SSRO

Single Source Regulations Office

*Assuring value, building confidence*

# Revised Allowable Costs guidance for consultation

October 2017

# Contents

# 1. Introduction

The following sections of this document set out the proposed Allowable Costs guidance which the SSRO is consulting with stakeholders on during the period 2 October – 24 November 2017. The SSRO has taken the opportunity to re-structure the guidance to improve navigation and understanding. The introduction section of the guidance remains largely unchanged from the previous guidance and incorporates some paragraphs from the previous background section. Paragraphs 2.1, 2.3. 2.4, 3.1, 3.2 and 3.3 from the existing guidance have been removed as they were not guidance and the SSRO considers them to be no longer relevant.

**Explanatory note:** The boxes at the top of each section in this document will be removed from the final guidance.

1.1 The Defence Reform Act 2014 (the Act) requires that qualifying defence contracts (QDC) and qualifying sub-contracts (QSC) are priced on the basis of Allowable Costs. A contract is a QDC if it meets the definition laid down in Section 14(2) of the Act. A QSC is a contract between a primary contractor and another contractor or between a sub-contractor and another contractor where it meets the definition laid down in Section 28 of the Act, and has been assessed and notified as a QSC pursuant to the procedure under Section 29 of the Act.

1.2 The Act also states that, in carrying out its functions, the SSRO must aim to ensure that:

- good value for money is obtained in government expenditure on QDCs; and
- persons (other than the Secretary of State) who are parties to QDCs, and QSCs are paid a fair and reasonable price under those contracts.

1.3 Section 20 of the Act specifies when costs are Allowable and sets out related provisions. Both parties need to be satisfied that costs are Appropriate, Attributable to the contract and Reasonable in the circumstances (the AAR test)[1].

1.4 Section 20(1) of the Act stipulates that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs. This guidance is issued by the SSRO for use by contractors and the Ministry of Defence (MOD) when determining whether costs are Allowable. Section 20(3) of the Act states that the Secretary of State and the contractor must have regard to the SSRO's guidance in determining whether a cost satisfies the AAR test.

1.5 Terminology used but not expressly defined in this guidance is as articulated in the the Act or the Single Source Contract Regulations 2014 (the Regulations). Specific accountancy terms have not been defined in this guidance as definitions of these terms exist in relevant accounting standards[2].

1 Section 20(2) – Defence Reform Act 2014
2 Financial Reporting Council

1.6 This guidance document has the following structure to assist its users with understanding and application:

a. Section 1 – Introduction;

b. Section 2 – The AAR principles;

c. Section 3 – Cost accounting and financial reporting principles;

d. Section 4 – Application; and

e. Section 5 – Specific guidance on individual cost types.

1.7 The following sections set out the SSRO's statutory guidance issued pursuant to Section 20 of the Defence Reform Act 2014.

# 2. The AAR principles

This section of the document includes paragraphs 8.1 – 8.7 of the current guidance and remains unchanged.

2.1 Costs are Allowable to the extent they are Appropriate, Attributable to the contract and Reasonable in the circumstances. These criteria apply to all costs (estimated and actual) of a QDC or QSC. This guidance sets out the principles to be followed. The subsequent paragraphs set out a non-exhaustive list that parties should consider when assessing whether a cost might meet the Appropriate, Attributable and Reasonable criteria and are therefore Allowable.

### Appropriate

2.2 Guidance on Appropriate costs:

*A cost is Appropriate if, by its character and nature, it represents a cost that is expected to be incurred in the conduct of delivering the QDC or QSC in question. Appropriate costs are those which should be able to withstand public scrutiny and which can be supported by sufficient justification.*

2.3 In order to assess whether a cost is Appropriate, consideration should be given to the following:

- whether a cost might be expected to be incurred in the delivery of the QDC or QSC;
- whether the cost is suitable for the purpose of the QDC or QSC;
- whether the inclusion of the cost would withstand public scrutiny; and
- whether the inclusion of the cost is fair and equitable.

