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SSRO

Single Source
Regulations Office

Single Source Cost Standards

Statutory Guidance on Allowable Costs

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Introduction

1. Introduction

- 1.1 This document is issued by the Single Source Regulations Office (SSRO) and sets out the Single Source Cost Standards that must be used by Contractors and the Ministry of Defence (MOD) when entering into any contract where lack of competition could impact on delivering value for money to the UK taxpayer.
- 1.2 The Single Source Cost Standards is a statutory guidance document and its application is mandatory in determining whether costs are *Allowable* under single source contracts. The Single Source Cost Standards only deal with the treatment of costs in relation to single source contracts.
- 1.3 The guidance is principles, rather than rules based. These core principles are that costs must be *Appropriate*, *Attributable* and *Reasonable* to be considered *Allowable*. These core principles are shown in italics throughout this document.
- 2.1 This document is issued by the Single Source Regulations Office (SSRO) and sets out the Single Source Cost Standards that must be used by Contractors and the Ministry of Defence (MOD) when entering into any contract where lack of competition could impact on delivering value for money to the UK taxpayer.
- 2.2 Annually, single source procurement makes up a significant proportion of MOD expenditure and thus it is important that the framework which supports this expenditure is robust and fit for purpose. The guiding principle is that non-competitive contracts must emulate competitive conditions and be subject to sufficient challenge to ensure that single source contract awards deliver value for money to the UK tax payer.
- 2.3 An independent review undertaken by Lord Currie in 2011 resulted in the Better Defence Acquisition White Paper (2013), which recommended strengthening the MOD's arrangements for single source procurement. This formed the foundations for the Defence Reform Act 2014 (the "Act"), which provides the legislative basis for the Single Source Procurement Framework. The Single Source Procurement Framework is the statutory framework for all single source defence procurements and these Single Source Cost Standards forms a part of the wider framework.
- 2.4 The purpose of the Single Source Procurement Framework is to ensure a fair and reasonable price is paid for goods, works and services in the absence of competition. Alongside this, there

2. Background

- 2.1 Single source procurement is used for a variety of reasons including:
- when there is only a single Contractor able to deliver the specification;
 - when there are strong reasons for maintaining national capability;
 - because of the specialised or unique characteristics of the required services; or
 - for issues of national security.
- 2.2 Annually, single source procurement makes up a significant proportion of MOD expenditure and thus it is important that the framework which supports this expenditure is robust and fit for purpose. The guiding principle is that non-competitive contracts must emulate competitive conditions and be subject to sufficient challenge to ensure that single source contract awards deliver value for money to the UK tax payer.
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- 2.4 The purpose of the Single Source Procurement Framework is to ensure a fair and reasonable price is paid for goods, works and services in the absence of competition. Alongside this, there

is also the fundamental principle to assure the taxpayer that single source procurement delivers value for money and can withstand public scrutiny.

- 2.5 The Framework has two main components:
- regulations¹ governing single source contracts and Contractors, combined with statutory guidance; and
 - the creation of an arms-length independent body known as the SSRO which manages and monitors the framework.

- 2.6 The Act identifies the following objectives of the framework:
- (a) to address shortcomings which arise from single-source procurement;
 - (b) to focus on areas where standardisation is of value;
 - (c) to be proportionate; and
 - (d) to support value for money.

3. About this Guidance

- 3.1 The SSRO is an independent arms-length Executive Non-Departmental Public Body established by section 13 of the Act. The Act states that the SSRO must aim to ensure:
- (a) that good value for money is obtained in Government expenditure on Qualifying Defence Contracts; and
 - (b) that persons (other than the Secretary of State) who are parties to Qualifying Defence Contracts are paid a fair and reasonable price under those contracts.
- 3.2 Amongst its other statutory and non-statutory functions, Section 20 of the Act stipulates that:

The SSRO must issue guidance about determining whether costs are Allowable Costs under Qualifying Defence Contracts

- 3.3 The statutory guidance on *Allowable Costs* set out in this document meets the SSRO's requirement to perform its duties under Section 20 of the Act. The aim of the guidance is to establish the basis upon which a Contractor determines and calculates *Allowable Costs* for the purpose of pricing a Qualifying Defence Contract fairly and transparently.
- 3.4 Non-compliance with the guidance is in breach of the Act and any breach allows for penalties and fines to be applied.

