Review Board
for
Government Contracts

REPORT ON
THE 2003 GENERAL REVIEW OF
THE PROFIT FORMULA FOR
NON-COMPETITIVE
GOVERNMENT CONTRACTS

MARCH 2004

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The Rt Hon Geoffrey Hoon, MP
Secretary of State for Defence
Ministry of Defence
Main Building
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31 March 2004

Dear Secretary of State

I have pleasure in submitting the Review Board's Report on the 2003 General Review of the profit formula for non-competitive Government contracts.

Copies have been sent to the President of the Confederation of British Industry and to the Director General Commercial at MOD.

Yours sincerely

George Staple

Chairman

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NOTE:

The recommendations in this report are accepted by the Ministry of Defence and the Joint Review Board Advisory Committee except that they will take effect from the date set out in the agreed Statement which is presented as an addendum to this report on page 111.

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EXPLANATION OF TERMS AND ABBREVIATIONS

Adjusted Baseline Profit Allowance	The rate of Baseline Profit after adjustment is made for risk in accordance with the risk matrix.
Annual return	The return to the Review Board prepared by a contractor showing the profit achieved each year on its non-competitive Government contracts.
Annual Review	The review by the Review Board of the principal components of the profit formula, undertaken annually between General Reviews. The report on the 2002 Annual Review was published by The Stationery Office (ISBN 0-11-772999-X) in September 2002.
Baseline Profit	That part of the profit calculated under the formula that is based on a percentage of the contract's cost of production excluding that part which is an allowance for the contractor's capital employed.
BBB3 Corporate Bond	The credit quality of debt obligations issued by corporations is evaluated by organisations such as Thomson Financial BankWatch, Moody's, S&P, and Fitch Investors Service. Bloomberg uses these evaluations to produce a composite rating. BBB3 is the lowest investment grade rating ie immediately above non investment grade.
Comparability principle	The aim of the profit formula to give contractors a return on capital employed equal on average to the overall return earned by British industry. This is referred to as the comparability principle (see Appendix C annex I). As stated in this Report the Board has now recommended that the comparability principle be amended so as to refer to giving contractors a return equal on average to the overall return earned by British Industry having regard to both capital employed and the cost of production.
CE	Capital employed.
CP	Cost of production.
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio is used to attribute to individual contracts a proportion of the contractor's capital employed.
CP:CE ratio unit	The business unit or other sub-division of a contractor's business for which a CP:CE ratio is calculated for the purposes of pricing non-competitive Government contracts.

CSAs	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
DEFCONs	The series of defence contract conditions applicable to MOD contracts. These are contained in the Commercial Managers' Toolkit which can be accessed on the MOD website. DEFCONs replace the Standard Conditions.
FCSA	Fixed Capital Servicing Allowance provided to contractors for their investment in fixed assets.
FRS 15	Financial Reporting Standard 15 – Tangible Fixed Assets. The Standard relates to the measurement of tangible fixed assets in company accounts. It was issued on 18 February 1999 and is effective for accounting periods ending on or after 23 March 2000.
General Review	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The report on the 1996 General Review was published by HMSO (ISBN 0-11-772486-6) in March 1996.
Government Accounting Conventions ('GACs')	The accounting conventions used for the determination of overhead costs attributable to non-competitive Government contracts and for the calculations of CP:CE ratios.
Historic cost	The accounting basis incorporating all assets at their original cost less depreciation excluding revaluations.
Historic cost rate of return	Operating profit (before interest and taxation) as a percentage of the average of the opening and closing historic cost capital employed.
Intra-group inter-unit trading	Trading between different CP:CE units within the same group of companies.
Joint Review Board Advisory Committee ('JRBAC')	A body comprising representatives of the CBI and those trade associations and companies that have particular interest in non-competitive Government contracts.
LIBOR	London Inter Bank Offered Rate
Ministry of Defence ('MOD')	The Ministry of Defence is the predominant user of the profit formula for non-competitive Government contracts and since the 1987 General Review has had the responsibility, formerly vested in HM Treasury, for communicating with the Board on behalf of Government on all matters concerning the profit formula. However, if both contracting parties agree, the profit formula and its associated arrangements are available for application to non-competitive contracts