### Attributable

2.4 Guidance on Attributable costs:

*A cost is Attributable if it is incurred directly or indirectly for the fulfilment of the QDC, or QSC in question and it is necessary to fulfil the requirements of that contract.*

*All costs should be incurred by the contractor and applied to the QDC or QSC on a basis that is consistent with the contracting company's overarching cost accounting practices. The costs should be costs not recovered in any way from another contract, whether past, existing or proposed.*

2.5 In order to assess whether a cost is Attributable, consideration should be given to the following:

- whether the treatment is consistent with generally accepted accounting principles;
- whether the cost is borne by the contractor;
- whether the cost has a causal relationship with the contract, in the sense of being required for its delivery;
- whether the cost is identifiable;
- whether the cost is incurred in fulfilling the requirements of the QDC or QSC; and
- whether it can be evidenced that the cost has not already been recovered.

### Reasonable

2.6 Guidance on Reasonable costs:

*A cost is Reasonable if by its nature it does not exceed what might be expected to be incurred in the normal delivery of the QDC or QSC in question, whether under competitive tendering conditions or as a single source contract.*

*Indicators of whether costs are Reasonable include, but are not limited to, the level of competitiveness and/or market testing undertaken in the supply chain, any particular specification and performance requirements, any uncertainty involved, the economic environment, the statutory provisions in place at the time of contracting, the expected benefits provided and any alternative options available, for example to justify decisions as to whether to sub-contract or undertake work 'in-house'.*

2.7 In order to assess whether a cost is Reasonable, consideration should be given to the following:

- whether it is congruent with meeting the contract requirements;
- whether the cost would withstand public scrutiny;
- whether cost estimates are based on empirical evidence, where this is possible;
- whether the cost is consistent with any available sector/market benchmarks;
- whether the quantum of the cost is consistent with good business practice; and
- whether the costs deliver value for money for the UK taxpayer.

# 3. Cost Accounting and Financial Reporting

This section of the document has been created by combining elements of the existing sections 7 and 11 and reflects the issues which were discussed in the working paper on Cost Accounting and Financial Reporting which the SSRO issued on 19 June 2017.

### Direct costs

3.1 A direct cost is a cost that can be attributed to the production or delivery of specific goods, works or services required to fulfil the QDC or QSC. Direct costs may consist of materials, labour or other costs. The parties must always be satisfied that the cost is Appropriate, Attributable and Reasonable.

### Overhead/Indirect costs

3.2 Overhead and indirect costs are defined as those costs which have necessarily been incurred for the performance of the QDC or QSC as part of the conduct of the contractor's business in general, but cannot be measured as directly applicable to the performance of a single contract. These costs may be apportioned to individual contracts if both the costs and the proposed apportionment satisfy the test of being Appropriate, Attributable and Reasonable.

### Cost allocation practices

3.3 Single source contractors are required annually to declare to the MOD, through the Questionnaire on the Method of Allocation of Costs (QMAC), their cost accounting and cost allocation approach. This declaration does not pre-determine whether costs are Allowable. The contractor must make information available on an open book basis.

3.4 The contractor's costing system must be the same for the Secretary of State's work as it is for other work in which it is engaged thus ensuring that the allocation of costs can be relied upon as being both fair and transparent.

3.5 In making an assessment of Allowable Costs, the parties must determine whether a cost is, or is not, Allowable in line with this statutory guidance.

3.6 The contractor is required to demonstrate to the Secretary of State and evidence any claim for a cost to be Allowable. Any unresolved disputes between the contractor and the Secretary of State can be referred to the SSRO.

### Sunk costs

3.7 If costs have already been incurred, referred to as 'sunk' costs when an amended contract becomes a QDC or QSC, the SSRO expects that the parties would make appropriate arrangements such that it should be unnecessary for any question to be raised with the SSRO in relation to the sunk costs[3].

