



# SSRO

Single Source  
Regulations Office

## Allowable Costs guidance

Version 7.2

Applies from: 1 April 2025

## Versions of this guidance

This is version 7.2 of the Allowable Costs guidance which applies to contracts agreed on or after 1 April 2025.

The table in Appendix A highlights changes that have been made from the previous version of the guidance.

The publication and application dates of versions of this guidance are shown below.

Version number	Date published	Applies to contracts agreed on or after
7.2	14 March 2025	1 April 2025
7.1	10 October 2024	10 October 2024
7	24 January 2024	1 April 2024
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4	18 March 2019	1 April 2019
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# 1. Introduction

## Guidance on allowable costs

- 1.1 This document is guidance on the determination of Allowable costs and the pricing of contracts under the regime. It should be read in conjunction with other SSRO guidance referenced in this document.

## Pricing of contracts

- 1.2 The Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations) require the price payable under a qualifying defence contract (QDC) or qualifying sub-contract (QSC), or component of a QDC or QSC, to be determined in accordance with (1) one of the default pricing methods (by applying the pricing formula) or (2) an alternative pricing method. This guidance aims to help contractors and the Ministry of Defence (MOD) to agree the price of QDCs or QSCs in a way that is consistent with the Act and the Regulations. Where relevant contract pricing matters are referred to the SSRO for an opinion or determination, the SSRO will have regard to its guidance and the extent to which this has been considered and applied by the contracting parties when reaching its conclusion. The SSRO may also take referrals on other matters discussed in this guidance.<sup>1</sup>
- 1.3 Section 15 of the Act, and part 3 of the Regulations set out how these pricing methods must be applied to determine the price payable under a QDC or QSC (or a component of such a contract). The methods to price a contract, whether applied individually or in combination, provide for flexibility to accommodate a range of contracting circumstances. It is important that the contracting parties familiarise themselves with the approaches to pricing set out in this and other SSRO pricing guidance and apply these pricing methods in a way that supports a commercial arrangement consistent with value for money and fair and reasonable prices.

## The default pricing methods

- 1.4 The price payable under a QDC or QSC, or a component of such a contract, which uses a default pricing method must be determined in accordance with the following formula:

$(\text{Contract profit rate} \times \text{Allowable Costs}) + \text{Allowable Costs}$

- 1.5 The contract profit rate must be determined using the four-step process and the allowable costs must be determined in accordance with one of the six default pricing methods. The contract profit rate applies at the agreed rate for the life of the contract or component and is not affected by future changes in the baseline profit rates or capital servicing rates, unless an amendment is made in respect of which these rates differ. The default pricing methods are:
- a. Firm pricing;
  - b. Fixed pricing;
  - c. Cost-plus pricing;
  - d. Estimate-based fee pricing;
  - e. Volume-driven pricing; and
  - f. Target pricing.

<sup>1</sup> <https://www.gov.uk/government/publications/guidance-on-the-ssros-referrals-procedures-under-the-defence-reform-act-2014-and-single-source-contract-regulations-2014>

- 1.6 The Schedule to the Regulations describes how the price of a contract or component must be redetermined if the parties propose to make an amendment which affects the original contract price.
- 1.7 The SSRO has provided separate guidance to assist the contracting parties determine Allowable Costs and on the use of alternative pricing types.<sup>2</sup>

### About allowable costs

- 1.8 Section 20 of the Act specifies when costs are Allowable and sets out related provisions as follows:
- a. Section 20(1) of the Act requires the SSRO to issue guidance about determining whether costs are allowable costs under QDCs and QSCs.
  - b. Section 20(2) of the Act states that both parties need to be satisfied that costs are appropriate, attributable to the contract or component and reasonable in the circumstances (AAR).
  - c. 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.<sup>3</sup>
  - d. Section 20(4) of the Act states that a contractor (prime contractor or sub-contractor) may at any time be required to show that a particular cost is allowable.

### Alternative pricing methods

- 1.9 There are a range of alternative pricing methods available and these are intended to be used in circumstances where application of the pricing formula may not be possible or because a fair price can be satisfactorily established by other means. This includes, for example, where prices are already regulated or where there is a market price which can act as a reference.
- 1.10 The price payable under a QDC or QSC, or a component of such a contract, which does not apply a default pricing method, must be determined in accordance with one or more of the alternative pricing methods specified in the Regulations. The SSRO has issued separate guidance on the application of these alternative pricing methods. The alternative pricing methods specified in the Regulations are:
- a. Commercial pricing;
  - b. Prices determined in accordance with law;
  - c. Previously agreed price;
  - d. Novated contract price;
  - e. Competed rates applied to uncompleted volumes (CRUV);
  - f. Agreed changes to the contract profit rate; and
  - g. Aggregation of components.
- 1.11 The Schedule to the Regulations describes how the price of a contract or component must be redetermined if the parties propose to make an amendment which affects the original contract price.

<sup>2</sup> <https://www.gov.uk/government/collections/allowable-costs> and <https://www.gov.uk/government/collections/alternative-pricing>

<sup>3</sup> For practical purposes, the agreement of allowable costs will generally fall to an MOD officer with delegated authority from the Secretary of State. To reflect this, and where appropriate, this guidance refers to the MOD rather than the Secretary of State directly.

## Components

- 1.12 Prior to 1 April there were limited opportunities for contracts to have more than one contract profit rate. With the introduction of alternative pricing methods, the legislation now provides a definition of a component. A component of a contract means a part of a contract that is to be treated distinctly from other such parts in determining the price payable under a contract. A part of a contract is to be treated distinctly where either the Regulations contain provision to that effect (i.e. the effect of applying the Regulations is that part of the contract is treated distinctly in determining the price payable), or where the parties agree that it should. Regulation 9A specifies three circumstances in which a component must be formed:
- a. Where a part of the contract uses a different contract pricing method to the contract pricing method used in any other part of the contract. A contract pricing method means an alternative pricing method or a default pricing method.
  - b. Where a part of the contract has a different contract profit rate to the contract profit rate used in any other part of the contract.
  - c. Where it is mandated in the context of certain alternative pricing methods by regulation 19C(6), and paragraphs 14(7)(c) and 16(2)(b) of the Schedule (to the Regulations).<sup>4</sup>
- 1.13 It is ultimately for the parties to decide whether they wish to price a QDC or QSC in a way that results in components being formed. A component is only formed when both parties to the contract elect to price it in a manner which meets the requirements for a component to have been formed. The parties should ensure that they have identified components formed as the result of having made one or more pricing amendments.
- 1.14 There must be a demonstrable commercial purpose for agreeing to price a part of a contract distinctly from another part i.e. forming components. For example, in order to price an amendment which only affects part of the contract price, or because it makes commercial sense to use different pricing methods for different parts of the contract. This requirement is to prevent the parties from dividing and further subdividing contract price for no reason other than to avoid application of the final price adjustment. The parties should carefully consider how they structure components as dividing the contract into small components will add complexity to both pricing and reporting. In addition, a disproportionate approach to componentisation may not be consistent with value for money and fair and reasonable prices. Where a contract has two or more components, the price payable under the contract is the sum of the price payable in respect of each component. Where an aggregated cost risk adjustment or incentive adjustment has been applied (see section 9 of the SSRO's guidance on Alternative Pricing), this also forms part of the price payable under the contract.
- 1.15 There are specific reporting requirements associated with pricing or amending a contract which results in components being formed, such as the need to report profit and cost in a way which make up parts of a component in certain prescribed circumstances. The parties should familiarise themselves with these requirements when entering into or amending a contract in a way which results in components being formed. This is particularly important when making multiple contract pricing amendments, as whether each is treated distinctly for the purposes of pricing or not will determine the extent of the component level reporting that is required.

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<sup>4</sup> For more detail on this parties should review the schedule to the regulations. We intend to issue specific guidance on contract amendments in due course.

## About the SSRO's pricing guidance

- 1.16 The SSRO issues guidance on the pricing of contracts under Sections 18(1), 20(1) and 35A of the Act. The SSRO may issue such guidance as it considers appropriate in relation to the application or interpretation of the Act or Regulations.
- 1.17 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 QSCs; 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.
- 1.18 It is a legal requirement for the contracting parties to have regard to guidance the SSRO issues:
- about determining whether costs are allowable costs under qualifying defence contracts; and
  - in relation to any of the steps in the calculation of the contract profit rate.
- 1.19 The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.<sup>5</sup>
- 1.20 This document updates the version published in October 2024<sup>6</sup> in line with the annual update of the baseline profit rate and capital servicing rates that apply for the financial year commencing 1 April 2025. The SSRO has provided separate guidance that will assist the contracting parties to determine:
- the contract profit rate; and
  - the price of a contract or component using an alternative pricing method.
- 1.21 Where terminology used in the guidance is defined in the Act and Regulation, it is explained where that might be helpful. The definitions of specific accountancy terms used can be found in the relevant accounting standards.<sup>7</sup> Other text in this guidance should be read in accordance with its natural and ordinary meaning. It is important for understanding and interpretation that specific parts of the guidance are not read in isolation from other relevant parts, but instead within the context of the complete text.

