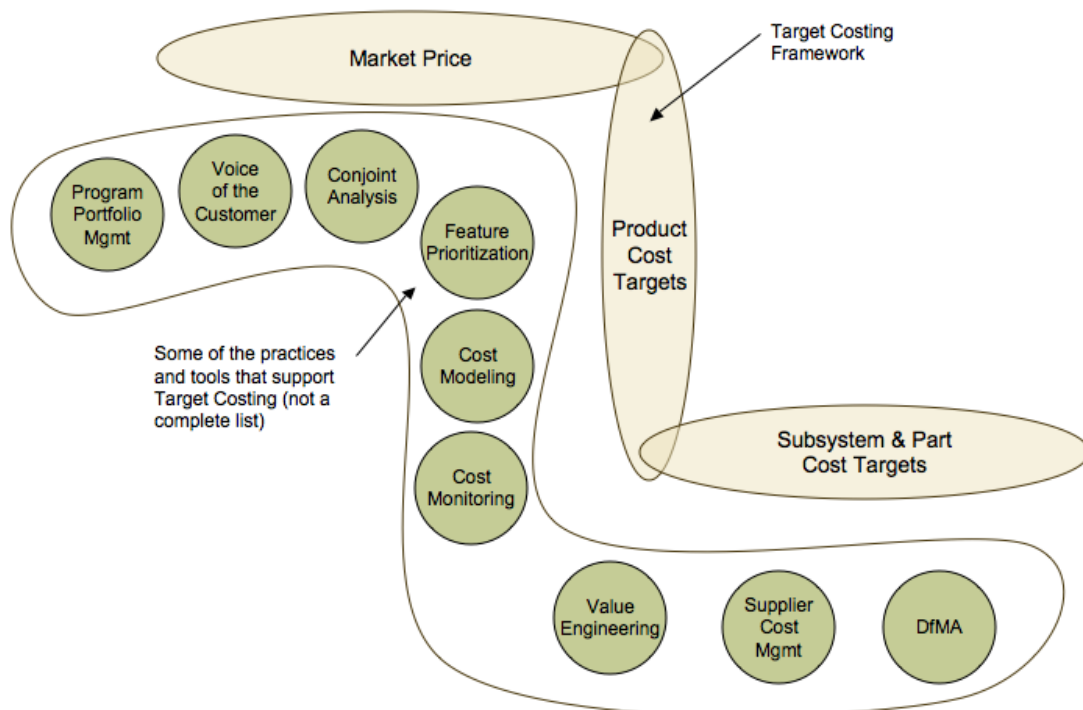


# Target Costing

Managing Product Costs to Deliver More Value

by Katherine Radeka



Model adapted from:  
"Develop Profitable New Products with Target Costing" by Robin Cooper and Regine Slagmulder.  
*Sloan Management Review*, Summer 1999, Vol. 40, No. 4, pp. 23-33.



# Target Costing

## Managing Product Costs to Deliver More Value

### Key Takeaways



- Target Costing helps development teams effectively set and meet targets for product costs,, and helps a product deliver more value for the customer and the business.
- Three phases define the overall Target Costing process.
- Within these phases, specific tools help teams identify, monitor and manage target costs at the product and subsystem levels.

### What is Target Costing?

Target costing is an approach to managing product costs and gross margins that works backward from the price a customer will pay for a specific product with a specific feature set, sets product cost targets based on that product's expected gross margin and then manages the development process to achieve the targets. This is different from how many companies approach product costs, where the teams may set targets based on historical data and prediction, and then set the price by adding a specific percentage of margin.

Target costing places customer value at the center of the financial decisions that a development team makes about a product. To do this effectively, a team needs to know such things as how much extra a customer will pay for a specific feature or level of performance, which areas of the product may be over-performing or especially difficult to manufacture, how to re-think a product design to make it easier and less expensive to produce, and how to partner with suppliers to drive down costs. The idea is to rethink our assumptions about a product and ask our customers directly to give us guidance on the elements of the product that create the most value for them - so that we can deliver them more effectively and eliminate everything else.

The main benefit of this approach is increased gross margins, primarily by reducing direct labor and material costs for the product. One design goal can be fewer parts, which leads to savings in inventory management throughout the supply chain. The same techniques usually lead to products that are easier to transition to manufacturing, more reliable and easier to maintain, which also drives down development, warranty, service and support costs.

Surprisingly, this approach can make customers happier, too. By simplifying the products to reduce excess features and complexity, we can make the products easier to use and maintain from the customers' perspective. They also benefit from lower service and support costs, and higher reliability.