3 Sunk costs not subject to the regime will still need to be notified in accordance with the reporting requirements.

3.8 Such arrangements may include stating in the amended contract that:

- the contracting parties agree that the sunk costs are Allowable Costs; and
- the parties will not seek to reclaim costs or to claim additional costs in respect of the period prior to the amended contract becoming a QDC or QSC.

### Accounting systems

3.9 The contractor's accounting systems should be able to differentiate between costs that are Allowable and those which are incurred but where they are not Allowable. The SSRO does not otherwise provide guidance about the choice of accounting systems that a contractor uses to record accounting entries.

### Financial reporting

3.10 The SSRO does not provide guidance in relation to the preparation of financial statements for statutory reporting purposes. Contracting companies may adopt a variety of accounting policies and make judgements in the preparation of financial statements for statutory reporting purposes (e.g. International Financial Reporting Standards, UK Generally Accepted Accounting Practice). Application of these policies to QDCs will not necessarily result in costs charged satisfying the AAR principles and contractors must have regard to this guidance.

### DefCARS

3.11 Users of this guidance should be aware that the SSRO has developed the Defence Contract Analysis and Reporting System (DefCARS) to enable contractors to submit contract and supplier reports. These reports include information on Allowable Costs including estimates, approved rates, forecast and actual costs. The SSRO has developed statutory guidance[4] to assist contractors to meet their reporting obligations under the Act and the Regulations.

4 DefCARS – reporting guidance and system user guidance for defence contractors (SSRO website)

# 4. Application of the guidance

This section of the document explains how the guidance should be applied and combines the current guidance sections on application (Section 4) and other sources of classification (Section 5). Paragraphs 4.4, 4.5 and 4.6 of the current guidance have been removed as they are not considered relevant. The SSRO is consulting stakeholders on the application date of 1 April 2018 included in this section.

4.1 It is a legal requirement to have regard to this guidance in determining whether costs are Allowable under a QDC or QSC. This guidance applies to QDCs or QSCs entered into or amended on or after 1 April 2018 and replaces the version of the guidance published on 1 July 2016.

4.2 Section 20(4) of the Act places the onus upon the primary contractor of a QDC to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance as being Allowable.

4.3 In the case of a QSC, the sub-contractor may have to satisfy the MOD that costs are Allowable. The prime contractor may also need to be satisfied that costs within the price of a QSC are Allowable if it forms part of the price of a QDC.

### Further clarification

4.4 Any points may be clarified with the SSRO as they arise. The SSRO responds as quickly as possible to such requests, provided they are matters of general guidance and not contract-specific. The SSRO publishes SSRO Answers, which provides clarification in response to a range of general questions and is a useful reference point.

4.5 If the parties to a QDC or QSC, in advance of entering into the contract, would like a view as to whether costs under the contract may be Allowable Costs, then a referral may be made to the SSRO for an opinion. The SSRO has published guidance as to how it will deal with such referrals for an opinion.

4.6 Post-contract award the parties to a QDC or QSC may apply to the SSRO to determine the extent to which costs are Allowable Costs. If such a referral is made, the SSRO will make a determination as to whether the costs are Allowable Costs. The final determination has legal consequences for the parties. The SSRO has published guidance as to how it will deal with such referrals for a determination.

# 5. Guidance on specific cost types

This section of the document provides guidance on individual cost types and makes clear whether the guidance has been revised. Paragraph 5.1 below replaces paragraphs 9.1 – 9.4 in the current guidance. The SSRO has also considered the ordering of the individual cost types covered in this section of the guidance and suggests some changes to the grouping of different cost types.