## Statutory reports

- 1.22 In relation to any QDC (or QSC) the primary contractor (or sub-contractor) must provide statutory reports as described in Part 5 of the Regulations. Suppliers may also be required to provide statutory reports on overheads as described in Part 6 of the Regulations. Regulation 23(1) requires a contract pricing statement to be provided within one month of the initial reporting date. The contract pricing statement must provide specified information regarding the application of any of the alternative pricing methods that have been used to determine the price of the contract or component. The SSRO has provided separate guidance that will assist defence contractors with preparing and submitting the reports required.<sup>8</sup>

5 SSRO Guidance on preparation and submission of contract reports, paragraphs 3.28 to 3.53, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

6 A guide to the changes which have occurred from the previous version is provided in Appendix A

7 For example, those of the International Accounting Standards Board or Financial Reporting Council.

8 SSRO Reporting guidance on preparation and submission of contract reports, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

## Contracts entered into prior to 1 April 2024

- 1.23 The price of a contract entered into prior to 1 April 2024 does not need to be redetermined unless the contract is amended in a way that affects the original contract price, in which case the new provisions will apply. As part of the legislative changes which came into force on 1 April 2024, the Profit on Cost Once (POCO) adjustment was removed from the contract profit rate steps and is now dealt with through a reduction to allowable costs. Contracts with a POCO adjustment determined under the previous six-step process are now subject to the new provisions to make an adjustment through allowable costs. Further guidance on this may be found in section 5 Part I of this document.
- 1.24 The SSRO funding adjustment has also been removed from the contract profit rate steps and contracts that are entered into or amended on or after 1 April 2024 will no longer be required to apply this adjustment. This change does not affect contract profit rates agreed prior to 1 April 2024.

## Relevant records

- 1.25 In relation to a QDC, regulation 20 requires the primary contractor to keep ‘relevant records’. In the case of a QSC, it is the sub-contractor who must do this. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor, as the case may be, ‘may reasonably be expected to keep’ and ‘which are sufficiently up-to-date and accurate’ for use by the MOD for specific purposes, such as verifying certain matters relating to the price payable under a QDC or QSC. Such matters may include the calculation of the contract profit rate, the determination of allowable costs or the calculation of any final price adjustment (where applicable) following contract or component completion.

## Opinions and determinations

- 1.26 The Act makes specific provision for determinations by the SSRO in relation to whether a particular cost is an allowable cost under a qualifying contract. The Act and Regulations also provide for the SSRO to give opinions and make determinations on matters related to the pricing of proposed or agreed qualifying contracts upon referral by specified persons. Further details of the matters that may be referred and how the SSRO responds to referrals can be found in the SSRO’s related procedural guidance.<sup>9</sup>

## Non-referral advice

- 1.27 The SSRO can provide independent and authoritative advice on a confidential basis on any matter related to the interpretation and application of the regulatory framework for single source defence contracts. Either party to a current or proposed qualifying contract may seek non-referral advice on the application of the regulatory framework to that contract. Further information on the SSRO’s non-referral advice service can be found on our website.<sup>10</sup>

<sup>9</sup> <https://www.gov.uk/government/publications/guidance-provided-by-the-ssro>

<sup>10</sup> <https://www.gov.uk/government/publications/the-ssros-non-referral-advice-service>



## Key terms and definitions

Allowable costs	A term used for the costs incurred to deliver a QDC or QSC. Costs must be appropriate, attributable to the contract or component and reasonable in the circumstances to be considered allowable.
Alternative pricing method	An alternative pricing method is one of the seven non-default methods specified in the Regulations. These are: Commercial pricing, Prices determined in accordance with law, Previously agreed price, Novated contract price, Competed rates applied to uncompleted volumes, Agreed changes to the contract profit rate, and Aggregation of components.
Baseline profit rate (BPR)	Section 17(2) of the Act and regulation 11 of the Single Source Contract Regulations 2014 (the “Regulations”) require that the contract profit rate for any qualifying defence contract that uses the pricing formula must be calculated by applying four steps. The first step requires taking the baseline profit rate which has been determined by the Secretary of State.
Capital employed (CE)	The total amount of capital used for the acquisition of profits or the capital investment necessary for a business to function. The SSRO defines this as the sum of fixed and working capital.
Capital servicing adjustment	A term used to refer to fixed capital servicing adjustment and positive or negative working capital servicing adjustments collectively.
Cash and cash equivalents	A term used for current assets comprising receivables from other sources, short-term investment of money, and cash at hand and at bank.
Cost of production (CP)	A cost incurred by a business when manufacturing a good or providing a service before financing charges (interest). It is calculated as: cost of production = operating revenue (turnover) – operating profit/loss [EBIT].
Component	A component is a part of the contract that is treated distinctly from other such parts in determining the price payable under the contract.
Contract pricing method	A part of a contract must be treated distinctly if Regulations require this, or may be treated distinctly by agreement of the parties.
CP:CE ratio	The method that has been used to determine the price of the contract or component. For a qualifying defence contract, or qualifying sub-contract, this must be one of the default pricing methods or one of the alternative pricing methods.
Current assets	A company’s balance sheet items that represent the value of all assets that can reasonably expect to be converted into cash within one year.
Current liabilities	A company's balance sheet items that represent debts or obligations that are due within one year.
Default Pricing method(s)	<p>There are six default pricing methods, all of which determine the contract (or component) price by the formula:</p> $\text{Allowable costs} \times \text{Contract profit rate} + \text{Allowable costs} = \text{Contract (or component) price.}$ <p>These six methods are: Firm Price, Fixed Price, Cost-plus, Estimate based fee, Volume-driven pricing method, and Target pricing method.</p>

Defence Reform Act 2014	The primary legislation applicable to qualifying defence contracts.
Fixed capital	The total capital outlay that is invested in fixed assets, that stay in the business almost permanently – or at the very least, for more than one accounting period. The assets are considered fixed in that they are not used up in the actual production of a good or service but have a reusable value. Fixed capital investments are typically depreciated over a number of years.
Fixed capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in fixed capital.
Fixed capital servicing rate	The cost of servicing medium-term to long-term (i.e. more than one year) debts.
Government owned contractor rate	Where a qualifying defence contract is made between the Secretary of state and a company wholly owned by the UK Government, and both parties agree, the government owned contractor rate will be used instead of the baseline profit rate when calculating the contract price.
Negative working capital	A term used when the working capital number is negative. It results when a company holds less current assets than its current liabilities.
Negative working capital servicing adjustment	An adjustment that accounts for the rate of return (interest earned) which is attributed to investment in negative working capital (i.e. depositing creditors' cash on fixed-deposit accounts).
Negative working capital servicing rate	The rate of return (interest earned) on short-term (i.e. up to one year) bank deposits.
Positive working capital	A term used when the working capital number is positive. It results when a company holds more current assets than its current liabilities.
Positive working capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in positive working capital.
Positive working capital servicing rate	The cost of servicing short-term (i.e. up to one year) debts.
Qualifying defence contract (QDC)	Those contracts that fall within the scope of the Defence Reform Act and the Single Source Contract Regulations 2014, and that the Secretary of State has not exempted from being a QDC. In such contracts, where a default pricing method is used, an allowance for profit is calculated by reference to the baseline profit rate applicable at the time of pricing.
Qualifying sub-contract (QSC)	A qualifying sub-contract 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 qualifying sub-contract pursuant to the procedure under section 29 of the Act.
Single Source Contract Regulations (SSCRs)	Secondary legislation in the form of a Statutory Instrument, enabled by the Defence Reform Act.
Single Source Regulations Office (SSRO)	The independent non-departmental public body established under the Defence Reform Act.
Working capital	A measure of both a company's efficiency and current/short-term (up to one year) financial health. It indicates how much capital a company uses in its day-to-day activities.

## 2. Application of the guidance

### Duties on the contracting parties

- 2.1 It is a legal requirement to have regard to guidance the SSRO issues about determining whether costs are allowable costs under qualifying defence contracts (QDCs) or qualifying sub-contracts (QSCs). This guidance applies to QDCs or QSCs entered into or amended on or after 1 April 2025 and replaces version 7.1 of the guidance. The SSRO has provided guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.<sup>11</sup> Where a change in guidance occurs during contract negotiations, the contractor must report an agreed deviation from the statutory guidance if the previous guidance has informed the majority of the negotiation. Readers of this guidance should be aware that changes to legislation came into force on 1 April 2024 which may apply to an existing contract and will not have been included in guidance issued prior to that date. Section 1 of this document addresses contracts entered into prior to 1 April 2024.
- 2.2 This guidance is intended to assist the parties to determine whether costs are allowable under qualifying contracts or components. It sets out advice and information on how the parties should assess particular costs under a QDC or QSC against the requirements of allowable costs. It may also be used to support the formulation of cost recovery rates, which may in due course form part of the price of a qualifying contract or component. An example is where cost recovery rates are agreed at a business unit level, but not yet applied for the purposes of determining a discrete cost under a contract or component.
- 2.3 For the purpose of pricing a QDC, the Act requires the MOD and the primary contractor to be satisfied that particular costs meet the requirements of allowable costs under section 20(2) (a) to (c) of the Act, having regard to SSRO guidance. In the case of a QSC, it is the MOD and the sub-contractor who must be so satisfied. To be satisfied, the MOD may require the primary contractor (in the case of a QDC) or the sub-contractor (in the case of a QSC) to show that the requirements are met (with reference to SSRO guidance or otherwise). In such cases, the burden of proof rests with the contractor or sub-contractor, as the case may be. Whether or not the MOD requires the contractor or sub-contractor to show that the requirements of allowable costs are met, the MOD and the contractor or sub-contractor must be satisfied that the costs are allowable costs.