4. Application of this Guidance

- 4.1 This is statutory guidance from the SSRO issued under Section 20 of the Act. It applies to all Qualifying Defence Contracts.
- 4.2 A contract is a Qualifying Defence Contract if:
- (1) it is a contract under which the Secretary of State procures goods, works or services from another person ("a Primary Contractor or Sub-Contractor to a Primary Contractor"); and
 - (2) the value of the contract is of or above the amount specified in the Regulations Part 2, Regulation 6;
 - (3) and
 - (a) the contract is entered into on or after the commencement of the Regulations;² and
 - (b) the award of the contract is not the result of a competitive process;
 or
 - (c) the contract is amended on or after the commencement of the Regulations; and
 - (d) the original contract was not the result of a competitive process; and
 - (e) in amending the contract, the Secretary of State and the Primary Contractor agree that following its amendment that it is to be a Qualifying Defence Contract;

¹ Single Source Contract Regulations 2014

² Expected to be in December 2014, subject to Parliamentary approval

- or
- (f) the award of the contract is the result of a competitive process; and
 - (g) the contract is amended on or after the commencement of the Regulations; and
 - (h) the amendment is not the result of a competitive process; and
 - (i) in amending the contract, the Secretary of State and the Primary or Sub-Contractor agree that following its amendment it is to be a Qualifying Defence Contract.
- 4.3 The guidance applies to Qualifying Defence Contracts above the amount specified in the Regulations. To establish whether the threshold values have been met for a Qualifying Defence Contract all revenues pertaining to a contract have to be taken into account, including:
- (a) whether received from the MOD or from third parties;
 - (b) the total cost of an acquisition as it applies to a Prime Contractor; and
 - (c) any sub-contracts; or
 - (d) secondary contracts to the Prime Contractor.
- 4.4 This means:
- for acquisition of primary equipment it is the total cost of that acquisition to the MOD, not the value of the individual contracts that pertain, which applies to the threshold;
 - for non-primary equipment procurements, the value of the procurement is defined as the total anticipated contract value.
- 4.5 The Regulations determine that a number of contracts do not qualify and are therefore excluded from this guidance. Exempt contracts are those:
- (1) to which the government of any country other than the United Kingdom is party;
 - (2) made within the framework of an international cooperative defence programme; or
 - (3) made wholly for the purposes of one or more of the following:
 - (a) the acquisition of land (including existing buildings or other structures, and land covered with water), and any estate, interest, easement, servitude or right in or over such land;
 - (b) the management or maintenance of any land or buildings or other structures; or
 - (c) intelligence activities.
- 4.6 The diagram below illustrates the systematic approach to establish whether this guidance is applicable.
- This applies to both a Primary Contractor and sub-Contractor to a Primary Contractor.

5. Previous Guidance

- 5.1 The MOD has used the same non-legally binding single source pricing framework since 1968, the 'Government Profit Formula and its Associated Arrangements', commonly referred to as the 'Yellow Book'. This guidance replaces the existing Government Accounting Conventions, a part of the 'Yellow Book'. The Government Accounting Conventions were non-binding which resulted in most Qualifying Defence Contract issues being resolved through negotiation.
- 5.2 Despite many shifts in the industrial landscape and procurement approaches since 1968, the 'Yellow Book' remains largely unchanged, partly because each amendment had to be agreed by both sides to the agreement.

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Allowable Costs

6. Importance of Allowable costs

- 6.1 The Act requires that Qualifying Defence Contracts are priced on the basis of “*Allowable Costs*”. *Allowable Costs* are an important element of MOD contract pricing mechanisms as they are the key driver of the contract price.
- 6.2 The definition and guidance for Allowable Costs is important because it enables the negotiation of fair contract prices between the MOD and the Contractor. To support this the Act states that *Allowable Costs* must be: “*Appropriate, Attributable* to the contract, and *Reasonable* in the circumstances” (Section 20(2)(a)-(c)).
- 6.3 The overall objective of the *Appropriate, Attributable* and *Reasonable* principles is to provide that, to the extent practicable, all organisations undertaking similar types of work under a Qualifying Defence Contract will follow the same principles and procedures to determine those costs which are Allowable.
- 6.4 This guidance provides principles and procedures to determine whether or not costs meet the criteria for *Allowable Costs*. It does not provide guidance with regard to the methodology employed to calculate those costs. The assessment and agreement of the costing methodology used by the Contractor is delivered

through completion and sign off of the Questionnaire on Method of Allocation of Costs.