5.1 All costs must satisfy the AAR test in order to be Allowable. Costs will either be completely Allowable, Allowable in part or not Allowable. This section provides guidance in relation to how the AAR test should be applied in relation to the specified categories. In some cases, the SSRO indicates the type of evidence that should be considered but the contracting parties may agree that additional evidence is necessary. The relevant parts of this section are:

| Part | Sub-section | Cost type |
|---|---|---|
| Part A – Labour costs | A.1 | Employee benefits |
| | A.2 | Pension costs |
| | A.3 | Redundancy costs |
| | A.4 | Inflation of labour costs or rates |
| Part B – Material costs | B.1 | Inflation of material costs or rates |
| Part C – Sales, marketing, bid, entertainment and third party costs | C.1 | Marketing and sales costs |
| | C.2 | Bid costs |
| | C.3 | Entertainment costs |
| | C.4 | Third party costs |
| Part D – Research and development costs | D.1 | Research and development costs |
| Part E – Costs associated with loss, poor performance or other events | E.1 | Losses, obsolescence and bad debt |
| | E.2 | Reworks and wastage |
| | E.3 | Faulty workmanship |
| | E.4 | Damages and compensation |
| | E.5 | Refunds, penalties and notional transactions |
| | E.6 | Insurance |

| Part | Sub-section | Cost type |
|---|---|---|
| Part F – Exceptional and abnormal costs | F.1 | Exceptional and abnormal costs |
| | F.2 | Costs associated with closure, rationalisation or restructuring |
| | F.3 | Idle facilities and capacity |
| Part G – Non-cash costs | G.1 | Non-cash costs |
| Part H – Risk related costs | H.1 | Risk related costs |

# Part A – Labour costs

The guidance in Part A is unchanged from the 1 July 2016 version (paragraphs 9.14; 9.15 – 9.17; 9.24 – 9.25; 9.37 – 9.38) apart from the grouping of cost types as set out below.

## A.1 Employee benefits

A.1.1 Where employee benefits payments are made for items such as profit sharing schemes, shares or benefits in kind, which are an element of employees' normal remuneration, then these may be included in Allowable Costs. The cost of shares issued to employees at favourable prices, is to be arrived at in the manner prescribed by the relevant generally accepted accounting principles.

A.1.2 Payments of staff bonuses must be in line with company policies. In order for these costs to be considered Reasonable, contractors must be able to provide supporting evidence. Exceptional bonuses payable following the sale of a company or part thereof and not part of normal remuneration are unlikely to be considered as Allowable Costs.

A.1.3 Distributions of profit, are generally not Allowable, as these costs are earnings as a result of sales exceeding production costs (they do not form part of production).

## A.2 Pension costs

A.2.1 Current pension costs, whether a defined benefit scheme or a defined contribution scheme, as provided in the income statement as an operating cost, may be Allowable subject to the application of this guidance.

A.2.2 These costs should be reconcilable by scheme to the disclosure notes in the statutory accounts for the contractor in accordance with the relevant generally accepted accounting principles. The following guidance applies to assessing whether pension costs are Allowable Costs:

a. Defined Contribution scheme: all employer contributions paid or accrued in the year.

b. Defined Benefit scheme: the relevant annual Allowable expense will be limited to the current or 'normal' service cost charged to the income statement, and not related to the funding of any deficit cost or past expenses, therefore:

- the current service cost is Allowable, this represents the increase in the pension scheme liability for an extra year of service for the contractor's employees; and
- the annual administrative expenses and running costs are Allowable as these are reported as an operating cost relating to the scheme (including Pension Protection Fund levies); however
- all other expenses recognised in the income statement which relate to past service costs, settlement gains and losses, net interest on the pension liability and all re-measurements recognised through the statement of other comprehensive income, are not Allowable.

## A.3 Redundancy costs

A.3.1 Redundancy payments made in the normal course of business, and which are in accordance with the rates laid down by statute, may be included in Allowable Costs. If payments are made in excess of such rates then these may also be included as agreed between the contractor and employees, but only if approved by the Secretary of State.

## A.4 Inflation of labour costs or rates

A.4.1 Inflation of labour costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable Cost.

# Part B – Material costs

Part B has been added in order to split guidance relating to labour and material related costs (paragraphs 9.37 – 9.38). Further guidance may be developed in future which relates to material costs given that these costs can be significant.