### Sub-contracts

- 2.4 If the primary contractor has entered into sub-contracts to a QDC (including any QSC), then the prices of those sub-contracts will be costs in the QDC. The MOD and the primary contractor will need to be satisfied that the prices of those sub-contracts are allowable costs (section 20(2)). The MOD may require the primary contractor to demonstrate that this is the case (section 20(4)). The legislation does not prescribe how this may be demonstrated, nor what would be sufficient evidence that a sub-contract price satisfies the AAR test. It may be that the price of a sub-contract can be demonstrated to be allowable without the need to demonstrate that each of the component costs are allowable. Contractors entering into sub-contracts should ensure that they are familiar with the guidance in part 5 on costs associated with group profits.

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<sup>11</sup> Reporting guidance on preparation and submission of contract reports available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

- 2.5 In the case of a sub-contract that is a QSC, the sub-contract price must conform to the price formula or an alternative pricing method. If the price formula has been used on a sub-contract or component of such a sub-contract the costs must be allowable. In terms of whether a cost in a QSC is allowable, the application of section 20(2) and (4) is modified by section 30(1) of the Act. This means that the MOD and the sub-contractor must be satisfied that the costs are allowable. The obligation to demonstrate to the MOD that a cost included in the price of a QSC is allowable rests with the sub-contractor. Where a QSC uses the price formula, the price of any sub-contract to the QSC will need to be an allowable cost in the QSC and the guidance given at paragraph 2.3 will equally apply.

## Evidential standards

- 2.6 The Act and Regulations do not specify what information is required in order to be satisfied that a cost is an allowable cost. Information used for this purpose will include relevant records kept by the contractor, information held by the MOD or information available from third party sources. In determining what type and standard of information is required, the relevant parties identified in paragraph 2.3 should take a proportionate approach considering:
- a. the specific requirements and circumstances of the contract;
  - b. the materiality and type of particular costs;
  - c. the information that is available and its relevance; and
  - d. what it is reasonable to expect would be available.
- 2.7 Transparency between the parties as to what type and standard of information each considers is required to be satisfied that a cost is an allowable cost will facilitate the achievement of a proportionate approach.
- 2.8 The information used to show that costs are allowable costs should make sufficiently clear to both the MOD and the primary contractor (in a QDC) or sub-contractor (in a QSC) how the costs meet the requirements to be appropriate, attributable to the contract or component and reasonable in the circumstances.

## Further clarification

- 2.9 Any enquiries related to this guidance or its application should be addressed to the SSRO helpdesk.<sup>12</sup> The SSRO responds as quickly as possible to such enquiries.

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<sup>12</sup> The Helpdesk can be contacted on 020 3771 4785 or by email at [helpdesk@ssro.gov.uk](mailto:helpdesk@ssro.gov.uk). It operates from 9am to 5pm Monday to Friday, excluding UK bank holidays. Most helpdesk queries are responded to within 1 or 2 working days and we aim to respond to all queries within a maximum of 5 working days.

## 3. The AAR principles

### How to interpret and apply the requirements of allowable costs

- 3.1 A contractor's costs (which include those already incurred and those which are anticipated) are allowable costs in a QDC or QSC to the extent that the relevant parties are satisfied that they are appropriate, attributable to the contract or component and reasonable in the circumstances (AAR). These are the requirements of allowable costs. The relevant parties must be satisfied that each of these requirements of allowable costs is met whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost (i.e. one which has been calculated using a cost recovery rate).
- 3.2 References in this guidance to a cost means expenditure by the contractor that is required to deliver goods, works and services, or to acquire assets. Such expenditure may take the form of, but is not limited to, cash or cash equivalents, the fair value of other consideration given to acquire an asset, or an amount attributed to an asset to recognise its value. Incurring a cost means to become liable or subject to the obligation to meet such an expenditure. Depending on the chosen default pricing method, costs must either have actually been incurred or be expected to be incurred, if they are to meet the requirements of allowable costs.
- 3.3 Paragraphs 3.13 to 3.16 of this guidance sets out the typical characteristics of costs that meet the requirements of allowable costs. The relevant parties should consider the characteristics when evaluating whether a particular cost incurred by the contractor meets each of the requirements of allowable costs.
- 3.4 Determining whether each requirement of allowable costs is met calls for judgement to be applied by the MOD and the contractor or sub-contractor, as the case may be. This includes judgement regarding:
- the relative importance of the characteristics identified in the guidance to the particular cost under consideration, taking account of the circumstances of the case; and
  - the type and standard of information required to be satisfied that the particular cost demonstrates the characteristics identified in the guidance.
- 3.5 The relevant parties may agree on differing standards and types of information in evidencing each of the three requirements of allowable costs.
- 3.6 Section 20 of the Act sets out the requirements of allowable costs which apply to a particular cost under a qualifying contract. These requirements may be assessed at any time. Where this guidance is applied in advance of a cost being applied to a particular qualifying contract (for example when agreeing cost recovery rates for a business unit), the parties should agree which aspects of the requirements of allowable costs can be demonstrated at the time, and those which should be considered once the circumstances of the contract are known. Section 4 of this guidance provides additional guidance on the application of the requirements of allowable costs in the agreement of cost recovery rates.
- 3.7 Section 5 of this document provides additional guidance related to the evaluation of specific categories of cost including, in some cases, the types of evidence that should be considered.
- 3.8 This guidance is intended to assist the parties to determine the allowable costs for a QDC or QSC in a way that supports the SSRO's statutory aims of ensuring that:

- a. good value for money is obtained in government expenditure on qualifying defence contracts; and
  - b. persons (other than the MOD) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.
- 3.9 The relevant parties should have regard to these aims when applying the guidance and considering whether costs meet the requirements to be appropriate, attributable to the contract or component and reasonable in the circumstances.
- 3.10 References in this guidance to costs that ‘enable the performance of the contract’ include those suitably and necessarily incurred by the contractor before, at or after the time of agreement to:
- a. deliver the contract or component(s) in question; or
  - b. deliver multiple contracts including the contract or components(s) in question and equitably apportioned to those contracts; or
  - c. ensure the efficient and proper operation of the business of delivering defence contracts and sub-contracts.
- 3.11 Delivering the contract in question may require sustaining an essential or desirable capability. This may include a capability that is required to deliver the contract in question or similar contracts in the future. Whether the cost of sustaining an essential or desirable capability is allowable will depend on the circumstances and the contract in question. For example, if there is an explicitly recorded agreement between contracting parties that the MOD requires an essential or desirable capability to be maintained, or other circumstances which would indicate the MOD’s ongoing or future need for the capability.
- 3.12 References in this guidance to costs which ‘would withstand public scrutiny’ include those which meet high standards of regularity, propriety and prudence, such that the relevant standards expected by Parliament or the Ministry of Defence can be met.

## The requirements of allowable costs

### *Appropriate*

- 3.13 A cost is appropriate if it is of a type and arising from an activity that:
- a. a reasonable person informed of the facts would consider enables the performance of the QDC or QSC in question; and
  - b. would withstand public scrutiny.

### *Attributable to the contract or component*

- 3.14 A cost is attributable to the contract or component if it:
- a. is incurred by the contractor;
  - b. enables the performance of the contract or component(s) in question;
  - c. is applied directly or indirectly to the contract on a basis that is consistent with the contractor’s overarching cost accounting practices or using a methodology agreed with the MOD; and
  - d. has not been and is not anticipated to be recovered, directly or indirectly, from another source, as allowable costs must only be recovered once.

### *Reasonable in the circumstances*

- 3.15 A cost is reasonable in the circumstances if it is of an amount that:
- a. a reasonable person informed of the facts would consider consistent with enabling the performance of the QDC or QSC in question;
  - b. would withstand public scrutiny;
  - c. is consistent with costs incurred by the contractor in similar circumstances; and
  - d. demonstrates due regard for economy and efficiency in the use of resources.
- 3.16 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs, and which may, therefore, be considered when determining if a cost is reasonable in the circumstances, include, but are not limited to:
- a. the level of competitiveness and/or market testing undertaken in the supply chain;
  - b. the particular specification and performance requirements of the contract or component;
  - c. the capability necessary to perform the contract or component;
  - d. uncertainty and risk affecting estimated costs;
  - e. the impact on actual costs of events which were not anticipated at the time of agreement;
  - f. the economic environment;
  - g. the statutory provisions in place at the time of contracting; and
  - h. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.

## 4. Cost accounting, direct costs, indirect costs and overheads

### Cost accounting

- 4.1 When used in this guidance, the terms direct, indirect and overhead costs have the meanings assigned to them in Table 1. Contractors may use terms which differ from those given. Where those terms are synonymous, or otherwise refer to the same thing, the guidance should be construed and applied accordingly.

**Table 1: Terms and definitions**

Definitions	
Direct cost	A cost that can be traced to a discrete package of goods, works or services specified under a particular qualifying contract.
Overhead cost or overhead	A cost that is used by multiple activities and which cannot be traced, or that the parties agree not to trace, to a discrete package of goods, works or services specified under a particular qualifying contract.
Indirect cost or indirectly recovered cost	A cost that is allocated and apportioned to a qualifying contract using a cost recovery rate. Indirect costs may include overheads. Some direct costs, such as labour, may be applied indirectly as a matter of convenience.