- 6.5 The Act gives the SSRO the ability to determine the extent to which a particular cost is an *Allowable Cost* under a qualifying defence contract where an application is received for a determination.

7. Principles of Allowable Costs

- 7.1 To be *Allowable*, a cost **must** meet all three criteria; any one of the principles of *Appropriate, Attributable* and *Reasonable* is not sufficient on its own.
- 7.2 It is essential to the establishment of *Allowable Costs*, both at pricing and contract delivery stages, that *Allowable Costs* are auditable from resources employed through activities undertaken (using those resources) to the outputs and benefits required by the Qualifying Defence Contract. An audit trail is achieved through a transparent understanding of the causal link between the final outputs and benefits and the resources/ activities employed to deliver them.
- 7.3 It is expected that any costing system and costing methodology used by Contractors will allow the identification of costs as they are allocated from resources to activities to outputs and benefits. Presentation of costs in this manner supports a degree of standardisation of cost information

which in turn supports testing of costs to ensure that they meet the criteria for *Allowable Costs*.

7.4 Section 20(4) of the Act states that the onus is upon the Primary Contractor of a Qualifying Defence Contract, to evidence that costs, whether by reference to this guidance or otherwise, meet those requirements set out in this guidance as being *Allowable*. Whilst the burden of proof clearly rests with the Contractor it is essential that the MOD operates as an intelligent client and has the ability to verify, challenge and agree the costings that are submitted as being *Allowable*.

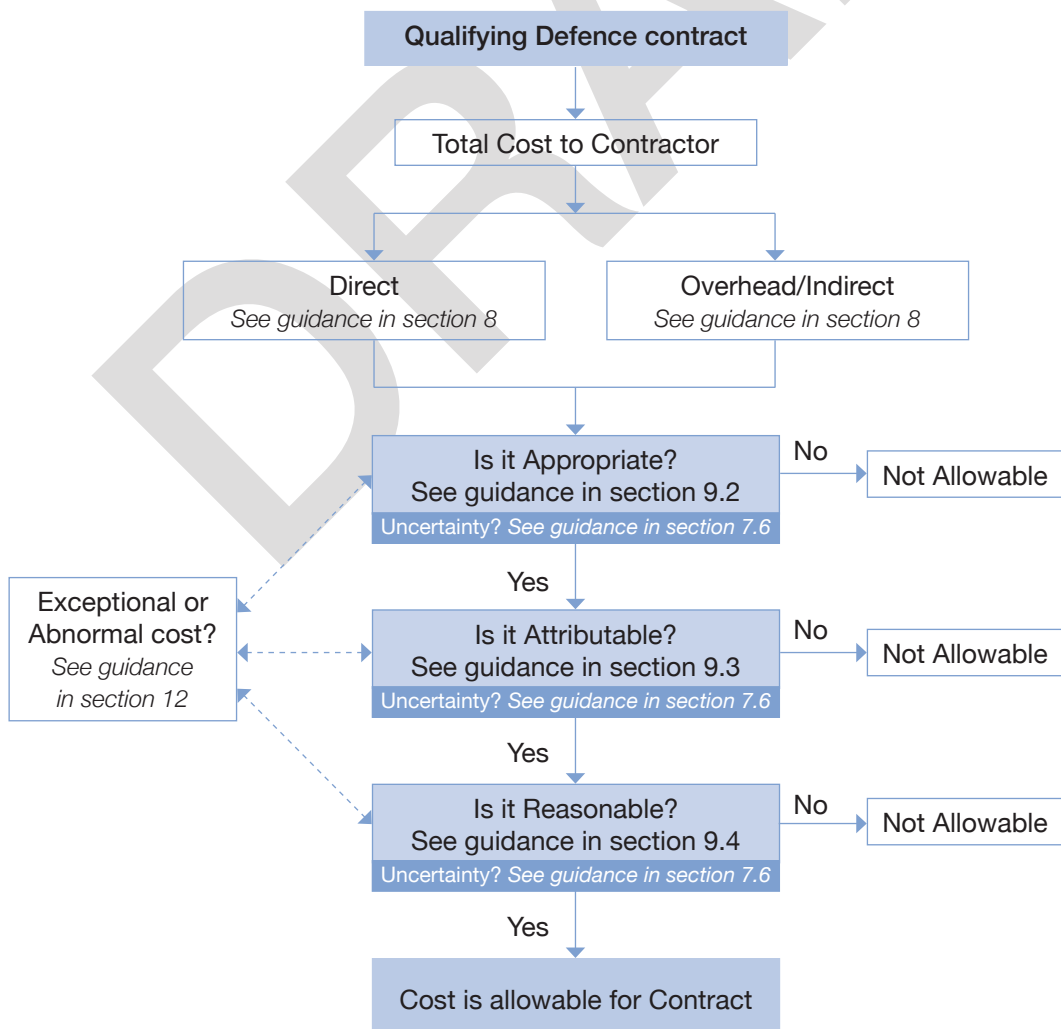
7.5 Under Section 20(5) of the Act the SSRO is the sole arbiter, and may determine the extent to which a particular cost is an *Allowable Cost* under a Qualifying Defence Contract where required so to do