## B.1 Inflation of material cost or rates

B.1.1 Inflation of material costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable Cost.

# Part C – Marketing, sales, bid, entertainment and third party costs

The SSRO is consulting on an update to the guidance in relation to sales, marketing, bid and entertainment costs (paragraphs 9.26 – 9.27; 9.28 – 9.29; 9.30). Paragraphs 9.31 – 9.32 remain unchanged. This update builds on the analysis included in the working paper on Individual Cost Types issued by the SSRO on 19 June 2017 and the responses to those working papers.

## C.1 Marketing and sales costs

C.1.1 The MOD may decide to award single source contracts without the need for sales or marketing. However, marketing and sales costs may be considered Allowable in a single source contract if they meet the AAR principles and deliver demonstrable financial benefit to the MOD.

C.1.2 Benefit to the MOD may be demonstrated where proven successful orders have resulted (retrospective test) or are expected to result (prospective test) in increased throughput of activity and maintenance or reduction in the rates charged to the MOD or unit costs on a QDC or QSC. In particular, to be considered Allowable the following should apply:

a. Any retrospective or prospective benefit to the MOD through cost savings on QDCs is greater than the costs being claimed.

b. The current and forecast spend is supported by a sound evidence base which clearly demonstrates the benefit.

c. The evidence base has been agreed with the MOD.

C.1.3 Marketing and sales costs may include such items as salary costs and related staff expenses (travel and subsistence), marketing and sales campaigns, relationship/account management activities, sponsorships and other related commercial activities.

C1.4 It may assist in demonstrating benefit to the MOD if a contractor can show the breakdown of their costs. For example:

a. Segmenting their market by geography or product/service; or

b. Identifying where campaigns have Government support.

C.1.5 A contractor should ensure that any costs claimed have not or will not be recovered through other means. For example, where there is Government financial support for sales and marketing campaigns already in place these costs should not be claimed.

## C.2 Bid costs

C.2.1 The costs incurred by a contractor in pricing a QDC or QSC may be Allowable Costs under the resulting contract. These costs are referred to as bid costs and may include the staff costs of preparing and reviewing proposals. These costs would normally be incurred after the date of issue of a request for expression of interest, Preliminary Qualifying Questionnaire or Invitation to Tender.

C.2.2 If bid costs are Allowable they should be charged directly to a contract rather than being apportioned as indirect costs. If no contract is awarded, then the contractor's costs of bidding for that contract will generally not be Allowable under another QDC or QSC. This is because the costs will not be attributable to a QDC or QSC. However, the MOD may agree that these costs can be claimed as indirect costs on a future QDC or QSC or are dealt with separately.

C.2.3 The contractor's marketing and sales costs should not be included as bid costs and should be treated separately under C.1 of this guidance.

## C.3 Entertainment costs

C.3.1 Entertainment costs are not Allowable Costs.

## C.4 Third party costs

C.4.1 Donations of a political and charitable nature are not Allowable as these form no part of the costs associated with QDCs or QSCs.

C.4.2 Discounts allowed on sales to third parties are not Allowable as these do not financially benefit the QDC or QSC in question.

# Part D – Research and development costs

The guidance in Part D is unchanged from the 1 July 2016 version (paragraphs 9.18 – 9.23).

## D.1 Research and development

D.1.1 Contractors will account for private venture research and development expenditure in accordance with the relevant generally accepted accounting principles. Where it is realistic and suitable to do so, any expenditure of this nature must be allocated as closely as possible to those product groups that the expenditure is designed to benefit. Product groupings already established for the contractor's own purposes will normally be adopted and only revised when this is a necessity to achieve a fair allocation of the expenditure.