### Cost accounting

- 4.2 Contractors with QDCs and QSCs may agree with the MOD a methodology for the allocation and apportionment of costs to be used in the contract. A cost accounting methodology includes:
- choosing whether a cost, or class of cost, is to be applied directly or indirectly to the contract;
  - where a cost is applied indirectly to the contract; identifying the cost recovery base for each pool and measuring it; and calculating the cost recovery rates (for example £ per hour of labour).
- 4.3 The methodology may be described in a Questionnaire on Method of Allocation of Costs (QMAC) which is agreed between the relevant parties. The agreement of a QMAC does not demonstrate that costs are allowable, however the parties may find its contents informative in applying this guidance. For example, in identifying the type of costs and corresponding cost recovery bases which the parties may agree to recover through application of rates. The methodology detailing in what circumstances costs will be applied should be unambiguous.
- 4.4 In order to be allowable, the contractor must be able to demonstrate that costs have been allocated in a way that is fair in the circumstance and which avoids systematic over or under recovery. Additional care will be needed where the contractor’s costing system for work under contract to the MOD is different from that used for other work, as the costing systems may not be directly comparable.



- 4.5 Where a contract contains more than one component, the contractor must be able to demonstrate that costs are attributed to the relevant component (or apportioned across multiple components) only once.
- 4.6 The SSRO is not prescriptive about whether costs are categorised as direct or indirect costs, but the MOD will want to be satisfied with the assignment of costs to contracts (or groups of contracts) and the method by which costs are shared amongst contracts. Section 2 of this guidance sets out the contractor's duty to keep relevant records and submit statutory reports in respect of allowable costs.

### **Direct costs**

- 4.7 Direct costs which are attributable to a single contract or component should be assessed against section 3 and relevant guidance in section 4 to be claimed as allowable. Direct costs which the contractor seeks to recover following use of cost recovery rates should be assessed against the guidance on indirect costing in paragraphs 4.9-4.12.

### **Overhead costs**

- 4.8 Overhead costs considered allowable and not identified as arising from performing a single qualifying contract should be assessed against the guidance in section 3 and any relevant guidance in section 4. Overhead costs which the contractor seeks to recover following use of cost recovery rates should be assessed against the guidance on indirect costing in paragraphs 4.9-4.12.

### **Indirect costs and cost recovery rates**

- 4.9 Some costs may be determined through the use of recovery rates which are applied to an appropriate recovery base. A contract or component may contain allowable costs which are both applied directly, and applied indirectly through the use of a rate. A cost recovery rate is a rate of cost per unit of a cost recovery base. For example, a rate of £50 per hour applied to a cost recovery base of 1,000 labour hours would generate a cost of £50,000.
- 4.10 The agreement of estimated and actual rates will be determined between the contractor and the MOD. For cost recovery rates to be consistent with the requirements of allowable costs, a cost recovery rate, when applied to a suitable cost recovery base, should produce a cost estimate which is allowable. It cannot be fully determined, however, that a particular cost is an allowable cost under a qualifying contract in accordance with the requirements of section 20(2) of the Act until the contract to which the rate is to be applied is being priced.
- 4.11 Because cost recovery rates may be used as the basis of a cost claimed as allowable under a qualifying contract or component, their formulation should be guided by the requirements of allowable costs. Rates which are not consistent with the requirements of allowable cost are unlikely to be applicable in a way that would be suitable for determining the allowable costs under a qualifying contract or component. The following are typical characteristics of a suitable cost recovery rate which is consistent with the requirements of allowable costs. The relevant parties should consider these characteristics during the process of evaluating whether a cost recovery rate to be used to price a qualifying contract is consistent with each requirement:

- i. **Appropriate:** cost pools comprise costs arising from activities which relate to the performance of contracts (or components) of the type to which the rate is anticipated to apply. It is not a requirement that a cost that is included in a cost pool meets the requirements of allowable costs, only the element which is to be allocated and apportioned to qualifying contracts. Examples of costs which may be appropriate include: the HR cost of the relevant business unit delivering the contract(s); research in the domain of the scope of the contract(s); and other business enablers that exist for the benefit of the customer or are required for the contracting company to function lawfully or efficiently.
  - ii. **Attributable to the contract or component:** the recovery base used to apportion the cost pool is applied in a way that fairly reflects use of resource by the contract(s) or component(s) to which the rate may apply. In general, a suitable method is one which most closely aligns the driver of a particular cost to the recovery base. For example, using a recovery base of labour hours may be suitable for direct labour costs, but headcount may be more suitable for back office functions. The scope of the recovery base should match that of the cost pool.
  - iii. **Reasonable in the circumstances:** the quantum of costs in the pool and of the recovery base are justifiable with respect to agreed levels of efficiency and productivity. For example, they may be consistent with those that a well run company operating under competitive market pressure to maximise efficiency would be expected to incur and allocate to contracts. This may reflect improvements on historical trends given the outputs, accounting for any changes in circumstance, cost control measures, and the expectation of productivity improvements.
- 4.12 The parties will need to apply judgement in agreeing the type and standard of evidence that it is reasonable for the contractor to provide in order to demonstrate that their estimated, actual and claimed costs within recovery rates are consistent with the requirements of allowable costs. In determining what type and standard of information is required, the relevant parties should take a proportionate approach (see section 2). When determining a proportionate type and standard of information to support the calculation of cost recovery rates, the parties should:
- Consider the types of contracts to which the rates will be applied to ensure the scope of the cost pool and recovery base are suitable.
  - Consider consistency between the scope of the cost pool and recovery base when adjusting either.

## Accounting methods

- 4.13 Contracting companies may adopt a variety of accounting policies and practices and make judgements in the preparation of financial statements for statutory reporting purposes (for example, International Financial Reporting Standards and UK Generally Accepted Accounting Practice) and for the preparation of management accounts to inform internal decision-making. Application of these policies and practices to QDCs, will not necessarily result in costs charged satisfying the AAR principles, and contractors must therefore have regard to this guidance.

## 5. Guidance on specific 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 structure of this section is set out below:

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
	D.2	Research applied indirectly
	D.3	Development
	D.4	Other matters
Part E – Costs associated with loss, poor performance or other events	E.1	Losses, obsolescence and bad debt
	E.2	Reworks, wastage and faulty workmanship
	E.3	Damages and compensation
	E.4	Credits, notional transactions and penalties
	E.5	Insurance
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
	F.4	Sunk and committed costs
Part G – Non-cash and financing costs	G.1	Non-cash costs
	G.2	Financing costs
Part H – Risk and uncertainty	H.1	Costs which are affected by risk or uncertainty
	H.2	Risk contingency element
	H.3	Costs associated with mitigating risk or uncertainty
	H.4	Cost risk adjustment
Part I – Costs associated with group profits (POCO)	I.1	Basis of the POCO adjustment
	I.2	Application of the POCO adjustment
	I.3	Connected persons
	I.4	Determination of the POCO adjustment
	I.5	Group sub-contracts not under the Regulations
	I.6	Worked example of the POCO adjustment
	I.7	Glossary of POCO terms

## Part A: Labour costs

### 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 in the circumstances, 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.

### 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.2.3 Defined Contribution scheme: all employer contributions paid or accrued in the year.
- A.2.4 Defined Benefit scheme: the relevant annual allowable cost 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 MOD.

## **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**

### **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**

### **C.1 Marketing and sales costs**

- C.1.1 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.
- C.1.2 The MOD may decide to award single source contracts without the need for marketing and sales activity. Section C.2 refers to guidance on bid costs which may be incurred by a contractor when bidding for a single source contract. Marketing and sales costs may either in total or in part be considered allowable in a single source contract if they meet the AAR principles and deliver demonstrable benefit to the UK Government.
- C.1.3 Financial benefit to the MOD should be demonstrated by showing that the inclusion of marketing and sales costs results in a lower rate or unit costs charged to the QDC or QSC than if marketing and sales costs were excluded. The reduction in costs should be at least equivalent to the marketing and sales costs claimed. A sound evidence base should be provided to show how proven successful orders have resulted (retrospective test) or are expected to result through forecast sales (prospective test) in increased throughput of activity which then leads to the cost reduction in the QDC or QSC.
- C.1.4 A contractor should ensure that any costs claimed are not or will not be recovered through other means. For example, where there is UK Government financial support for marketing and sales campaigns already in place these costs should not be claimed. Where possible, a contractor should provide a breakdown of their costs to enable them to be properly understood and to help determine whether they are allowable. For example:
- a. segmenting their market by geography or product/service; or
  - b. identifying where campaigns have UK Government financial support.

### **C.2 Bid costs**

- C.2.1 Bid costs are those costs incurred in pursuit of the expected award of a specific contractual outcome. Bid costs incurred by a contractor in pricing a QDC or QSC may be allowable costs under the resulting contract and may include the staff costs of preparing and reviewing proposals. As the length of time to develop proposals varies depending on the nature of the contract the SSRO does not determine a timeframe within which these costs would be incurred.