	placed by other Government departments or public sector bodies, by incorporation of the appropriate contract conditions. References in this report to MOD include, where appropriate, reference to other bodies making use of the profit formula and its associated arrangements.
Modified historic cost ('MHC')	MHC is not defined in accounting standards or company law. For the purposes of the GACs we take it to mean the depreciated fixed asset value shown in a company's statutory accounts. These assets might be shown at cost or might be revalued in accordance with UK GAAP.
NAPNOC contracts	'No Acceptable Price No Contract'. Contracts placed according to arrangements introduced by MOD in July 1992 where MOD's aim is that such contracts should be priced before they are placed.
Non-competitive Government contracts	Those Government contracts, or sub-contracts from other contractors in aid of Government contracts, let other than by means of competitive tendering and priced either prior to or following contract award with reference to the profit formula.
Non-risk contract	A contract placed on a cost reimbursement basis (whether with a fixed fee or a percentage profit) which insulates a contractor against loss.
Post-costing	A review by MOD of the actual costs incurred on a contract, for comparison with the costs as estimated at the time when the price for the contract was agreed.
Profit formula	The formula for the pricing of non-competitive Government contracts.
Private Venture Research and Development ('PV R & D')	Research and development expenditure which is not directly chargeable to the Government or any other customer under the terms of a specific contract.
Reference Group	The group of UK companies representative of British industry whose average rate of return is used by the Review Board to determine the target rate of return in the profit formula.
Risk contract	A contract with a pricing arrangement which does not insulate the contractor against loss.
SAYE	Save As You Earn
Semi-CCA	A basis of inflation accounting incorporating fixed assets at their depreciated current cost, but making no allowance for the effect of inflation on the value of stocks and net working capital.
SORP	Statements of Recommended (Accounting) Practice relating to specialised sectors.

Standard Baseline Profit Allowance	The rate of Baseline Profit before any adjustment is made for risk in accordance with the risk matrix.
Standard Conditions of Government Contracts for Stores Purchases (SCs)	The series of conditions applicable to Government contracts, published as Form GC/STORES/1. At MOD these have now been replaced by DEFCONs.
Target Cost Incentive Fee ('TCIF') Contracting	A pricing basis whereby the target fee is calculated by reference to the average total cost outturn estimate and a formula is agreed between Government and the contractor on how to share cost over-runs and cost savings usually subject to an overall maximum price.
The 1968 Memorandum of Agreement	The agreement between the Government and the CBI establishing the Review Board (reproduced at Appendix A to this report).
The Profit Formula Agreement	The agreement between the Government and the CBI reached in 1968 which set out the basis of pricing non-competitive Government contracts (reproduced at Appendix B to this report).
Trigger points	A contract or sub-contract, incorporating the appropriate conditions, is eligible for reference to the Board where outturn costs vary from estimated costs by more than a specified percentage. The limits thus defined are referred to as the trigger points and are currently set by reference to a 10 per cent variation from estimated costs (see also paragraph 17 of the 1968 Memorandum of Agreement at Appendix A).
UITF 17	Urgent Issues Task Force Abstract 17 Employee Share Schemes. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment for various issues.
UK GAAP	UK Generally Accepted Accounting Practice. There is no formal definition of UK GAAP, but in simple terms it means compliance with UK company law and accounting standards (including UITF abstracts and SORPs).
WCSA	Working Capital Servicing Allowance provided to contractors for their investment in working capital.
WIP	Work in progress.