D.1.2 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following guidelines to assess it as Allowable will normally apply:

a. Any costs relating to projects where the research and development activity has already been funded via other routes should not be an Allowable Cost. In a case of a joint venture between the Secretary of State and other customers, a proportion of costs relevant to the Secretary of State's take up could be Allowable provided these costs have not been recovered elsewhere.

b. Research and development costs should not be allowed where there has been no discernible benefit provided to the QDC or QSC as a whole or where sufficient evidence is not available to support the research and development costs.

c. In the case of a product or service under development, the nature of which is such that it will be possible to ascertain the utilisation of the product or service developed, the recovery should be by direct charge to the product or service concerned.

d. In the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs should be recovered by a charge to the current total output of the product or service group.

D.1.3 Development expenditure that gives rise to an intangible asset should be attributed to the relevant product or products of the contractor. The intangible asset generated should fulfil the criteria set out in the relevant accounting standard and such expenditure will be charged direct to the products being developed. The costs of this research expenditure would be recovered through the costs of the relevant products when they are sold.

D.1.4 Due to the timeframes that research and development programmes can span, there may be circumstances where the parties may agree to carry forward a decision on whether costs are Allowable to a future date.

D.1.5 Abortive research and development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost.

D.1.6 Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims should generally be Allowable.

# Part E – Costs associated with loss, poor performance or other events

The SSRO is consulting on an update to the guidance in relation to reworks, wastage and faulty workmanship costs (paragraphs 9.33 – 9.35) in this section. This update builds on the analysis included in the working paper on Individual Cost Types issued by the SSRO on 19 June 2017 and the responses to those working papers. No changes have been made to the guidance on losses, obsolescence and bad debt (paragraphs 9.11 – 9.13), damages and compensation (paragraph 9.36) refunds, penalties and notional transactions (paragraphs 9.39 – 9.41) and insurance (paragraphs 9.42 – 9.44).

## E.1 Losses, obsolescence and bad debt

E.1.1 Stock losses and obsolescence should be charged directly to the contracts to which they relate as Allowable Costs. In circumstances where it is not possible to identify stock losses or obsolescence costs that specifically apply to contracts then they may still be Allowable. This will only apply when the contractor's costing system is able to isolate these stock losses as an indirect overhead. Contractors will be requested to provide evidence to support any claimed obsolescent stock write-offs and be able to demonstrate that these were not as a result of poor storage, handling or control.

E.1.2 Losses on other contracts are generally not Allowable, as by their nature these are not applicable to the QDC or QSC in question.

E.1.3 Bad debts, and any provision for those bad debts, are generally not Allowable unless they specifically relate to and arise on the QDC or QSC in question.

## E.2 Reworks and wastage

E.2.1 The costs of reworks and wastage may be Allowable. This recognises that no production or manufacturing process is completely effective and that the level of effectiveness can vary depending on whether a complex, new product is being developed or a long-standing service is being provided.

E.2.2 The contractor can demonstrate that costs may be Allowable by providing evidence that they meet the AAR test when assessed against industry benchmarks or similar comparative information. Costs above a reasonable level as indicated by the evidence would not be Allowable. Contractors should have adequate quality control and monitoring systems in place to identify the causes of reworks and wastage and have plans to reduce costs through learning curve and efficiency gains.

## E.3 Faulty workmanship

E.3.1 The costs of faulty workmanship are not Allowable where they are above a reasonable level or where the fault has occurred due to poor skills, training, systems or materials that the contractor has in place or has purchased. Costs associated with faulty workmanship may be Allowable where both parties are satisfied that faulty workmanship cannot be avoided because of the complexity or lack of maturity of the process being undertaken and the AAR test is met. These costs may be re-classified as reworks in some circumstances.

## E.4 Damages and compensation

E.4.1 Damages, compensation or loss of profit for poor performance, such as breach of contract, are not Allowable Costs.

## E.5 Refunds, penalties and notional transactions

E.5.1 Where reimbursements, credits, grants or refunds are received by contractors and cannot be identified to a particular contract then these should be apportioned to individual contracts to reduce Allowable Costs.

E.5.2 Notional transactions are generally not Allowable.