- C.2.2 Bid costs, where possible, should be charged directly to a contract although it is recognised that in some cases they may need to be apportioned as indirect costs. If no contract is awarded for which bid costs have been incurred these costs would generally not be allowable as there is no QDC or QSC to which they would relate. However, the MOD and contractor may agree if and how any costs are to be recovered through alternative arrangements.
- C.2.3 The contractor's marketing and sales costs should not be included as bid costs and should be treated separately under section 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**

### **D.1 Research and development**

- D.1.1 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- D.1.2 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
- D.1.3 The costs of research and development incurred, whether applied directly or indirectly to a QDC or QSC, may be allowable costs.

### **D.2 Research applied indirectly**

- D.2.1 A proportion of the costs of research undertaken during the period of the contract that are applied indirectly to contracts may be attributable to the QDC or QSC in question where the research to which the costs relate enables the performance of the contract.
- D.2.2 In determining whether research expenditure is an allowable cost, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research costs may be necessary if:
- the goods or services could not have been provided but for the research or research of a similar nature, having been undertaken.
  - the research costs were necessarily incurred to sustain the contractor's skills, expertise and capability to deliver the contract and other defence contracts in the future.
  - there is an explicit agreement between the contractor and the MOD in respect of research to meet the MOD's long-term need.

### **D.3 Development**

- D.3.1 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Either approach may be used in determining the level of development costs that are allowable costs.
- D.3.2 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.
- D.3.3 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the MOD.

### **D.4 Other matters**

- D.4.1 The costs of research or development that did not achieve its planned objectives may be allowable costs and should be evaluated in the same way as any other research or development costs.

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

### **E.1 Losses, obsolescence and bad debt**

- E.1.1 Reasonable stock losses and obsolescence costs 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, wastage and faulty workmanship**

- E.2.1 The costs of reworks and wastage may be allowable. This recognises that no production or manufacturing process is likely to be completely effective and that attempts to achieve zero rework or wastage may be uneconomical.
- E.2.2 The assessment of what is a reasonable level of rework or wastage will depend on the information available and the specific circumstances of the contract being delivered:
- a. Contractors should have adequate quality control and monitoring systems in place to be able to identify the level and, where material, the causes of reworks and wastage. There should be plans in place to reduce costs through learning curve and efficiency gains.
  - b. Once both parties have considered the information available and the specific circumstances of the contract, including how they compare to other contracts, a judgement can be made about whether costs are allowable.

E.2.3 The costs of faulty workmanship are not allowable 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.3 Damages and compensation**

E.3.1 Damages, compensation or loss of profit for poor performance, such as breach of contract, are not allowable costs.

### **E.4 Credits, notional transactions and penalties**

E.4.1 Allowable costs should be net of any credits received by contractors that reduce a particular cost for the contractor. Credits may include, but are not limited to, reimbursements, grants, discounts or refunds.

E.4.2 Credits that do not reduce a particular cost are not relevant to the determination of allowable costs.

E.4.3 The treatment of a particular credit should be consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the MOD. In determining whether the treatment for a particular credit is appropriate, the relevant parties should consider:

- a. the legal basis of the credit and whether this indicates it reduces costs or not;
- b. the economic substance of the credit, which may indicate that it reduces costs if:
  - i. there is a requirement, intent, or common practice for the credit to be used to reduce costs;
  - ii. the credit is calculated with direct reference to costs;
  - iii. the credit is received from the same entity with which the costs were incurred; and
  - iv. transactions are settled net of the credit; and
- c. whether the credit is received as a result of a particular requirement of the contract, which may indicate that it reduces costs.

E.4.4 Notional values of transactions are generally not allowable costs.

E.4.5 Costs arising from civil penalties and fines are not allowable costs. Such costs result from charges imposed by third parties on contractors to penalise them for wrongdoing or to derive compensation for harm done. As such, they do not satisfy the requirements of allowable costs.

### **E.5 Insurance**

E.5.1 The costs of insurance, for example, insurance premiums, may be allowable costs, subject to satisfying the requirements of this guidance.

E.5.2 The costs of insurance may be considered to enable the performance of the QDC or QSC in question when:



- a. the insurance is required by statute or by the contract terms and conditions; and
- b. the costs affected by risk or uncertainty which would be met or reduced by the insurance provider should they be incurred, would, in the absence of the insurance, satisfy the requirements to be appropriate and attributable to the contract or component.

E.5.3 In determining whether the costs of insurance are reasonable in the circumstances the relevant parties should ascertain:

- a. whether due regard for economy and efficiency in the use of resources is demonstrated by the relative amounts of:
  - i.. the costs of insurance; and
  - ii. the estimated impact of the insured event on the costs of performing the contract or component given the likelihood of its occurrence; and
- b. what, if any, other benefits are or were anticipated to arise for the MOD as a result of purchasing the insurance, for example, greater certainty as to contract schedule performance.

E.5.4 The contractor may purchase insurance for risks associated with a single contract or multiple contracts. Accordingly, the costs of insurance may be applied directly or indirectly to contracts.

E.5.5 Where insurance provides cover for risks arising from multiple contracts, the benefits of that insurance may accrue disproportionately between those contracts and will be impossible to ascertain at the time of purchase. Accordingly, the relevant parties should agree a methodology for the allocation of insurance costs to contracts that seeks to ensure those costs are equitably apportioned.

E.5.6 Costs associated with insured events but not covered by insurance, for example policy excesses or deductibles, or costs exceeding the limits of insurance cover, may be allowable costs subject to satisfying the requirements to be appropriate, attributable to the contract or component and reasonable in the circumstances.

E.5.7 Where such costs are affected by risk or uncertainty the parties should have regard to the guidance in Part H when determining whether the costs are allowable costs.

## **Part F: Exceptional or abnormal costs**

### **F.1 Exceptional or abnormal costs**

F.1.1 This guidance is applicable to all contract discussions between the MOD and contractors regarding allowable costs in regard to QDCs and QSCs. Whilst the majority of discussions about whether costs are appropriate, attributable to the contract or component and reasonable in the circumstances 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 MOD 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 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 MOD as necessary to meet uncertain defence demands;
- b. are of a strategic nature that the MOD 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 MOD, to which the contractor is to provide the relevant evidence to support the payment.

## **F.4 Sunk and committed costs**

F.4.1 Sunk costs are costs that have been incurred, and committed costs are costs that have already been agreed to be incurred, at the time a contract becomes a qualifying contract. Sunk and committed cost may include, for example, bid costs (see C.2) or the cost of work undertaken at risk.

F.4.2 Sunk and committed costs may be allowable costs subject to satisfying the requirements described in this Part, Section 3 of this guidance and any other relevant Part of Section 5 of this guidance.

- F.4.3 If a contract becomes a qualifying contract following an amendment,<sup>13</sup> there may be a part of the contract price (including cost and profit) which was agreed prior to the date of the amendment that resulted in the contract becoming a qualifying contract. In such cases the parties should refer to the SSRO guidance on alternative pricing which explains the contract pricing method that should be applied in these circumstances.<sup>14</sup>

## Part G: Non-cash and financing costs

### 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:

- construction of a facility;
- property, plant and equipment which has been purchased;
- internally generated intangible assets, such as development of intellectual property; and
- 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 costs associated with tangible assets are known as depreciation and the non-cash costs associated with intangible assets are amortisation.
- G.1.3 A contractor should apply its own accounting policies when valuing and recognising assets on its balance sheet. Contractors should adopt a consistent approach to the allocation or apportionment of 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 to determine if the acquisition of the business is attributable to the contract (or component) and whether any associated non-cash costs are appropriate and reasonable in the circumstances.

<sup>13</sup> For example, a QDC by amendment. For further details on amended contracts see *Reporting guidance on preparation and submission of contract reports* available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>.

<sup>14</sup> See section 5 of the SSRO's *Guidance on the alternative pricing of contracts (version 8.2)*.

*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 (for example, 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 (for example, an impairment expense or gain). Such circumstances will require a case-by-case review to understand why the value has changed, whether the MOD is due any balancing credit and ensure that any costs are reasonable in the circumstances.

**G.2 Financing costs**

G.2.1 Borrowing costs are generally not allowable costs. The approach to calculating the step 4 capital servicing adjustment compensates contractors for these costs. The SSRO publishes separate guidance on how the step 4 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital it employs for the purpose of enabling it to perform the contract.<sup>15</sup>

**Part H: Risk and uncertainty**

**H.1 Costs which are affected by risk or uncertainty**

H.1.1 This guidance applies to costs affected by risk or uncertainty that fall within one of the categories shown in Table A. Reference in this guidance to costs which are affected by risk or uncertainty means that one of the categories in Table A applies to the costs. The terms provided are intended to be used in the interpretation of this guidance document. Where contracting parties use alternative terms in respect of any of the categories shown, this should not alter the substantive interpretation or application of this guidance.

**Table A**

Category	Term
The costs may or may not be incurred by the contractor;	Risk
The actual amount of the costs incurred may be higher or lower than the estimated amount of the costs	Uncertainty
The costs possess both of the characteristics described above.	Risk and uncertainty

H.1.2 A contractor’s estimated costs which are affected by risk or uncertainty may be allowable costs subject to satisfying the requirements described in this Part, Section 3 and any other relevant Part of Section 5 of this guidance.

H.1.3 In determining an estimate of the total allowable costs for the contract or component the parties should consider:

<sup>15</sup> SSRO's *Guidance on the Baseline profit rate and its adjustment (version 8.2)*.