by either the Secretary of State, the MOD, or an authorised person. Furthermore a Primary Contractor may apply independently to the SSRO for such a determination.

Opinion and Determination

7.6 Under the Act, where there is uncertainty whether a particular cost is *Allowable*, and the parties are unable to agree, either party may refer to the SSRO for an opinion, or a determination. For clarification an opinion can be binding on the parties if it is referred before a contract is let whereas a determination is a binding judgement by the SSRO when it is referred after a contract is let.

7.7 The diagram below illustrates the systematic approach to establish whether the costs associated with a Qualifying Defence Contract are *Allowable*.



8. Costs

- 8.1 The total cost, including standard costs properly adjusted for applicable variances, of a contract is the sum of the direct and overhead or indirect costs/related to the contract, incurred or to be incurred. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is consistently applied may be used. The allocation must be based on a Contractor's normal accounting system and policies.
- 8.2 Direct costs are those charged directly to contracts, as opposed to indirect costs which are apportioned over a number of contracts, products, or services.
- 8.3 The attribution of costs between indirect and direct recovery must be agreed between the MOD and individual Contractors.
- 8.4 Regardless of the type of cost, the *Appropriate, Attributable* and *Reasonable* principles will always apply in determining whether the cost is Allowable.
- 8.5 The following cost definitions are provided to inform the different characteristics of costs;

Direct Costs

A direct cost is a cost that can be completely attributed to the production or delivery of specific goods, works or services. Direct costs refer to materials, labour and costs related to the production of a specific product, building or service. Direct costs are classified as those that can be traced directly to a cost object included in delivering the Qualifying Defence Contract. The principles of *Appropriate, Attributable* and *Reasonable* will always apply.

Overhead / Indirect Costs

Overhead and Indirect Costs are defined as those costs which, though necessarily having been incurred during the performance of the Qualifying Defence Contract for the conduct of the Contractor's business in general, cannot be identified and measured as directly applicable to the performance of that Contract.

These costs may include but are not restricted to:

- electricity used to operate equipment;
- depreciation on the factory equipment and facilities used to deliver the Qualifying Defence Contract;
- non-direct supplies and personnel;
- non Qualifying Defence Contract assigned personnel;
- occupancy expenses for non-Qualifying Defence Contract deliverable facilities, including:
 - rent, light, heat, property taxes, maintenance, etc.;
 - depreciation of non-Qualifying Defence Contract deliverable equipment; and
- general expenses.

9. Definition of the Appropriate, Attributable, and Reasonable principles

- 9.1 Costs are *Allowable* to the extent they are *Appropriate, Attributable* and *Reasonable*. These criteria apply to all costs of a Qualifying Defence Contract. The definitions and checklists below set out the principles to be followed when determining whether a cost meets the *Appropriate, Attributable* and *Reasonable* criteria. The boxes below provide a checklist of key questions that must be considered when determining the treatment of costs and the likelihood they are *Allowable*.

Appropriate

9.2 Definition of *Appropriate* costs:

A cost is seen to be *Appropriate* if, by its character and nature, it represents a cost that is expected to be incurred in the conduct of delivering a contract such as the Qualifying Defence Contract in question. *Appropriate Costs* must be able to withstand public scrutiny and be supported by sufficient justification in line with the Act.

Checklist to determine whether a cost is *Appropriate*

- Is it a cost that would be expected to be incurred in the delivery of the Qualifying Defence Contract?
- Is the cost suitable for the purpose of the Qualifying Defence Contract?
- Would the inclusion of the cost withstand public scrutiny?
- Is inclusion of the cost fair and equitable?