E.5.3 Civil penalties and fines, are not Allowable as these are payments imposed to compensate for harm done through the wrongdoing of the party concerned, which in this case would be the contractor, and as such generally do not meet the Appropriate, Attributable and Reasonable criteria.

## E.6 Insurance

E.6.1 The costs of insurance may be Allowable, but the nature of the insurance cover will be material to whether the costs satisfy the Appropriate, Attributable and Reasonable test. The costs of insurance covering buildings and equipment, employer's liability or vehicles and plants may be Allowable.

E.6.2 However, it would be neither Appropriate nor Reasonable for the taxpayer to pay for the contractor to be covered against its own poor performance in delivering the contract in question and, accordingly, the costs of such insurance should not be Allowable.

E.6.3 Accordingly, insurance against faulty workmanship (see E.3 above), defective parts, breach of contract or loss of profit associated with poor performance should not be Allowable. If insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable. A part of the costs may be Allowable if the contractor demonstrates what the cost would be with any Inappropriate, Non-attributable or Unreasonable cover excluded.

# Part F – Exceptional or abnormal costs

The guidance in Part F is unchanged from the 1 July 2016 version (paragraphs 10.1 – 10.11).

## F.1 Exceptional or abnormal costs

F.1.1 This guidance is applicable to all contract discussions between the Secretary of State and contractors regarding Allowable Costs in regard to QDCs and QSCs. Whilst the majority of discussions about whether costs are Appropriate, Attributable and Reasonable will be resolved without reference to further guidance there are a number of more complex issues that arise that may require additional guidance and this should be sought from the SSRO if agreement cannot be reached between the Secretary of State and the contractor.

F.1.2 Where costs arise which are exceptional or abnormal in size or incidence then they will be reviewed on a case-by-case basis to determine the extent to which such costs (wholly or in part) are Allowable. These generally relate to exceptional or abnormal costs which would have a major impact on Allowable Costs and require specific additional analysis and evidence to arrive at an agreement on suitable treatment.

F.1.3 In all cases of an exceptional nature which result in separate negotiations the SSRO should be informed.

F.1.4 Where the Allowable element of any of the costs is exceptional or abnormal in size and incidence, it is possible that the cost may be spread over a number of years.

## F.2 Costs associated with closure, rationalisation or restructuring

F.2.1 Exceptional costs will not be allowed where they relate to normal commercial business risk and any discussions around closure, rationalisation or restructuring must ensure that value for money remains the primary consideration. Contractors must demonstrate innovation and efficiency in the proposals they submit for reducing the costs associated with the closure, rationalisation or restructuring.

F.2.2 Where a site is closed resulting in other sites operated by the contractor or within a joint venture benefiting from gaining more work as a result of the site closure, the net cost of closure, rationalisation or restructuring must be tested and recovered against the benefits associated with the other sites or joint venture.

F.2.3 Profits and losses must be calculated at the time that closure, rationalisation or restructuring takes place.

## F.3 Idle facilities and capacity

F.3.1 Idle facilities are defined as those facilities and capital assets which are completely unused and that are not required by the contractor to fulfil current QDC or QSC commitments but which were designed for that purpose.

F.3.2 Idle capacity is that part of an overall facility or capital asset which is under-utilised for the delivery of a QDC or QSC.

F.3.3 The costs of idle facilities or capacity are not generally Allowable unless after application of the Appropriate, Attributable and Reasonable criteria it is confirmed that those unused facilities:

a. are determined by the Secretary of State as necessary to meet uncertain defence demands;

b. are of a strategic nature that the Secretary of State has determined may be called upon to enable, or support, urgent deployments; or

c. are unused due to a change in government or defence policy which could not have been predicted by the contractor.

F.3.4 Any decision on whether such costs are Allowable must be subject to a separate agreement between the contractor and the Secretary of State, to which the contractor is to provide the relevant evidence to support the payment. Any such agreement is to be separately reported to the SSRO with the necessary evidence to support the agreement.