- a. costs already incurred by the contractor;
- b. known future costs;
- c. estimated costs which are affected by risk or uncertainty;
- d. the anticipated effects of any actions to mitigate risk or uncertainty in the contractor's costs (see Part H.3) which have been agreed by the relevant parties, for example, in risk mitigation plans; and
- e. the terms and conditions of the contract.

- H.1.4 For a contractor's estimated costs to be allowable costs the estimate should aim to anticipate the actual allowable costs the contractor will incur in performing the contract or component, taking account of risk or uncertainty. There should be economy and efficiency in the use of resources, unless there is a clear reason to the contrary (see paragraph 3.15 d). The contractor should seek opportunities for risk reduction or increased efficiency to be captured through the life of the contract.
- H.1.5 There is a range of approaches available to contractors to estimate costs which are affected by risk or uncertainty. The estimating approach or approaches should be suitable to the circumstances of the case, taking account of:
- a. good practice in cost estimation; and
  - b. the information available at the time of estimation concerning the assumed or known characteristics of any risk or uncertainty.
- H.1.6 Costs may be estimated using random sampling methods, for example, Monte Carlo simulation, where this is the suitable approach.
- H.1.7 Costs which are affected by risk or uncertainty should typically be estimated with reference to their expected value as defined in a statistical sense, except where an alternative approach would produce an estimate the parties consider to be closer to the actual allowable costs the contractor anticipates it will incur in performing the contract.
- H.1.8 The relevant parties should take a proportionate approach to determining what type and standard of information is required about risk or uncertainty in order to be satisfied that estimated costs are allowable costs, having regard to the guidance at paragraphs 2.6-2.8.
- H.1.9 In determining what type and standard of information it is reasonable to expect would be available, the relevant parties should have regard to:
- a. the specificity of the contract requirements;
  - b. the contractor's experience in performing similar activities;
  - c. good practice in cost estimation; and
  - d. the number and type of factors giving rise to risk or uncertainty affecting costs.
- H.1.10 Evidence might include risk registers, lists of assumptions, cost models or other cost aggregation methods.

## H.2 Risk contingency element

- H.2.1 For the purpose of this guidance, ‘risk contingency element’ refers to the aggregate of costs which are affected by risk or uncertainty that:
- a. the contractor estimates it will incur to enable performance of the contract, and
  - b. whose allocation to a particular cost cannot be made at the time of estimation.
- H.2.2 The term ‘risk contingency element’ is adopted as the legislation requires contractors to report any risk contingency element within the allowable costs of a QDC or QSC. Contracting parties may use alternative terms to describe cost items set out in H.2.1, for example, ‘risk allowance’; ‘contingency’; or ‘management reserve’. This should not alter the substantive interpretation or application of this guidance.
- H.2.3 In assessing if a risk contingency element in the contractor’s costs is an allowable cost the relevant parties should consider:
- a. whether the estimated costs to which the risk contingency element may be allocated would, if incurred, satisfy the requirements of costs that are appropriate;
  - b. whether the estimated costs to which the risk contingency element may be allocated would, if incurred, satisfy the requirements of costs that are attributable to the contract or component; and
  - c. whether the amount of the risk contingency element is reasonable in the circumstances given:
    - i. the extent and nature of the risk or uncertainty affecting the estimated costs to which the risk contingency element may be allocated;
    - ii. the contractor’s experience in performing similar activities; and
    - iii. the potential for cost efficiencies and risk reduction arising from opportunities for the contracting parties to learn from experience during the life of the contract.
- H.2.4 The approach or approaches to be taken when quantifying a risk contingency element in costs should be appropriate to the circumstances of the case, having regard to the guidance at H.1.3 to H.1.7.
- H.2.5 Where there are no estimated costs affected by risk or uncertainty there should be no requirement for a risk contingency element in allowable costs.
- H.2.6 The SSRO provides separate guidance for contractors on the reporting of data on any element of risk contingency in allowable costs.<sup>16</sup>

## H.3 Costs associated with mitigating risk or uncertainty

- H.3.1 Contractors may take action to reduce the likelihood or impact of risk or uncertainty affecting either the costs of performing the contract, component of such a contract or other aspects of contract performance. The costs of such mitigating action (‘the costs of mitigation’) may be allowable costs subject to satisfying the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.

<sup>16</sup> Reporting guidance on preparation and submission of contract reports available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

- H.3.2 The contractor may take action to mitigate the likelihood and impact of risk or uncertainty for a single component or contract or for multiple components or multiple contracts. Accordingly, the costs of mitigation may be applied directly or indirectly to contracts.
- H.3.3 The costs of mitigation may be considered to enable the performance of the contract or component if they are incurred with the intention of reducing the likelihood and impact of risk or uncertainty affecting:
- a. a cost which, if it was incurred, would satisfy the requirements to be appropriate and attributable to the contract or component; or
  - b. any other aspect of contract performance, for example, schedule risk.
- H.3.4 In determining whether the costs of mitigation are reasonable in the circumstances the relevant parties should ascertain:
- a. Whether due regard for economy and efficiency in the use of resources is demonstrated by the relative amounts of:
    - i. the costs of mitigation; and
    - ii. the reduction in the amount of a cost or costs that is or was anticipated as a result of the mitigating actions; and
  - b. what, if any, other benefits are or were anticipated to arise for the MOD as a result of the mitigating actions, for example, greater certainty as to contract schedule performance.
- H.3.5 More specific guidance on determining whether the costs of insurance are allowable costs is provided in Part E.5.
- H.3.6 Costs associated with mitigating risks or uncertainty may still be allowable costs even if a non-zero cost risk adjustment is present.

## H.4 Cost risk adjustment

- H.4.1 Cost risk reflects the financial risks to the primary contractor of entering into the contract or component, taking into account the particular type of activities to be carried out by the primary contractor under that contract or component. The presence of cost risk may be reflected through the agreement of a cost risk adjustment in determining the contract profit rate for a QDC or QSC. The cost risk adjustment should not be used to include within the contract price any element of the estimated costs that have been identified, as these should be considered in the determination of the estimated allowable costs. The SSRO provides separate guidance on the cost risk adjustment.<sup>17</sup>

## Part I: Costs associated with group profits (POCO)

### I.1 Basis of the POCO adjustment

- I.1.1 Section 20(2A) of the Act provides for a reduction to the allowable costs under a qualifying defence contract or component of such a contract so as to ensure that profit arises only once in the allowable costs that relate to the price payable under any group sub-contract (including any further group sub-contract). For the purpose of this guidance, this reduction is called the Profit on Costs Once (POCO) adjustment.

<sup>17</sup> See Section 4 in the SSRO's *Guidance on the Baseline profit rate and its adjustment (version 8.2)*.

- I.1.2 The requirements of allowable costs may not be met where the cost arises from profits made by a person connected with the primary contractor: The requirements of allowable costs are that they must be Appropriate, Attributable to the contract or component, and Reasonable in the circumstances (AAR). A cost which is not agreed by the parties as AAR, cannot form part of the price of a QDC or QSC (or component of such) that uses the price formula.
- I.1.3 Regulation 13A sets out the basis upon which a reduction to the allowable costs must be determined so as to exclude certain costs relating to sub-contractor profit from being allowable costs under the contract. This guidance sets out the process and calculation which, when followed, ensures the reduction to allowable costs is applied in accordance with the Act and Regulations. The amount of the deduction is called the “attributable profit” and is defined in the regulation 13A (5) and (6).
- I.1.4 Section 30(1) of the Act sets out that “[the Act] and Single Source contract regulations apply to qualifying sub-contracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)”. In the case of a qualifying sub-contract, the calculation of the POCO adjustment is agreed between the sub-contractor and the contracting authority, rather than the MOD, and this guidance must be modified by reading references to the Secretary of State as the contracting authority and references to the contractor as the sub-contractor.

## I.2 Application of the POCO adjustment

- I.2.1 The POCO adjustment applies in the calculation of allowable costs of a QDC if the primary contractor is party to, or proposes to enter into, a group sub-contract.<sup>18</sup> Diagram A below demonstrates when a POCO adjustment should or should not be made. The definition of a group sub-contract is set out in the glossary of terms (I.8).
- I.2.2 The POCO adjustment does not apply if the primary contractor is not party to, or does not propose to enter into, a group sub-contract. Such sub-contracts are not within scope of the POCO adjustment. For example, if the sub-contract is competed or priced using the commercially priced item method then it is out of scope, as are sub-contracts with parties that are not connected with the primary contractor in accordance with the definition in I.3. A sub-contract does not have to be a Qualifying Subcontract in order to be in scope of the POCO adjustment (see I.6).
- I.2.3 Where a POCO adjustment applies, the parties will need to take into account default pricing method being used. This is because some pricing methods require the allowable costs to be those as estimated at the time of agreement, and others use the actual allowable costs. Therefore, the POCO adjustment may need to be reflected in the allowable costs at the time of agreement, or through the life of the contact as the actual allowable costs are determined. Beyond this there are no legislative restrictions on when assessment of the allowability of costs should be made and consequently when any deductions for group profits should be made. However, it may be convenient for the POCO adjustment to be agreed concurrent with the assessment of the allowability of the costs of a Group Sub-Contract (GSC) or Further Group Sub-Contract (FGSC). The parties should agree the most appropriate arrangements for the contract or component in question.