Checklist to determine whether a cost is *Attributable*

- Is the treatment of the cost consistent with normal business practices?
- Is it consistent with the firm's normal accounting practices?
- Is the cost borne by the Contractor?
- Is there causality of the cost to the contract?
- Is the cost identifiable?
- Is the cost incurred in fulfilling the specification of the Qualifying Defence Contract?
- Can it be evidenced that the cost has not been recovered elsewhere?

Reasonable

9.4 Definition of *Reasonable* Costs:

A cost is seen to be *Reasonable* if by its nature it does not exceed that which would be expected to be incurred in the normal delivery of a contract such as the Qualifying Defence Contract in question, whether under competitive tendering conditions or as a single source contract. Reasonableness must be demonstrated by delivering value for money to the UK taxpayer.

Attributable

9.3 Definition of *Attributable* costs:

A cost is seen to be *Attributable* if it will be incurred in regards to the fulfilment of the Qualifying Defence Contract in question and is necessary to fulfil the requirements of the contract.

All costs must have been (or will be) met by the Contractor and applied to the Qualifying Defence Contract on a basis that is consistent with the contracting company's overarching cost accounting practices, whilst having not been, or planned to be, recovered in any way from existing or future contracts.

9.5 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, the expected benefits provided and any alternative options available. Consideration must also be given to:

- any particular specification and performance requirements;
- any uncertainty involved;
- the economic environment; and
- statutory provisions in place at that time.

Checklist to determine whether a cost is *Reasonable*

- Is it congruent with meeting the contract performance requirements?
- Would the cost withstand public scrutiny?
- Are cost estimates based on empirical evidence?
- Is the cost consistent with sector / market benchmarks?
- Is the quantum of the cost consistent with good business practice?

10. Guidance on Costs generally Allowable

- 10.1 The costs described in this section must be tested against the *Appropriate*, *Attributable* and *Reasonable* principles to determine whether they are partly *Allowable*, wholly *Allowable* or completely excluded from *Allowable Costs*.
- 10.2 Costs that are assessed as being *Allowable* under the *Appropriate*, *Attributable* and *Reasonable* principles outlined in this document will be expected to be reconcilable to actual costs incurred.
- 10.3 Whilst normally any cost which is *Appropriate*, *Attributable* and *Reasonable* will be *Allowable*, the following cost items are provided as an illustration. This list is not exhaustive.

Depreciation and amortisation

- 10.4 Depreciation and amortisation charges are to be calculated at the Contractor's own rates, provided they are consistent, equitable and relate to the fixed asset values. Changes to the valuation of assets have to be agreed by the MOD, but subject to scrutiny by the SSRO.

General stock losses and obsolescence

- 10.5 General stock losses and obsolescence should be charged directly to the contracts to which they relate. In circumstances where it is not possible to identify general stock losses or obsolescence costs that specifically apply to contracts then they may be accepted for inclusion as *Allowable Costs*. 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.

Redundancy Payments

- 10.6 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, if agreed between the Contractor and employees and approved by the MOD. Any such agreements are to be notified to the SSRO.

Employee Benefits

- 10.7 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 International Financial Reporting Standards. Payments of staff bonuses must be in line with company policies, and employed across all parts of the workforce. In order for these cost items to be considered *Reasonable*, Contractors must provide supporting evidence in accordance with the definitions in this document. Exceptional bonuses payable following the sale of a company or part of are not part of normal remuneration and are

unlikely to be considered *Allowable Costs*.