Report on the 2003 General Review of the Profit Formula for Non-Competitive Government Contracts

SECTION I

Introduction and terms of reference

The Board

101. The Review Board for Government Contracts was established under the terms of a Memorandum of Agreement ('the 1968 Memorandum of Agreement'[1]) applicable from February 1968 following agreement between the Government and the Confederation of British Industry ('CBI'), the latter representing the interests of contractors engaged in non-competitive Government contract work.

102. The way that the Review Board was established in 1968 reflected the essential requirement that it should be an independent body, not under the influence of either Government or industry. Whilst all five members of the Board are appointed by MOD, two are nominated by the Government and two by industry. Each party is required to consult with the other to ensure that its nominations are acceptable to both parties. The fifth, the Chairman, is appointed by agreement between Government and industry. All members are part-time, and the Board meets as and when necessary in order to conduct its business. The Board's Secretariat is currently provided by Deloitte & Touche LLP.

103. The Review Board's general role is to review, report and recommend on the pricing of non-competitive Government contracts. These contracts are used predominantly by the Ministry of Defence ('MOD') for procurement of military requirements in circumstances where there is only a single potential supplier so that prices cannot be regulated by competitive forces.

104. The Board's principal function is to recommend from time to time to all parties to non-competitive Government contracts a formula which is fair to both sides ('the profit formula')[2] the aim of which is to give contractors a return equal on average to the overall return earned by British industry ('the comparability principle'). For this purpose it has been agreed between MOD and the JRBAC that British industry is to be represented by a number of identified companies or groups of companies ('the Reference Group'). The actual average of their returns in recent years is the rate of return that ought to be earned by all contractors who are party to non-competitive Government contracts ('the target rate of return'); and a formula is then constructed such as to achieve that target for the contractors as a whole.

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[1] See Appendix A.

[2] As the predominant user of the profit formula for non-competitive Government contracts the Ministry of Defence has the responsibility, formerly vested in HM Treasury, for communicating with the Board on behalf of Government on all matters concerning the profit formula. However, if both contracting parties agree, the profit formula and its associated arrangements are available for application to non-competitive contracts placed by other Government departments or public sector bodies, by the incorporation of the appropriate contract conditions. References in this report to MOD as the contracting department should be taken to include, where appropriate, reference to other bodies making use of the profit formula and its associated arrangements.

History of the profit formula

105. A common profit formula for Government Departments based on capital employed was established before the Second World War and, with a change in 1941, remained until the late 1960s. The formula was intended as a guide to Departments and settlements were generally below the maxima set for the formula. The amount of profit allowed by the formula had for many years been considered in industrial circles to be inadequate.

106. The establishment of the Review Board was a consequence of two episodes during the 1960s in which public attention had been drawn to weaknesses in the then existing arrangements for pricing non-competitive contracts. The first of these cases, involving the supply of Bloodhound guided weapons to the Ministry of Aviation, led to the appointment of Sir John Lang to conduct an Inquiry. The facts of the case were, briefly, that Ferranti was found to have made a profit on 40 contracts several times greater than the profit level allowed for by the Ministry when agreeing prices. Besides criticising the Ministry's practices the Inquiry found that Ferranti had included in the price an estimate of production man-hours far higher than they might have been expected to incur. The Inquiry found that the pricing methods used by the Ministry resulted in the contractor knowing more about the likely pattern of costs than the Ministry. The Inquiry recommended, amongst other things, that the Ministry should try to secure the right of 'equality of information' by means of a contract condition, that the profit formula should be reviewed and that, exceptionally, post-costing might be undertaken.

107. As a consequence of the Ferranti case, and a subsequent similar case involving Bristol Siddeley Engines, new arrangements for the pricing of non-competitive contracts were agreed between the Government and industry. These arrangements were reflected in two formal agreements which were announced to Parliament by the Chief Secretary, HM Treasury, on 26 February 1968.