<sup>18</sup> Refer to paragraphs I.8.1-I.8.2 for the definitions of ‘group sub-contract’ and “further group sub-contract”.



- I.2.4 Where a primary contractor has an existing contract that was entered into prior to 1 April 2024 that contains a POCO adjustment applied to the contract profit rate, they should refer to section I.5. for further guidance.

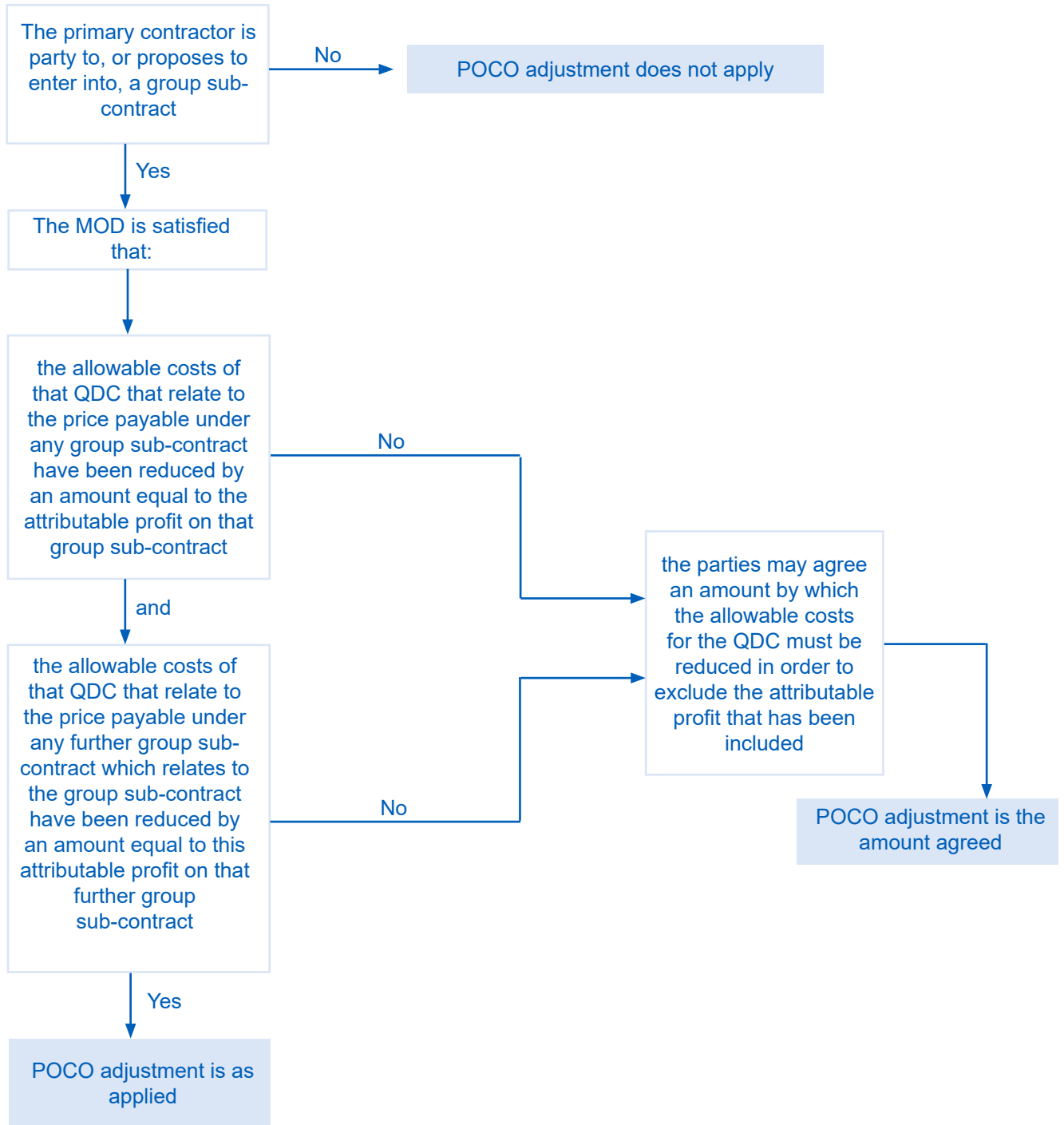
### **I.3 Connected persons**

- I.3.1 Establishing whether there is a group, or further group sub-contract, requires consideration of the connection or association of the parties in the supply chain.
- I.3.2 As set out in regulation 13A (9) a person is connected with another person for the purpose of the POCO adjustment if they are associated with each other. As set out in section 43(3) of the Act, one person is “associated” with another if they are group undertakings in relation to each other, where “group undertakings” has the meaning given by section 1161 of the Companies Act 2006.<sup>19</sup>

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<sup>19</sup> <https://www.legislation.gov.uk/ukpga/2006/46/section/1161>

### Diagram A: Process for the application of the POCO adjustment



## I.4 Determination of the POCO adjustment

- I.4.1 The information upon which the POCO adjustment calculation is based is likely to be held by the prime contractor and its group sub-contractors and not the MOD. In such cases, in order for the parties to reach an informed agreement as to the POCO adjustment:
- a. the prime contractor should propose the POCO adjustment to the MOD, supported by the facts, assumptions and calculations relied upon; and
  - b. the contracting authority should scrutinise the proposed adjustment and request any further information required to form a view as to the amount by which the allowable costs must be decreased in order to exclude attributable profit that would otherwise be included.
- I.4.2 Table 2 below demonstrates the process that when applied results in a reduction to the allowable costs of the contract in accordance with the requirements of the Act and Regulations. Please refer to paragraph I.8.1 onwards for a glossary of the terms used and I.7.1 for a worked example of the process.
- I.4.3 The incurred costs of a QDC which relate to the price of any group sub-contract and further group sub-contract will include any profit which those sub-contracts ultimately charge to the QDC. The purpose of the POCO adjustment is to remove this element of profit, which is known as attributable profit (subject to certain adjustments) from the allowable costs of the QDC. This is intended to ensure profit arises only once in relation to those allowable costs under any such qualifying defence contract that relate to the price payable under any group-sub-contract (including any further group sub-contract) at a suitable rate for each contract in the supply chain.
- I.4.4 According to regulations 13A (5) to (6), the “attributable profit” is:
- a. where all of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, all the profit element in the price payable under that group sub-contract or further group sub-contract; or
  - b. where only part of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, that part of the profit element in the price payable under that group sub-contract or further group sub-contract which relates to the output necessary for that performance.
- I.4.5 Performing the contract for the MOD may include specific financial risk that the subcontractor is taking and not the prime. In these situations, it is appropriate for MOD to pay for that within the allowable costs related to the GSC within the prime contract price. The sub-contract ‘attributable profit’ to be removed from the prime’s allowable costs therefore does not include any ‘risk premium’ (the profit arising from the application profit rate step 2 - CRA) paid to the subcontractor which is above the amount of any risk premium paid by MOD to the prime contractor. In practice, this involves looking to see if the CRA of the GSC is higher than the CRA of the QDC, and if it is, adding back the profit on the GSC’s allowable costs associated with that difference. In respect of this, it is important the CRA of each contract in the supply chain fully reflects the financial risk each contractor is exposed to in entering into the QDC or QSC.

I.4.6 Attributable profit also excludes:

- a. any capital servicing adjustment made under step 4 of regulation 11; and
- b. any profit which is received by a person which is not associated with the primary contractor.

## **I.5 Contracts entered into prior to 1 April 2024**

I.5.1 Subject to the relevant conditions being met, a POCO adjustment may apply to the allowable costs if the primary contractor is party to, or proposes to enter into, a group sub-contract. Contracts that were entered into prior to 1 April 2024 may already have a POCO adjustment applied as part of the six-step process. However the Regulations do not exclude these contracts from the provision which applies the POCO adjustment to allowable costs.

I.5.2 Where a step 3 POCO deduction has previously been agreed, the parties may agree that attributable profit is zero and therefore the adjustment to the allowable costs for POCO is zero.

I.5.3 In the case of pricing amendments:

- a. Where the entire contract price is being redetermined using a default pricing method, a POCO adjustment may be applicable to the allowable costs and the new 4 step contract profit rate will not include a step 3 POCO adjustment.
- b. Where only a component of the contract price is being redetermined using a default pricing method, a POCO adjustment may be applicable to the allowable costs of the component and the new 4 step contract profit rate for the component will not include a step 3 POCO adjustment.

## **I.6 Group sub-contracts that are not qualifying sub-contracts**

I.6.1 It is not a requirement for a group sub-contract or further group sub-contract to be a QSC. If the primary contractor has entered into sub-contracts to a QDC (including any QSC), then the prices of those sub-contracts will be costs in the QDC. The MOD and the primary contractor will need to be satisfied that the prices of those sub-contracts are allowable costs (see 2.4). In relation to non-QSC group sub-contracts, provisions under the POCO adjustment which makes reference to the four-step contract profit rate process may not operate in the same manner as for a QSC. For example, attributable profits of a group sub-contract that have not been determined using the regulation 11 four step process will generally not include a step four capital servicing adjustment (CSA). In such cases, the attributable profit conforms to the legislative requirement that it should not include any CSA made under regulations, without further adjustment.

