



Actuals

Limitations and Opportunities

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Buyers for the Department of Defense (DoD) have the rare ability to require cost history from their suppliers, and these records can help buyers determine fair and reasonable prices. However, focusing on the cost “actuals” as the ultimate indicator of reasonableness can result in higher costs over time. The situation exemplifies Goodhart’s Law, which states, “When a measure becomes a target, it ceases to be a good measure.”¹ Recognizing the limitations of actuals, and focusing on three ways to get better value, will unlock budget potential for DoD priorities—a rising imperative due to the COVID-19 pandemic and other budgetary pressures.

¹Strathern, Marilyn (1997). “Improving ratings’: audit in the British University system”. *European Review*. John Wiley & Sons. 5 (3): 305–321. doi:10.1002/(SICI)1234-981X(199707)5:3<05::AID-EURO184>3.0.CO;2-4.

Limitations

It's not that actuals are inherently bad. Understanding a contractor's incurred costs—especially at the sub-tier level, which frequently gets less attention—can pay big dividends for buyers. For example, our past work has highlighted situations in which the reported actual costs were far less than the up-front estimated costs, resulting in excessive profit percentages for the contractor at completion—percentages exceeding well

over 100%, in some cases. Actuals enable buyers to recognize and correct such pricing disconnects.

But there are many assumptions that falsely equate actuals with reasonableness. Actuals present at least five primary challenges that suggest they should be subject to more critical examination:

- 1** | A contractor's historical costs may be riddled with past inefficiencies and performance shortfalls. These actuals then get incorporated into future proposals, driving up what the costs should be.
- 2** | Subjectivity in the specific actuals provided (for example, "cherry-picking," in which the supplier selectively chooses time periods, complex tasks, or the most expensive rates) can be problematic for the basis of estimates that use reference programs or tasks to justify future estimates. A common misperception is that when actuals are provided, the buyer receives the entire data set of costs; in reality, suppliers furnish a subset of the data based on the specific request or requirement.
- 3** | Contractors have an incentive to keep costs higher over time, particularly in the absence of competition. A stable baseline of costs provides predictable revenues and margins. Maintaining a higher cost base during earlier program phases can put a significant profit cushion under future production contracts.
- 4** | Actuals do not reflect a market-based view, but rather an internally focused perspective on costs. In a sole-source environment, over time this can mean an increasing divergence from what a "prudent person in the conduct of competitive business"² should pay.
- 5** | Maintaining a government-approved accounting system does not mean that all the costs incurred by the supplier are automatically reasonable. Cost accounting standards (CAS) and contractor accounting-system approvals focus on allocability of costs, an important factor for consistency and transparency. Actual costs, however, should not be treated as reasonable simply because they are CAS compliant and run through a supplier's approved accounting system.

²Federal Acquisition Regulations (FAR) 31.201-3(a).



Opportunities for Value

There are at least three ways in which buyers can change their focus from past actuals to continuous improvement and thus achieve better outcomes.

1. Be strategic and specific about the form and content of data.

Appropriate contractor data format is often emphasized as the most efficient way to obtain cost or pricing data. Focusing on a contractor's format allows suppliers to control the discussion. Actuals are often given for broad categories of cost, and possibly in a manner that is confusing, voluminous, not machine readable, or all three. A contractor's accounting system should enable a much greater level of insight, and Federal Acquisition Regulations provide contracting officers with a great deal of discretion regarding the information requested to determine fair and reasonable pricing.³ Buyers should supply the contractor with a structured template to streamline the provision and evaluation of actuals. This would both accelerate the acquisition

and provide more specific data insights. For instance, the following details would allow government buyers to make better-informed determinations of reasonableness, though they are often withheld by suppliers in proposal submissions:

- Specifics of labor category and discipline, seniority levels, and skill mix for labor costs
- Geographic locations of the actual work performed
- Comparisons of fixed and variable labor hours and material costs
- Actual learning/experience curves achieved over time

We have observed contractors that maintain approved labor rates that cover multiple geographic locations and seniority levels, with corresponding actuals that align with

³FAR 15.402(a)(3).

these rates at a macro level. However, when the rates are compared against those in local labor markets where some of the actual work is occurring, large disconnects are often apparent. Why, on a given contract, should the government pay rates that are driven up by senior specialized workers in high-cost areas, when most of the work on that specific contract is more basic and in a cheaper area? The effects can be profound in both individual contracts and for entire programs.

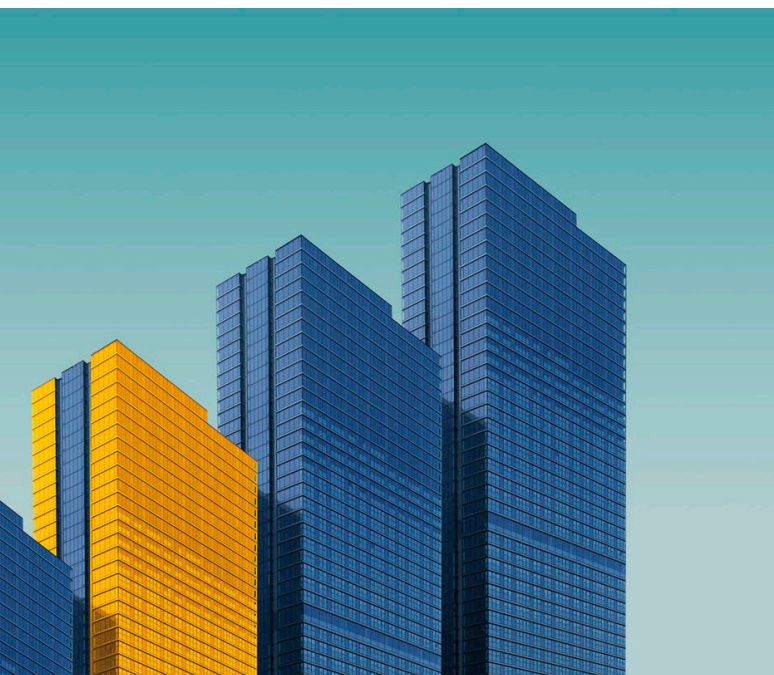
2. Leverage market benchmarks.

The preferred approach to proposal analysis and negotiations should be more like a “should cost” analysis to push cost estimates toward more-competitive pricing. Even if the work is specialized or technically demanding, there is still other work that is comparable in process steps, workforce skills, materials, and so forth. Market benchmarks that include commercial data should be leveraged to obtain detailed data from the contractor to support (or refute) the contractor’s proposed estimates. For example, commercial benchmarks are available for direct labor rates by geographic area and discipline,

overhead expense pools (such as health care), and raw material indices, but they are often overlooked in favor of the contractor’s own actuals history. DoD buyers should be trained to use, and open to employing, market-based information to question suppliers’ estimates.

3. Communicate effectively to place the burden back on the supplier.

The ingrained use of actuals by both contractors and government agencies means that challenging past precedent will not be easy. Buyers should expect significant pushback, externally and even internally, when questioning past actuals as the basis for future estimates. A data-driven communications plan to senior government decision makers and to the contractor is often required to educate key stakeholders about why they should expect more. The burden of demonstrating why an estimate is reasonable—with both actuals and relevant market-based data—must rest with the supplier. After all, the government is the customer.



The affordability of major products and services is always a concern. Additional obstacles and budgetary pressure from the COVID-19 pandemic will only exacerbate the situation. Analyzing historical costs and future estimates through a critical, market-based lens is crucial if capability is to be increased and unit costs reduced. The acquisition workforce can meet this challenge, and the great power competition demands it.

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