108. One of the formal agreements between Government and the CBI in February 1968 concerned the establishment of the Review Board, under the terms of the Memorandum of Agreement[3]. The other, which took effect from 26 February 1968 was a new formal Profit Formula Agreement[4], the principal effects of which were to:

- extend the scope of information available to the Ministry in price negotiation through the introduction of contract terms covering the principles of equality of information and post-costing; and

- achieve a more equitable pricing basis by a revised profit formula the aim of which was 'to give contractors a fair return on capital employed; that is to say, a return equal on average to the overall return earned by British industry'.

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[3] See Appendix A.
[4] See Appendix B.

This agreement also contained a term by which the parties agreed to the future establishment of a Review Board for Government Contracts to review the effect of these new arrangements and to adjudicate in future pricing disputes.

109. The total annual value of non-competitive MOD contracts placed fluctuates depending on the timing of major defence projects, but tends to be around £3-4 billion. This equates to about 30 per cent of all MOD procurement. Around a further 60 per cent is let through competition, with the remainder (some 10 per cent) being let by reference to market forces, for example using price lists.

Review of the profit formula

110. In accordance with the 1968 Memorandum of Agreement the Board conducts triennial General Reviews of the profit formula, in which it (i) recommends a profit formula to apply in the period ahead, and (ii) determines whether the formula's past use has achieved the intention of giving contractors overall average earnings on non-competitive Government contracts equivalent to the overall average earnings of British industry. The first such General Review was completed in 1974 and covered the operation of the profit formula in the years 1969-71. Subsequent General Reviews were dated 1977, 1980, 1984, 1987, 1990, 1993, 1996 and 1999. Whilst the Board produced a Report on its 1999 General Review, Government suspended its consideration of the Report pending its own review of the profit formula arrangements. In September 1999 MOD and the JRBAC issued a joint statement[5] concerning the 1999 General Review. The 1999 General Review has not been published and this current review is informed by the Government's review.

111. With the agreement of Government and industry, the Board's General Reviews have not been confined to the two functions described above but have provided the occasion for either Government or industry to raise for the Board's consideration any matters connected with the profit formula. The Board's General Reviews have accordingly embraced consideration of the accounting conventions for non-competitive Government contracts and other aspects of the arrangements for agreement of prices, for post-costing of contracts and for encouragement of efficiency in production.

112. In its 1984 General Review the Board recommended that the triennial comprehensive General Reviews should be supplemented by limited Annual Reviews, the purpose of which would be to update the formula and so make it more responsive to changes in economic conditions. Annual Reviews were completed by the Board in 1985, 1986, 1988, 1994, 1995, 1997, 1998 and 2002. By agreement between Government and industry the Board was asked not to conduct an Annual Review in 1989, 1991, 1992, 2000 or 2001.

113. Following the completion of the 1990 General Review there were discussions between the MOD and the JRBAC[6] about the future arrangements for review of the profit formula and the functions of the Review Board. These discussions led to an agreement between MOD and the JRBAC which is recorded

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5 See Appendix D.

6 See Explanation of Terms and Abbreviations.

in a Joint Statement[7] issued in November 1991. The MOD and the JRBAC agreed to the continuation of the principles set out in the 1968 Memorandum of Agreement. These, it was recognised, provided the significant mutual benefits of a fair rate of return on capital employed (expressly based on the principle of comparability), the employment of agreed accounting conventions, a mechanism for dealing with 'excess' profits or 'unconscionable' losses and equality of information when fixing prices. The parties agreed new arrangements[8] to facilitate the negotiations between them on the basis of the Review Board's reports.

114. At the conclusion of each General Review or Annual Review the Board makes a report to the Government giving its recommendations. These reports are simultaneously made available to industry for consideration by Government and industry. Once considered, the reports are published by The Stationery Office.

The 2003 General Review

115. We have conducted this review on the basis of agreement between MOD and the JRBAC regarding the terms of reference and scope of the review. As in previous reviews, the Board invited MOD and the JRBAC to make submissions concerning those issues which they wished the Board to address during the review. The MOD and the JRBAC asked the Board to consider a number of specific issues and submitted a substantial amount of argument and evidence to us; these have largely defined the scope of this review.