### Three Phases of Target Costing

In 1999, Cooper and Slagmulder defined three stages of target costing:

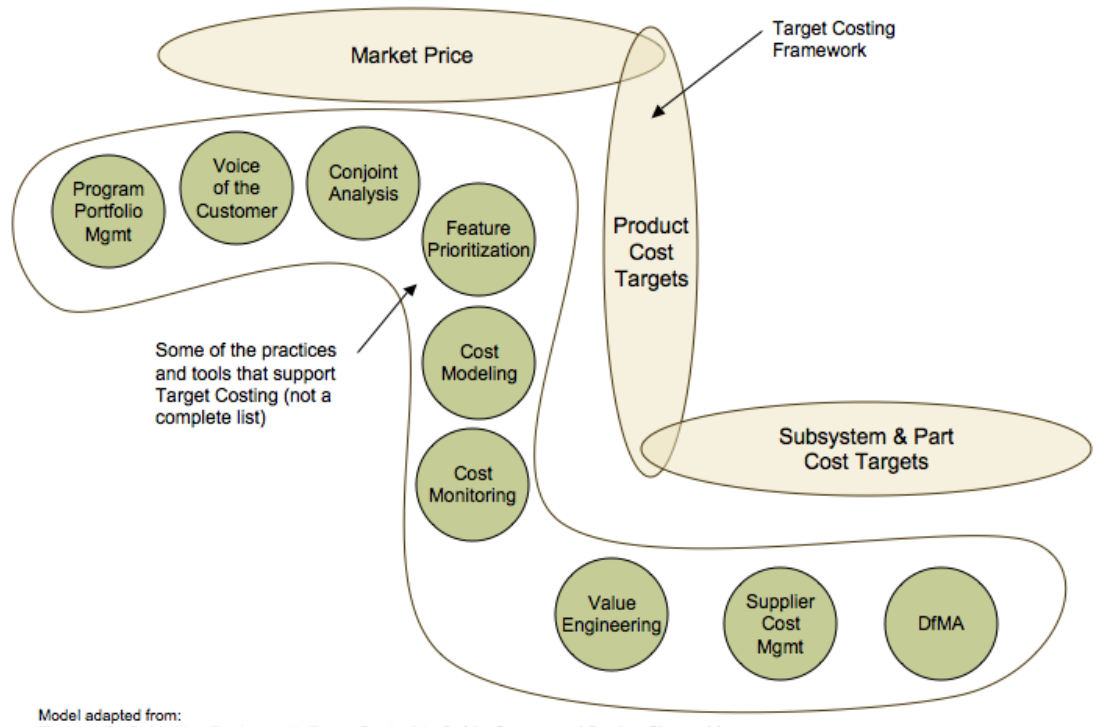
- Setting the market price: In this phase, Marketing sets a target price for the product, and provides the development team with a prioritized list of features that will deliver a product that the customer will buy at the target price.
- Managing the product cost: The development team sets a target cost for the product that will meet the organization's expectations for gross margin. They set up a process for monitoring product cost through the development cycle.
- Managing subsystem and part level costs: Using existing products and competitive data as guides, the team creates a "budget" for each subsystem and major component. The team then develops a strategy for closing any gaps between the expected costs and the target cost and engineers the product to achieve the costs. Along the way, the team continuously monitors both subsystem and product level costs to assess progress towards closing the gap and address the issues that arise.

These three phases provide a comprehensive focus on product cost throughout the product lifecycle that pulls together the entire development team.. In the beginning, Marketing is heavily involved in setting the target price and helping the development team understand relative value for features and performance parameters. Manufacturing people get involved early - in one case, as early as the concept phase, to provide early feedback on production process alternatives and their costs. Procurement and suppliers also get engaged to contribute ideas for closing the inevitable gaps between projected product costs and targeted costs.

## Target Costing Toolkit


This is a complex problem that encompasses the entire lifecycle of a product, from concept to launch. A comprehensive toolkit for managing product costs includes some elements of the following:

- A portfolio management system to ensure that we are working on the right products with the right value propositions.
- Effective means to gather and analyze customer feedback, including opportunities to “go and see” for senior members of the engineering staff.
- Ways to identify the relative value of specific features and performance parameters, such as conjoint analysis.
- Methods for assigning priority to specific features and specs for a specific product at a specific price point.
- Models for predicting costs at the product and subsystem levels.
- Monitoring tools to continuously monitor product costs as the product moves through development.
- Platform development practices to leverage subsystem and part designs across multiple products to lower costs throughout the value stream.
- Value Engineering tools to identify opportunities and implement strategies for cost reduction in the product design.
- Supplier Management skills for bringing suppliers into the cost discussion as partners.
- Design for Manufacturability and Assembly methods and means for getting early feedback from production to lower manufacturing costs.



## How to Begin

Ask these questions of your organization to figure out where to start first:

- How does our portfolio management process help us work on the right products at the right price and manage our product families?
- How well do we know how much our customers value specific product features and performance parameters?
- What areas of our product perform better than our customers expect or need, and how does this impact both cost and usability?
- How effectively can our program managers or chief engineers predict product costs in mid-development, and how well do they hit their projections at the release to production?
- How much time and energy do we expend on post-release cost reduction projects?
- What historical cost data is available to the team, and how effectively can they use it?
- How well do we know how much our customers value specific product features and performance parameters?
- Are there areas where our products perform better than our customers expect or need?
- What does maintaining our current standards cost us? 

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## For Further Reading:

Clifton, M. Bradford, Townsend, Wesley Pl, Bird, Henry M. B., Albano, Robert E. (2003). *Target Costing: Market Driven Product Design*. Marcel Dekker, New York, NY.

Cooper, Robin and Slagmulder, Regina. "Develop Profitable New Products with Target Costing." *Sloan Management Review*, Summer 1999, Vol. 40, No. 4, pp. 23-33.



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