# Part G - Non-cash costs

The SSRO is consulting on an update to the guidance in relation to depreciation, amortisation and impairment costs (paragraphs 9.5 – 9.7). This update builds on the analysis included in the working paper on Allowable Costs associated with Tangible and Intangible Assets issued by the SSRO on 19 June 2017.

## G.1 Non-cash costs

G.1.1 This section is concerned with tangible and intangible assets that have been recorded in the contractor's balance sheet and in respect of which the contractor seeks to charge costs under a QDC. The following are examples of these assets:

a. construction of a new facility;

b. property, plant and equipment which has been purchased;

c. internally generated intangible assets, such as development of intellectual property; and

d. goodwill that arises when a contractor buys another contractor.

### Depreciation and amortisation

G.1.2 A non-cash cost is an item that is reported on the income statement for which there is no related cash payment during the period. The non-cash cost associated with tangible assets is known as depreciation and the non-cash cost associated with intangible assets is amortisation.

G.1.3 A contractor should apply its own accounting policies to the valuation and recognition of assets on its balance sheet. Contractors should adopt a consistent approach to the application of their accounting policies to allocate or apportion non-cash costs such as depreciation and amortisation to QDCs or QSCs.

G.1.4 Depreciation and amortisation should not be Allowable in respect of an asset if the costs of the asset have already been recovered from the MOD. For example, if the MOD pays for a tangible asset at or before the start of the contract it should not pay additional costs in the form of depreciation in relation to that asset while the contract is being delivered.

G.1.5 If the MOD retains ownership of an asset and makes it available to the contractor in order for it to deliver the contract, depreciation and amortisation should not be Allowable Costs.

G.1.6 Business combinations, such as the acquisition of a company or business, may result in the creation of goodwill. Goodwill itself is not an Allowable Cost because it is an intangible asset which a contractor may record on its balance sheet due to the application of its accounting principles. A case by case review is required to determine the reason for the business combination, whether the acquired asset is attributable to the contract and whether any associated non-cash costs are Allowable.

### Re-valuation and Impairment

G.1.7 If a contractor's application of its own accounting policies results in a change in the valuation of an asset (e.g. through a re-valuation or an impairment review), this may also result in a change in non-cash costs such as depreciation and amortisation, or a new non-cash cost (e.g. an impairment expense or gain). Such circumstances will require a case by case review to understand why the value has changed and ensure that any costs are reasonable.

### Financing costs

G.1.8 Any costs associated with the raising of capital will not be Allowable. The step 6 capital servicing adjustment is intended to compensate for financing costs and the SSRO would not expect these to form part of the Allowable Costs. The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ in delivering QDCs or QSCs.

# Part H - Risk related costs

The study the SSRO has undertaken on risk in the summer of 2017 will inform the re-drafting of Allowable Costs guidance. The SSRO will consult on revised Allowable Costs guidance on risk as part of its consultation on profit rate adjustments guidance in December to ensure guidance is consistent with that on the cost risk adjustment. The paragraphs below are those included in the current guidance (paragraphs 9.8 – 9.10) and new paragraphs on risk will feature in the final guidance which will apply from April 2018 after stakeholders have been consulted.

## H.1 Risk related costs

H.1.1 Risk that can be estimated and modelled may be an Allowable Cost within the contract price if agreed by the Secretary of State. Costs associated with compensating the contractor for such risk should be evidenced, be appropriately modelled, and only be recovered once.

H.1.2 A risk over which the contractor has no or little control, may be covered under the provision of an adjustment to the baseline profit rate if the relevant evidence is provided. Further detail on the basis of a cost risk adjustment is covered in the SSRO's Guidance on Adjustments to the Baseline Profit Rate.

H.1.3 Given that there is no consistent definition of the various terms relating to risk, the underlying principle to be applied is that costs associated with compensating the contractor for risk should be clearly evidenced and only be recovered once.