116. The issues raised by the JRBAC concerned:

- The need to update the profit formula;
- Proposed changes to the Government Accounting Conventions; and
- The reporting of post-costing results of non-competitive contracts where MOD and contractors agree sharing arrangements for cost variances.

117. The issues raised by MOD were:

- The treatment of risk;
- Sharing excess profit;
- The Reference Group;
- Cost weighting;
- Materiality;
- Simplicity;

[7] See Appendix C.
[8] See paragraph 4 of the Joint Statement reproduced in Appendix C.

- Outcome of post-costing;
- Timely submission of post-costing data;
- The increasing use of prime contracting leading to ‘Profit on Profit’;
- The reporting of post-costing results of TCIF contracts; and
- Managing the issue of exceptional CP:CE ratios within the profit formula arrangements.

118. Through press advertisements the Board also invited representations from any other interested parties, but no such representations were received.

119. The recommendations are summarised in Section II. The organisation of the remainder of this report is as follows:

III: Review of the profit formula methodology

IV: The Reference Group and the target rate of return

V: The recommended profit formula

VI: Recent profits on non-competitive Government contracts

VII: The accounting conventions for non-competitive Government contracts

SECTION II

Summary of Recommendations

The comparability principle

201. In accordance with its terms of reference, the Board recommends that it is no longer appropriate to link the application of the comparability principle solely to a return on capital employed; and that Government and industry should agree to amend the 1968 Memorandum of Agreement and the Board's terms of reference to exclude the words 'on capital employed' and insert the words 'by reference, subject to consultation with both parties, to both capital employed and cost of production'. Accordingly, comparability will refer to giving contractors a return equal on average to the overall return earned by British industry having regard to both capital employed and the costs of production (paragraph 322).

202. There should be no change to the principles adopted in defining the constituents of the Reference Group of UK companies which is used to derive the target return in the profit formula (paragraph 407).

The profit formula methodology

203. A new profit formula should be adopted which takes account of both capital employed and cost of production. This new formula provides for the return on non-competitive Government contracts to be made up of three elements:

A) an allowance for the servicing of Fixed Assets used for non-competitive contracts (referred to as a 'Fixed Capital Servicing Allowance' or 'FCSA');

B) an allowance for the servicing of Working Capital used for non-competitive contracts (referred to as a 'Working Capital Servicing Allowance' or 'WCSA'); and

C) after making allowances for servicing recognised capital through the above elements (A and B) (together the 'Capital Servicing Allowances' or 'CSAs'), the Reference Group would have a residual profit figure (referred to as 'Baseline Profit'). The Baseline Profit figure should be expressed as a percentage of cost of production ('CP') and given as an allowance on the CP of individual contracts (paragraph 306).

204. Based on prevailing long-term interest rates the FCSA should currently be at a rate of 7.3 per cent (paragraph 312).

205. Based on short-term interest rates the WCSA should currently be 5.67 per cent (paragraph 314).

206. The Baseline Profit rate indicated by the Reference Group is currently 6.27 per cent (paragraph 415).

207. The level of cost of production in the contractor group will be higher than that of the Reference Group because the contractor group includes intra group trading whereas similar trading within the Reference Group is eliminated as consolidation adjustments in the company accounts. Based on the estimated level of intra group inter CP:CE unit trading in the contractor group, the standard Baseline Profit allowance on cost of production adjusted for this difference should be 5.67 per cent (paragraph 507).

208. In its unpublished 1999 General Review the Board recognised a number of distortions and inconsistencies caused by the historic cost and semi-CCA bases, and recommended that they should be replaced with the Modified historic cost ('MHC') basis, based on UK GAAP. In a statement in September 1999 MOD and the JRBAC accepted the Board's recommendation concerning MHC. However, as the elements of the profit formula have remained unchanged since the 1998 Annual Review, this will be the first review to be based on MHC (paragraphs 408-410 and Appendix D).

