

## *The Hidden Costs of Inadequate Subcontract Price Analysis*

Government spending is always a hot topic, as it should be. After all, it's taxpayer money we're talking about. That's probably why these stories land particularly hard in the media when the GAO uncovers *yet another* case of overspending. Why is this happening? I'll argue that in large part, there is a fundamental misunderstanding of the cost of, and a general lack of focus on, price analysis. In general, price analysis is being overlooked as a source of cost savings and increased productivity.

### What is Price Analysis?

Price analysis as defined in FAR 15.404-1 "is the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit." This analysis of price occurs in two distinct places in the value chain: first between prime contractors and subcontractors, and second between the Government and the prime.

In a general sense, both the government and prime contractors rely on FAR 15-404 as the authority on adequate price analysis. While the FAR and its related supplements were written for federal agencies, contractors often adopt many of the same standards either because they make good business sense, or to simplify transactions with government customers.

### The Objective of Price Analysis

Ask a procurement agent the objective of price analysis and I'll bet that at least 75% of the time, you'll get some form of the following answer: "We conduct price analysis to justify the price paid." Taken on the surface, it's not wholly unreasonable. You could even support that statement using the very first sentence of FAR 15.404-1: "The objective of proposal analysis is

to ensure that the final agreed-to price is fair and reasonable."

So what's the problem here?

There's an incredibly important difference between "justifying a price as fair and reasonable" and "determining a fair and reasonable price." The objectives of these two statements are in absolute conflict. The first focuses on documenting a given price as justified. The second focuses on the open-ended analysis of price reasonableness which results in a value that is unknown at the outset.

It probably seems obvious that simply justifying a known price isn't productive. So why are so many companies doing it?

### Price Analysis in Practice

The answer to this question varies from organization to organization. However, there are a few basic principles that seem to apply across the board, both in government and private applications. It has to do with a lack of commitment that stretches from the bottom of the ranks to the top, the greenest of rookies all the way through executive leadership.

### The employee's perspective

- **Ever-increasing workloads** – The people responsible for conducting and documenting price analysis sit at the end of an open spigot that never shuts off. Price analysis, then, becomes just another task in a long list of requirements that causes their backlog to grow.
- **Lack of incentive** – For the owner of a company, there's an obvious tie between

determining the “right” price to pay and the effect on compensation. For employees, it’s far less clear. Most organizations’ main measurement of productivity is related to throughput, backlog, or both. While this may shine light on efficiency, it leaves “effectiveness” out in the cold.

- **Aiming for a moving target** – For companies that have spent time and committed resources to the price analysis process, quality control measures typically mean that a compliance or management review is required. Great! But all too often, the standard of review is not written down, so employees are left to figure out what works. Their efforts then change from documenting a proper analysis to saying what the reviewer wants to hear.

## The company’s perspective

- **If it ain’t broke, don’t fix it** – Unless there’s a significant finding in a CPSR (contractor purchasing system review), a negative GAO report, or companies are losing competitions based on price, it’s unlikely that anybody’s going to raise price analysis as an issue...never mind that there’s money being left on the table!
- **Competing interests** – The Contracts (sales) team wants to win deals. The Program (production) team wants goods on-dock so they can be delivered on time. Quality wants delivery standards to be met. Compliance wants to avoid audit findings. Finance wants everything cheaper. It benefits everybody in the organization, but finding budget and commitment to pay for improved price analysis is typically viewed as somebody else’s problem. Once a team steps up, the others often try to force their needs and any progress gained is lost to bureaucracy and in-fighting.

## Simple Tips for Improvement

1. **Nail down the costs and benefits** – Everybody talks about saving time and money, but hardly anybody signs up to specifics. When we explain that investing \$2,400 per employee in price analysis improvements results in a return of \$33,600 in efficiencies (plus margin improvements and additional deals), it becomes a goal that can be worked toward and measured.
2. **Provide the right tools** – All too often, price analysis is conducted using spreadsheets, word processors, calculators, and multiple internal and external websites. Switching between these results in loss of productivity and frustration. SpendLogic’s price analysis tool can help by streamlining the entire process!
3. **Remove ambiguity** – Set measurable objective standards, communicate them to employees, and apply them evenly in all situations.
4. **Get back to basics** – Remind people that the point of price analysis is to determine a price something should cost and sets an objective for negotiations. The work they put into the analysis becomes the information they need to be successful in closing the deal. Using a logic-based approach that relies on verifiable data opens the door to win-win agreements that grow the pie for everyone.
5. **Encourage people to work together** – We live in the social media age and are more connected than ever...unless you’re looking at life at work. If your employees can’t quickly and easily access, copy, and modify the work of their peers, then your company isn’t keeping pace. Embrace collaboration!

## Conclusion

If a company's buying team doesn't regard price analysis as ranking among the most critical parts of placing a purchase order, they're leaving money on the table and don't even know it. Furthermore, without the proper tools and top-down communication, expecting excellence in material pricing and negotiation is unreasonable on the part of Leadership. Put the tools in place, communicate the expectation, and then measure and communicate the results. You may be surprised to find that rather than carrying a cost, improving price analysis in your organization becomes a source of net incremental savings. ☺ - Patrick Mathern

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## Article at a glance

- Government and industry follow similar processes in price analysis, but the differences have a big impact on the final product.
- The term "price analysis" is not interchangeable with "price justification," contrary to popular belief.
- For price analysis to be effective, it must be conducted prior to negotiations.
- Employees aren't typically motivated to make price analysis a priority.
- Companies are often reluctant to change processes until the current system has experienced a significant failure.
- With the proper top-down communication and tools, including SpendLogic's price analysis tools and training, price analysis can become a source of incremental improvement and savings.