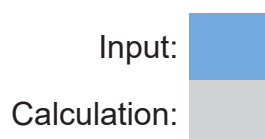
**Table 2: Process to calculate the POCO adjustment**

Stage	Process
1	<p><b>Document the supply chain</b></p> <p>Identify all the group sub-contracts and further group sub-contracts. Note the allowable costs (before any POCO deduction) and contract profit rate steps of the group and any further group sub-contract cost in the price of those contracts</p>
2	<p><b>Calculate the subcontract profit</b></p> <p>Calculate the profit of each group sub-contract and further group sub-contract identified at stage one. This is done by multiplying the allowable cost of each contract by its respective contract profit rate. The result is the attributable profit before the exclusion of capital servicing adjustment and appropriate subcontractor profit.</p>
3	<p><b>Calculate the amount of capital servicing adjustments</b></p> <p>Multiply costs identified at stage one for each group sub-contract and further group sub-contract with the respective step 4 capital servicing adjustment. The result is the amount of capital servicing which must be excluded from the attributable profit at stage 2.</p>
4	<p><b>Calculate the subcontract risk premium (appropriate subcontractor profit)</b></p> <p>Identify any step 2 cost risk adjustment applied in the calculation of the contract profit rate for each group subcontract and further contract which is over and above the CRA for the prime contract. For example if the CRA of the group sub-contract is +25% and the CRA of the QDC is 9% then difference is 16pp. For each group sub-contract and further-group contract, multiply that contract’s own allowable cost with the CRA differential. The contract’s own allowable costs do not include allowable costs associated with the price of any further group subcontracts. The result is the “appropriate subcontractor profit” must be excluded from the attributable profit at stage 2.</p>
5	<p><b>Determine the POCO adjustment</b></p> <p>Take all the profits calculated in stage 2 and subtract from then all the capital servicing adjustment and attributable profit calculated at stages 2 and 3 respectively. The result is the amount of profit in the price of the group and further group sub-contracts which is not an allowable cost in the price of the QDC.</p>

## I.7 Worked example of the POCO adjustment

- I.7.1 To calculate what the POCO adjustment is, apply the stages that have been described in Table 2. As mentioned in paragraph I.6.1, following these steps will also ensure a suitable outcome for non-QSC group sub-contracts whilst complying with the Act and Regulations.
- I.7.2 The diagram below reflects **Stage 1** of the process in table 2, with profit applied at each contract’s rate at each level. These figures are used in the calculations that follow.

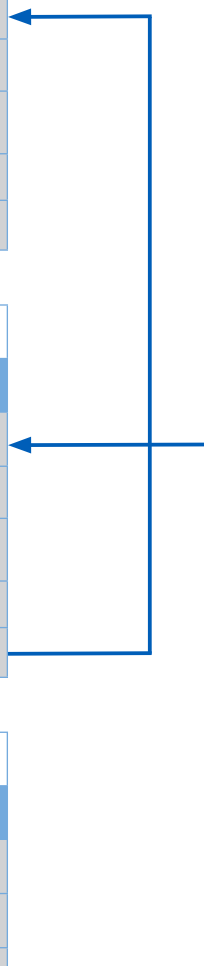
Contractor	BPR	CRA	Profit rate steps 1, 2 and 3	CSA - profit step 4
Primary Contractor (PC)	8.00%	0%	8.0%	1.50%
Group sub-contractor (SC1)	8.00%	25%	10.0%	2.00%
Further Group sub-contractor (SC2)	8.00%	10%	8.8%	1.00%



Primary contractor (£m)	
Prime Allowable Costs	£200.00
Price SC <sub>1</sub> (P <sub>s1</sub> )	£86.74
Total allowable costs (AC <sub>p</sub> )	£286.74
Profit (before CSA)	£22.94
CSA for Prime	£4.30
<b>Price (before any POCO adjustment)</b>	<b>£313.98</b>

Group sub-contractor (QSC) (£m)	
SC <sub>2</sub> Allowable Costs (AC <sub>sc2</sub> )	£50.00
Price SC <sub>2</sub> (PS <sub>2</sub> )	£27.45
Total Allowable Costs	£77.45
Profit SC <sub>1</sub>	£7.75
CSA for SC <sub>1</sub>	£1.55
<b>QSC Price</b>	<b>£86.74</b>

Further Group sub-contractor (QSC) (£m)	
SC <sub>2</sub> Allowable Costs (AC <sub>sc2</sub> )	£25.00
Profit SC <sub>2</sub>	£2.20
CSA for SC <sub>2</sub>	£0.25
<b>Price</b>	<b>£27.45</b>



Stage 2 - calculate the subcontract profit		(£m)
<b>Contract Profit Rate for each GSC and FGSC</b>		
$CPR_{SC1} \times AC_{SC1} = \text{Profit SC1}$	$= 12\% \times \text{£}77.45$	£9.29
$CPR_{SC2} \times AC_{SC2} = \text{Profit SC1}$	$= 9.8\% \times \text{£}25$	£2.45
<b>Total</b>		<b>£11.74</b>

Stage 3 - Calculate the amount of capital servicing adjustments		(£m)
Profit SC1 - $CSA_{SC1}$	$= \text{£}9.29 - \text{£}1.549$	£7.75
Profit SC2 - $CSA_{SC2}$	$= \text{£}2.45 - \text{£}0.25$	£2.20
<b>Total (initial POCO adjustment)</b>		<b>£9.95</b>

Stage 4 - Calculate the risk premium (appropriate subcontractor profit)		(£m)
$AC_{SC1*} \times BPR \times (CRA_{SC1} - CRA_{PC})$	$= \text{£}50 \times 8\% \times (25\% - 0\%)$	£1.00
$AC_{SC2*} \times (CRA_{PS2} - CRA_{PC})$	$= \text{£}25 \times 8\% \times (10\% - 0\%)$	£0.20
<b>Total appropriate subcontractor profit</b>		<b>£1.20</b>

Stage 5 - Determine the POCO adjustment		(£m)
Initial POCO adjustment		£9.95
Deduct appropriate subcontractor profit		-£1.20
POCO deduction to Allowable Costs		£8.75

Primary Contract price - after the application of the POCO adjustment		(£m)
Prime Allowable Costs		£200.00
Price SC1		£86.74
Initial POCO adjustment		-£9.95
Add back risk premium		£1.20
Total Allowable Costs		£278.00
Profit (before CSA)		£22.24
CSA for prime		£4.17
<b>QDC Price</b>		<b>£ 304.41</b>

## I.8 Glossary of POCO terms

### *Group sub-contract*

- I.8.1 As set out in regulation 13A (3), “group sub-contract” means a contract:
- under which the price payable includes an amount of profit;
  - which is made between the primary contractor and any person associated<sup>20</sup> with the primary contractor;
  - which has a value of no less than £250,000;
  - the award of which was not the result of competitive process (as defined in regulation 59 or 60);
  - the price of which is not determined in accordance with regulation 19A (commercial pricing) or 19B (3) (prices determined in accordance with law); and
  - where the goods, works or services to be provided under the contract are necessary to enable the performance of the qualifying defence contract.

### *Further group sub-contract*

- I.8.2 As set out in regulation 13A(4), “further group sub-contract” means a contract:
- under which the price payable includes an amount of profit;
  - which is made between two or more persons, each of which is associated with the primary contractor or a group sub-contractor;
  - which has a value of no less than £250,000;
  - the award of which was not the result of a competitive process (as defined in regulation 59 or 60);
  - the price of which is not determined in accordance with regulation 19A (commercial pricing) or 19B(3) (prices determined in accordance with law); and
  - where the goods, works or services to be provided under the contract are necessary to enable the performance of the qualifying defence contract.

### *Group sub-contractor*

- I.8.3 A “group sub-contractor” means a person with which the primary contractor makes a group sub-contract.

### *Appropriate sub-contractor profit*

- I.8.4 “appropriate sub-contractor profit” means an amount of profit in the sub-contract price which the MOD is satisfied is not duplicated by the values calculated by applying Step 1 (baseline profit rate) and Step 2 (cost risk adjustment) in regulation 11.

<sup>20</sup> As set out in section 43(3) of the Defence Reform Act 2014, one person is “associated” with another if they are group undertakings in relation to each other, where “group undertakings” has the meaning given by section 1161 of the Companies Act 2006.



## Appendix A: Changes from previous version

A.1 The table below highlights changes from version 7.1 of the guidance to this version. Sections which are not included in the table are unchanged from version 7.1.

### Key to changes:

No change (moved)
Deleted
Revised
Added

Section/paragraph v7.1	Section/paragraph v7.2
<b>1. Introduction</b>	
1.1-1.13	1.1-1.13
1.14	1.14
1.15-1.19	1.15-1.19
1.20	1.20
1.21-1.28	1.21-1.28
<b>2. Application of the guidance</b>	
<b>3. The AAR principles</b>	
<b>4. Cost accounting, direct costs, indirect costs and overheads</b>	
<b>5. Guidance on specific cost types</b>	
Part A – Part H	Part A – Part H
I.1.1-I.2.2	I.1.1-I.2.2
I.2.3	I.2.3
I.2.4-I.4.5	I.2.4-I.4.5
I.4.6	I.4.6
I.5.1-I.8.4.2	I.5.1- I.8.4