The risk/reward matrix

209. In the case of larger contracts, the Standard Baseline Profit allowance should be adjusted to reflect the varying risk characteristics of different contracts. A risk/reward matrix which reflects the risk characteristics of different contracts provides a mechanism for tailoring the Baseline Profit to the quantum of costs and risks associated with individual contracts (paragraph 318).

210. To start with, the risk/reward matrix should be kept relatively simple to facilitate implementation and deal mainly with different types of work and with the varying degrees of risk associated with prime contracting. As Government and Industry gain experience of applying this to individual contracts, the matrix can be further developed and perhaps also address varying degrees of risk in the context of different types of contracts (paragraph 509).

211. The revised formula is based partly on cost of production, and the Board is concerned that as sub-contracts pass up through a prime contractor's books they will attract a second layer of profit, with no automatic mechanism to make compensating adjustments as is the case under the existing formula. The Board intended to recommend different levels of Baseline Profit as between a prime contractor's own 'added value' costs and the costs arising on sub contracts that passed through its books (paragraphs 511 to 514). The MOD and the JRBAC were concerned that this may result in undue complexity and they were unable to agree on a satisfactory definition for sub contracts. In the circumstances, the parties agreed to an interim arrangement, whereby the standard Baseline Profit on firm or fixed price contracts with a value of £50 million or more be reduced by 30 basis points and the target Baseline Profit rate on TCIF contracts with a value of £50 million or more be similarly adjusted (paragraph 519).

212. Whilst recommending the interim arrangement, the Board will continue to work with the parties to try to develop a more refined proposal and intends to undertake further work during the course of the next Annual Review (paragraphs 520 and 521).

213. Accordingly, the initial risk/reward matrix should be as follows:

FLEXIBLE PROFIT ADJUSTMENT (TO STANDARD BASELINE PROFIT ALLOWANCE)			
Type of Work	*Standard Rate -10%*	*Standard Rate*	*Standard Rate +10%*
Supply	• Follow on and repeat orders for production/ supply involving existing specification • Repeatable quality	• Interrupted production • Typical/normal production orders	• First production batch for a new requirement with significant development/ production overlap • One-off high technology procurement
Support/ Service Provision	• Clearly defined specification • Repeatable quality • Reactive support/ repairs, maintenance or ongoing contracts	• Initial repair and support order • Customer specified repair and maintainability standards • Support requirements not fully defined	• Long term commitment to Service and Capability provision to a defined output standard
Development	• After design certification, support activities involving routine document maintenance and simple analysis of existing designs • Post development work, minor development work and programmes involving minor modification of established technologies	• Development work • Contractor accepts full responsibility for performance and integration • Modification Programmes including proposals for, and analysis of, extensive changes to existing design in respect of established technologies • Fault management	• High Technology or Specialist skills or new concepts

NOTES

1. Deciding on the appropriate rate on individual contracts should depend on a balance of factors. The underlying principle should be that the majority of activity should attract the standard rate of profit unless there are strong characteristics to indicate otherwise. Where there are strong characteristics indicating otherwise the profit rate applicable to that contract shall be the rate that is applicable to the majority of activity.
2. The risk matrix set out above should apply to contracts with an estimated cost in excess of £5 million. Contracts below this amount should receive the standard rate of risk (or non-risk) profit.
3. Cost-plus (ie non-risk) contracts should attract the Standard Profit Allowance less 25 per cent in all instances. The risk matrix set out above does not apply to cost-plus contracts.
4. The Baseline Profit rate applicable to firm or fixed price contracts and contract amendments with a value of £50 million or more should be 30 basis points less than the standard rate subject to any adjustment in accordance with the risk/reward matrix.
5. The Target Baseline Profit on TCIF contracts and contract amendments:
   - should be based on the Standard rate for contracts or contract amendments with a target cost below £50 million; and
   - should be based on the Standard rate less 30 basis points for contracts or contract amendments with a target cost of £50 million or more.
6. The aim of the variable profit rate arrangements should be to achieve a broadly neutral cost impact for MOD, assessed not on an annual basis but over a time period covering a number of years. The assessment should not include contracts that are dealt with in accordance with notes 4 and 5 above.
7. The variable profit arrangements and their application on individual contracts are to be reviewed and monitored on an annual basis in order that the arrangements can be refined and developed.

