Concepts in Action

Extreme Target Pricing and Cost Management at IKEA

Around the world, IKEA has exploded into a furniture-retailing-industry phenomenon. Known for products named after small Swedish towns, modern design, flat packaging, and do-it-yourself instructions, IKEA has grown from humble beginnings to become the world's largest furniture retailer with 301 stores in 38 countries. How did this happen? Through aggressive target pricing, coupled with relentless cost management. IKEA's prices typically run 30%–50% below its competitors' prices. Moreover, while the prices of other companies' products rise over time, IKEA says it has reduced its retail prices by about 20% over the last four years.

During the conceptualization phase, product developers identify gaps in IKEA's current product portfolio. For example, they might identify the need to create a new flat-screen-television stand. "When we decide about a product, we always start with the consumer need" IKEA Product Developer June Deboehmler said. Second, product developers and their teams survey competitors to determine how much they charge for similar items, if offered, and then select a target price that is 30%–50% less than the competitor's price. With a product and price established, product developers then determine what materials will be used and what manufacturer will do the assembly work—all before the new item is fully designed. For example, a brief describing a new couch's target cost and basic specifications like color and style is submitted for bidding among IKEA's over 1,800 suppliers in more than 50 countries. Suppliers vie to offer the most attractive bid based on price, function, and materials to be used. This value-engineering process promotes volume-based cost efficiencies throughout the design and production process.

Aggressive cost management does not stop there. All IKEA products are designed to be shipped unassembled in flat packages. The company estimates that shipping costs would be at least six times greater if all products were assembled before shipping. To ensure that shipping costs remain low, packaging and shipping technicians work with product developers throughout the product development process. When IKEA recently designed its Lillberg chair, a packaging technician made a small tweak in the angle of the chair's arm. This change allowed more chairs to fit into a single shipping container, which meant a lower cost to the consumer.

What about products that have already been developed? IKEA applies the same cost management techniques to those products, too. For example, one of IKEA's best selling products is the Lack bedside table, which has retailed for the same low price since 1981. How is this possible, you may ask. Since hitting store shelves, more than 100 technical development projects have been performed on the Lack table. Despite the steady increase in the cost of raw materials and wages, IKEA has aggressively sought to reduce product and distribution costs to maintain the Lack table's initial retail price without jeopardizing the company's profit on the product.

As founder Ingvar Kamprad once summarized, "Waste of resources is a mortal sin at IKEA. Expensive solutions are a sign of mediocrity, and an idea without a price tag is never acceptable."

Sources: Baraldi, Enrico and Torkel Strömsten. 2009. Managing product development the IKEA way. Using target costing in inter-organizational networks. Working Paper, December. Margonelli, Lisa. 2002. How IKEA designs its sexy price tags. *Business 2.0,* October. Terdiman, Daniel. 2008. Anatomy of an IKEA product. CNET News.com, April 19.

Step 5: Perform value engineering to achieve target cost. **Value engineering** is a systematic evaluation of all aspects of the value chain, with the objective of reducing costs and achieving a quality level that satisfies customers. As we describe next, value engineering encompasses improvements in product designs, changes in materials specifications, and modifications in process methods. (See the Concepts in Action feature to learn about IKEA's approach to target pricing and target costing.)

Decision Point

How do companies determine target costs?