Private Venture Research and Development

- 10.8 Contractors will account for private venture research and development expenditure in accordance with the relevant International Financial Reporting Standards. 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 disturbed when this is a necessity to achieve a fair allocation of the expenditure.
- 10.9 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following guidelines to determine it as *Allowable* will normally apply:
- 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. The direct charge should be a fair apportionment of the Contractor's unfunded private venture product development costs (whether or not these have been carried forward in the Contractor's accounts) calculated on the basis of the forecast total sales of the product or service;
 - 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 group;
 - it is a condition of admitting private venture research and development expenditure for recovery on MOD contracts that the MOD be satisfied that, having regard to all the circumstances, the classification, allocation and apportionment of costs adopted by the Contractor is fair and equitable;
 - expenditure that can be related to an agreement between the MOD and a Contractor which specifically limits the amount of MOD's contribution (including those cases where the limit is expressed as a share of total expenditure) will not, unless specifically provided for in the agreement, normally be recoverable through *Allowable Costs*;
 - the fact that a Contractor may have adopted a particular accounting treatment for research and development expenditure in its financial accounts will not prejudice the recovery of such expenditure on MOD contracts;
 - any costs relating to projects where the research and development activity has already been funded will not be an *Allowable Cost*; and
 - research and development costs will not be allowed where there has been no discernible benefit provided to MOD or the public sector as a whole and or in those circumstances where sufficient evidence is not provided to support the research and development costs.
- 10.10 Abortive research and technology expenditure should be treated in the same way as any other research and development expenditure and be admitted for recovery. The charges must be a fair apportionment of the Contractor's unfunded private venture product development, meet the *Appropriate, Attributable* and *Reasonable* requirement (whether or not these have been carried forward in the Contractor's

accounts) and be calculated on the basis of the forecast total sales of the product or service.

10.11 Expenditure on product development which proves abortive or is otherwise irrecoverable will be admitted as an *Allowable Cost* by a charge to the current total output of the product group only to the extent that the development had potential benefit to the MOD and where the MOD had agreed to it in advance of the research being undertaken.

10.12 Due to the timeframes that research and development programmes can span, it may be difficult to reach final decisions on the treatment for pricing purposes of certain expenditure. In these circumstances it may be possible for an agreed amount of such 'undecided' expenditure to be carried forward for decision as to whether it is *Allowable* to be made in a future period.

Pension Costs

10.13 The acceptance and level of pension costs as being *Allowable* will be dependent upon whether it is a Defined Benefit or Defined Contribution scheme. Contractors will account for pension costs under the relevant accounting standards. Any pension costs claimed must reconcile with those shown in the Contractor's income statement, otherwise these will be disallowed. This guidance sets out below the determination of *Allowable Costs*.

- defined contribution plan contributions are to be included as an *Allowable Cost*;
- in the case of defined benefit plans the value to be included as *Allowable Costs* will be limited to the current or "normal" service cost charged to the income statement;
- costs or credits relating to defined benefit plans that may be considered to be "normal" include, but are not necessarily

limited to the following items:

- changes to commutation arrangements; or
- discretionary increases where it is normal scheme practice.
- pension protection levy reimbursements to pension schemes in whole or part by Contractors employing scheme members should be included in *Allowable Costs*;
- any amounts not included in the income statement in arriving at profit before tax must not be included in *Allowable Costs*;
- any pension costs relating to scheme deficits are *not Allowable* because they are not considered a normal in-year service cost;
- other cost and credit entries to the Contractors income statement that are not considered to be normal, and which will not be included in *Allowable costs* include but are not limited to:
 - finance charges or credits;
 - experience or actuarial gains and losses;
 - amortisations;
 - pension curtailment and/or settlement gains; and
 - any element of current or normal service cost relating to deficit funding.

Marketing and Sales

10.14 Marketing and sales costs can only be considered *Allowable*, if they are demonstrably linked to a Qualifying Defence Contract, for example attendance at trade fairs to market new equipment. These costs will need to be analysed by cost type and product group. This will ensure that only the applicable share of total costs is reflected against the product groups that were expected to benefit. Marketing and sales costs may include such items as salary costs and related staff expenses (travel and subsistence), sales and marketing campaigns and other related commercial activities.

Refunds

10.15 Where reimbursements, credits, grants or refunds are received by Contractors and cannot be identified to a particular contract then these will act to reduce *Allowable Costs*. For example, where a Contractor can demonstrate that as part of its business activities it is taking suitable measures to minimise its emissions then any costs incurred to purchase permits under the EU Emissions Trading System may be deemed as being *Allowable*. The value of these *Allowable Costs* will be reduced by the value of any credits received through the sale of permits, whilst the cost of any breaches of emissions regulations will be excluded from any *Allowable Cost* calculations.