214. The Board has again considered the risk involved in non-competitive Government contracts as compared with the risks to which companies in the Reference Group are generally exposed. It has reviewed the evidence provided by both industry and Government and again concluded that the evidence presented to it did not support an allowance in either direction (paragraph 418).

Annual returns and post-costing data

215. The Board notes that MOD's post-costing data shows that contractors appear to be exceeding the target rate of return, but that the variance appears to be reducing (paragraph 617). As annual returns from contractors were not collected for 1997, 1998 or 1999, it is not possible to draw any meaningful conclusions from this data except that it appears that the volatility of returns may have increased (paragraph 610). Contractors with profit formula contracts with an annual value exceeding £5m currently provide annual returns to the Board on a voluntary basis. The Board recommends that provision of returns to the Board should be included in a DEFCON as a requirement for all applicable contractors (paragraph 610).

Timely submission of post-costing data

216. Delays in the submission of post-costing data have now persisted for over a decade. It is therefore proposed that there should be a retention of 2 per cent of the contract value. The retention is to be released on the earlier of MOD completing the audit of the certificate or six months after submission of the cost certificate unless it has been formally returned within two months on the grounds that it provides insufficient information (paragraphs 623 and 625).

217. The due date for submission of the post-costing data should be six months from submission of a formal post-costing request or six months after delivery of the articles whichever shall occur later. To facilitate timely submission, interim cost certificates should be used where the element of cost still subject to estimates is less than 2 per cent of the contract value and interim cost certificates should be submitted in the case of large, and particularly long-run, contracts where collating the data on termination can be a difficult task (paragraph 626), together with estimated certificates for the final year.

218. Contractors should be entitled to claim a working capital servicing allowance at the prevailing rate on the amount of the retention from the date of the final payments from which the retention was deducted until the earlier of the date the data is submitted or the due date of submission provided this amounts to at least £10,000 (paragraphs 628 and 629).

219. Contractors who fail to submit the post-costing data within twelve months of the due date forfeit the right to make this claim. Instead, the MOD may make a claim equivalent to the working capital servicing allowance, at the prevailing rate, on the amount of any refund that eventually becomes payable by the contractor, from the date when the claim became late, as defined, up to the date when the refund is made, provided that the claim for the period during which MOD undertakes its audit of the data is a maximum of six months and the aggregate value of the MOD's claim is at least £10,000 (paragraphs 630 and 631).

Unconscionable profits and losses

220. Where a contractor makes either an unconscionable profit or an unconscionable loss under a firm/fixed price contract where the contract price exceeds £5 million, such profit or loss should be shared 75:25 as between MOD and the contractor (paragraph 640).

221. For the purposes of the sharing arrangements, unconscionable profit should be defined as that proportion of any additional profit made by the contractor that exceeds five per cent of the contract value and unconscionable loss as that proportion of any loss that exceeds five per cent of the contract value. Payments by either party should only become due where they exceed £250,000 (paragraph 639 and 640).

222. It has to be recognised that there could be circumstances where there is serious inequity that is not remedied by application of the proposed sharing arrangements, and the Board is therefore prepared to accept references of individual contracts that fall within the standard sharing arrangements, and will look to see if there are wholly exceptional circumstances that justify a departure from these arrangements. Such exceptional circumstances might include:

- evidence to suggest that there was inequality of information at the time of pricing; or

- evidence that the excess profits arose through the contractor's innovation or use of new technology that could not have been foreseen at the time of pricing; or

- evidence to suggest that the losses arose as a consequence of the contractor willingly and recklessly pricing the contract in the knowledge that it could rely on the sharing arrangements, or evidence to support the view that the contractor was seriously negligent or incompetent in carrying out the contract (paragraph 643).

