in the mathematics than in the lack of alignment between the parties involved.

Current developments and practice in the procurement environment

Target costing is gaining in importance because margin pressure, material price volatility and short product life cycles no longer make price negotiations alone viable. Digital tools and early supplier involvement are noticeably changing the methodology.

Early supplier integration

The strongest lever lies in the design phase. Supplier integration therefore means that specialist suppliers contribute their process and material expertise before design release, for example via pilot runs during the pre-series. Tooling procurement and tooling costs can thus be calculated early and checked against target values before expensive changes arise. Demand aggregation across several projects or business units can unlock additional volume effects and support the target calculation.

Portfolio and strategy context

Target costing only unfolds its effect in the context of a clear supplier strategy and a structured supplier

portfolio. Those who know which commodity groups are procured strategically and which rather from the market can set target cost mandates in a differentiated manner. Supplier consolidation and a uniform ordering policy strengthen the negotiating position and facilitate the enforcement of target cost mandates. The procurement business plan links the target cost mandates with procurement budgets, initiatives and responsibilities across the year.

Digital support and data foundation

Digital costing tools, databases for material prices and machine cost rates, and AI-supported analysis of quote structures make target costing faster and more repeatable. This relieves buyers of laborious detailed research and allows standardised clean-sheet approaches even for smaller volumes. In all cases, professional plausibility checks remain essential: automation does not replace technical understanding, it complements it.

Typical metrics

Target cost achievement: typically > 95%

Share of assemblies that meet their target costs; define a target value per project phase

Cost gap: start frequently 5–15% above target costs

to be driven towards zero through revision rounds

On-Time Delivery (OTD): > 95%

check whether cost reductions come at the expense of delivery reliability

Material cost reduction per period: typically 2–5% p. a.

overall effect across all commodity groups, depending on market and project duration

Practical example

A mid-sized mechanical engineering company is developing a new product series and faces the problem that planned manufacturing costs exceed the planned market price by around 12 per cent. The project team carries out a target costing exercise and breaks the cost gap down across assemblies and key suppliers. For a central cast component, procurement works with the supplier to produce a clean-sheet costing and identifies cost-reduction potential through an optimised casting geometry and a modified heat treatment. After two design and procurement revisions, the cost gap has been reduced to below 2 per cent.

- Target costing with binding target values per assembly and milestone monitoring
- Clean-sheet costing with key suppliers under NDA as the basis for negotiation
- Value engineering workshops between engineering and supplier for geometry and material optimisation
- Supplementary supplier rating with OTD and quality metrics, so that savings do not come at the expense of supply security

Conclusion

Target costing shifts the procurement perspective from pure price negotiation to the systematic shaping of the cost structure. It forces target values to be defined early, gaps to be made visible and closed jointly with suppliers – through design, material, process and logistics. The method works best when it is anchored early in the product development process and operates with a robust data foundation and

clear contractual rules. Risks arise where targets are set unrealistically or where savings come at the expense of quality and delivery reliability. For buyers in DACH industry, it is therefore less a calculation technique than a steering logic that aligns procurement, engineering and suppliers on a common cost objective.

Frequently asked questions

What is target costing in simple terms?

Target costing works by calculating backwards: you take the price the market is willing to pay for a product, deduct the target margin, and arrive at the maximum permissible costs. These target costs are then allocated to assemblies, materials and manufacturing. The difference to the actually planned costs – known as the cost gap – is actively closed through design, process or procurement measures.

What is the difference between target costing and classic costing?

Classic costing starts from the costs incurred and derives a price from them. Target costing starts from the marketable price and derives permissible costs from it. It is therefore an upstream planning calculation that comes into play during product development, whereas classic costing usually only reports actual costs after the start of production.

How do you enforce target costs in procurement vis-à-vis suppliers?

A factual basis is essential: a clean-sheet costing shows which costs can be justified technically and in terms of process. On this basis, target figures are communicated per assembly or line item, and measures for achieving them are developed jointly with the supplier – for example design changes, material substitution or process optimisation. Binding target values are often contractually fixed with milestones and an agreement on sharing achieved savings, secured by an NDA.

Which KPIs belong to target costing?

Key performance indicators are target cost achievement, the absolute cost gap and the development of unit costs across project milestones. In addition, quality and delivery metrics such as scrap rate, on-time delivery and delivery lead time variance should be included, so that savings do not come at the expense of supply security. This combination corresponds to the logic of a supplier rating.

When is target costing useful and when is it not?

The method makes sense for new products with sufficient design flexibility, for high material or manufacturing costs and when there is competitive pressure in the sales market. It is less suitable in heavily regulated markets with fixed prices, for pure contract manufacturing without design latitude, or when the design has already been frozen. With very small volumes, too, the effort of detailed breakdown can outweigh the benefit.

What does target costing involve in practice?

Besides the calculation itself, this includes a robust data foundation from bills of materials, material prices and overhead rates, agreed target figures between sales, engineering and procurement, and milestone-based controlling. Contractually, an NDA, clear agreements on the obligation to pass on cost reductions and, where applicable, a quality agreement with the supplier are important. In terms of process, the method is typically anchored in the procurement business plan.