11. Guidance on Costs which are generally not Allowable

11.1 The following costs are generally not considered *Allowable*:

- any expenditure of a capital nature will not be allowable as capital costs are recovered through depreciation (which is classified as *Allowable*) and the Contract Profit Rate;
- distributions of profit as these costs are earnings as a result of sales exceeding production costs i.e. they do not form part of production;
- bad debts and any provision for those bad debts unless they specifically relate to and arise on Government Sub-Contracts;
- civil penalties and fines. These are payments imposed to compensate for harm done through the wrong doing of the Party concerned, which in this case would be the Contractor, and as such would never meet *Appropriate, Attributable* and *Reasonable* requirements;
- the cost of raising and servicing capital, including short-term financing and finance leases. This is not applicable as a cost item because of the different sources of funds that are available to Contractors which make it impossible to know what a fair return is, based on the mix of capital employed. There are also significant differences between debt and equity funding and the associated risk that makes it difficult to assess this as a relevant cost item. The financing is therefore dealt with through the Contract Profit Rate;
- costs and income related to assets excluded from Capital Employed in calculating the Contract Profit Rate. If it has been assessed that assets are to be excluded from the formula then by their nature they have been deemed to not be associated with a Qualifying Defence Contract;
- discounts allowed on sales (external) will not form part of *Allowable Costs* as the financial benefit is received by Parties other than the MOD;
- entertainment expenses of any sort can never be determined to meet *Appropriate, Attributable* and *Reasonable* and would not withstand public scrutiny;
- goodwill (an intangible asset), which is excluded from any Capital Servicing Allowances and so in turn any amortisation is excluded from *Allowable Costs*;
- losses on other contracts, by their nature, are not applicable to the Qualifying Defence Contract in question;
- notional transactions;
- provision for cost contingencies and cost risk are not *Allowable* as they are not a true contract cost and Contractors are expected to manage potential price fluctuations as part of contract delivery. Any exceptional or abnormal costs will be assessed under Section 12 of this guidance;
- subscriptions and donations of a political and charitable nature form no part of costs associated with Qualifying Defence Contract;
- cost or premiums and payments

for insurance which cover that element of consequential loss that relates to profit are excluded on similar grounds;

- cost or premiums and payments for insurance which covers the Contractor's own defects in materials or workmanship incidental to the normal course of construction or manufacturing. This includes the insurance to repair defects in materials or workmanship, and for any breach of contract and therefore will not meet *Appropriate, Attributable* and *Reasonable* principles; and
- costs for the remedy of faulty workmanship or the consequences that result.

11.2 This is not an exhaustive list and other costs may also be considered not to be *Allowable*. Elements of the above costs may also be considered *Allowable* if they meet the *Appropriate, Attributable* and *Reasonable* principles. In the event of uncertainty the SSRO will make a judgement.

12. Exceptional or Abnormal Costs

12.1 The Single Source Cost Standards must be applied in all non-competitive contract discussions between the MOD and Contractors. 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 require additional guidance.

12.2 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*.

12.3 These generally relate to exceptional items where the cost impact on the Contractor extends beyond the normal cost allocation process, requiring additional

analysis and agreement to determine the suitable treatment of the costs.

12.4 In all cases of an exceptional nature which result in separate negotiations the SSRO must be informed. The MOD must submit the details to the SSRO including:

- a full explanation of the issues that arose and why they are exceptional;
- the outcomes of the negotiations; and
- evidence that value for money is being achieved.

12.5 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.

12.6 Examples of exceptional or abnormal issues that warrant further explanation are provided as follows.

Costs associated with the closure or rationalisation of a plant

12.7 Exceptional or abnormal costs will not be allowed where they relate to normal commercial business risk and any discussions around closure or rationalisation of plant 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 or rationalisation of a plant.

12.8 Where a Contractor can demonstrate on materiality grounds that the rationalisation or closure of plant is due to the impact of delivering single source contracts then the following approach must be applied to determine whether the costs are *Allowable*.

Step 1: The relevant net costs must be quantified by the Contractor. The importance of net costs being used is that the Contractor must demonstrate on an open book basis that they have ensured best value in minimising the cost impact of the rationalisation or plant closure. This means that all profits from closure/rationalisation or benefits from the transfer/alternative use of assets must be netted off against the total cost of the closure/rationalisation; and

Step 2: The proportion of costs that is potentially *Allowable* must be referenced based on calculating the ratio of the value of single source turnover to total turnover for the business area that is affected. This should be calculated as an average over the previous three years in order to determine whether the closure/rationalisation is because the majority of business is single source.

12.9 Where a site is closed resulting in other sites operated by the Contractor or within a joint venture benefit from gaining more work as a result of the site closure, the net cost of rationalisation/closure must be tested and recovered against the benefits associated with the other sites or Joint Venture. The amount of the costs is subject to agreement on a case by case basis and the details must be passed to the SSRO for exceptional items based on the proposal offering value for money.

12.10 Profits and losses must be calculated at the time that rationalisation or plant closure takes place. Taking into account the exceptional nature of the cost the SSRO will be permitted to re-open this calculation within a limited period if the assumptions upon which the original calculation was based prove to be materially inaccurate.

Idle Facilities

12.11 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 Qualifying Defence Contract commitments but were designed for that purpose.

12.12 Idle capacity is a part of an overall facility or capital asset which is under-utilised for the delivery of a Qualifying Defence Contract.

12.13 The costs of idle facilities or capacity are not *Allowable* unless after application of the *Appropriate, Attributable* and *Reasonable* principles it is confirmed that:

- those unused facilities are determined by the MOD as necessary to meet uncertain defence demands; or
- are of a strategic nature that the MOD has determined may be called upon to enable, or support, urgent deployments; or
- are unused due to a change in Government or Defence policy which could not have been predicted by the Contractor.

12.14 The value of any payment is to be calculated in accordance with the relevant costing model as described in the Regulations.

12.15 Any determination that such costs are *Allowable* is to be subject to a separate agreement between the Contractor and the MOD, 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.

Pensions

12.16 If an exceptional or abnormal cost has an impact on pensions the only costs which may be *Allowable* relate to:

- the costs of defined contribution pension plans, being the actual

pension contributions paid to bona fide pension scheme providers in respect of current employees; and

- in relation to defined benefit schemes, the current service cost as recorded in the income statement in accordance with the relevant accounting standards. These costs are an additional cost of employment related to the terms and conditions under which staff are employed.

12.17 Any costs that do not relate to current year service costs, and are factors relating to financing costs, investment performance, insufficient contribution levels in previous years and other activities not directly connected with the current year, are generally not *Allowable*.

12.18 Examples of items that tend not to relate to a current year charge and therefore would not be considered *Allowable* include but are not limited to:

- financing charges or credits;
- experience or actuarial gains and losses;
- amortisations;
- pension curtailment and /or settlement gains; and
- any element of current service cost related to deficit funding.

Research and Development Tax Credits

12.19 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.

12.20 Expenditure made in respect of the research phase of a project that will not generate an intangible asset, and which will not generate probable future economic benefits for the MOD, will not be treated as an *Allowable Cost*.

12.21 Any benefits or credits gained by Contractors through the taxation system as a result of research and development expenditure must be offset against *Allowable Costs*. This can include tax reductions or cash offsets that reduce the tax liability.

12.22 The matching principle needs to be applied so that tax rebates that relate to research and development are accounted for and offset against the relevant expenditure.

Reporting, Monitoring and Authority

13. Cost Accounting Practices

- 13.1 The Contractor is required to disclose its cost accounting practices to the MOD and must apply them consistently. This information is obtained through the use of a Contractor cost allocation or disclosure statement known as a Questionnaire on the Method of Allocation of Costs. The Contractor must make information available on an open book basis.
- 13.2 A Contractor will follow its own normal accounting systems, and must declare when it plans or decides otherwise to the SSRO and the MOD, together with a clear statement explaining why it is doing so.
- 13.3 A Contractor's system of classification and collection of costs will be the agreed baseline unless these give rise to unreasonable or materially inaccurate results.
- 13.4 The Contractor's costing system must be the same for MOD 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.
- 13.5 In making an assessment of *Allowable Costs*, the parties must arrive at a determination on whether a cost is, or is not, Allowable in line with this statutory guidance.

- 13.6 The Contractor is required to demonstrate to the MOD and evidence any claim for a cost to be *Allowable*. Any unresolved disputes between the contractor and MOD must be raised with the SSRO.

14. Authority

- 14.1 The Act and this guidance empowers the SSRO to:
- Ensure that Primary Contractors keep, and require their Sub-Contractors where applicable to keep, relevant records and to report in accordance with the Act.
 - Require a Primary Contractor to show that the requirements set out as the principles for contract costs to be *Appropriate, Attributable* to that contract and *Reasonable* in the circumstances. The burden of proof rests with the Contractor to ensure that *Allowable Costs* are sufficiently evidenced.
 - Determine the extent to which a particular cost is *Allowable* under a Qualifying Defence Contract when required to arbitrate.
 - Determine whether the price payable under the Qualifying Defence Contract is to be adjusted, and by what amount.

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