Government Accounting Conventions ('GACs'[9])

223. The GACs should be amended as set out in Section VII. These amendments relate to:

- the recovery of site closure costs (paragraph 705);

- determining the value of work in progress ('WIP') to be deducted from advance payments in cases where there is a difference between the contractor's balance sheet valuation of labour and overhead costs and the valuation for pricing purposes (paragraph 710); and

- the valuation of WIP for the purposes of calculating capital employed, in cases where there are differences between a contractor's accounting

[9] See Explanation of Terms and Abbreviations.

policy for allocating overheads to WIP and the overheads it is entitled to recover from MOD (paragraph 712).

224. New accounting standards are expected in respect of accounting for pension costs, research and development and Save As You Earn ('SAYE') and other share incentive schemes. These and any other new standards should be addressed by a joint working party when the new standards are issued (paragraphs 716 and 717).

225. The Board recommends formal adoption of the amendments and clarifications to the GACs agreed following the unpublished 1999 General Review (paragraph 719).

Future reviews

226. There should continue to be comprehensive triennial General Reviews at which any matter connected with the profit formula can be raised. The formula should also continue to be subject to Annual Reviews. However, in this General Review the Board has recommended significant changes to the profit formula arrangements and it needs to be recognised that these changes could give rise to some additional implementation issues that come to light during practical contract negotiations. The Board wishes to make clear that it will be acceptable for the parties to make representations about any feature of the new profit formula or of other proposals so that the Board can review the operation of the new system at the next Annual Review (paragraph 525 and 526).

227. The GACs have been developed over many years, with successive amendments to reflect particular issues which have been relevant at particular times. The Board considers that a fundamental review of the text of the GACs might be appropriate at the time of the next Annual Review with the aim of eliminating material that is no longer relevant and producing a consolidated statement of the conventions that can more easily be used by those concerned with the pricing of Government contracts (paragraph 702). The opportunity might also be taken to publish a consolidated set of the current profit formula arrangements, as there have been a number of changes to these arrangements since they were first promulgated in the 1968 Memorandum of Agreement and the Profit Formula Agreement.

Implementation of the Board's recommendations

228. The Board proposes that the changes recommended in this report be introduced with effect from 1 June 2004. This is not in accordance with the normal 1 April implementation date and it would be the Board's intention to revert to the normal implementation timetable at the next Review. The revised arrangements should apply to:

a) TCIF and risk contracts where no price arrangement has been agreed on the date the revised arrangements take effect;

b) Non-risk work carried out after that date for which no arrangement for profit has been agreed by that date.

229. As there are a significant number of changes proposed in this report the Board recommends that MOD and the JRBAC arrange appropriate training workshops to minimise the risk of disruption when the proposals take effect.

SECTION III

Review of the profit formula methodology

The existing methodology

301. The existing methodology used to structure the profit formula is based on the return on capital employed of British Industry, as represented by the Reference Group. This return is then applied to the group of contractors undertaking non-competitive work by converting the Reference Group return on capital employed to a return on cost of production based on the relationship between the contractor group's cost of production and its capital employed (referred to as the contractor group CP:CE ratio).

302. When applying the formula to individual contracts, one half of the return is based on the average CP:CE ratio of the contractor group and the other half is based on the CP:CE ratio of the individual contractor. Since 1984, special arrangements have been put in place for contractors with exceptional CP:CE ratios (currently defined as either less than 1/3 or more than 3 times the average). These arrangements result in additional payments to these contractors. The overall target rate of return is then subject to a compensating downward adjustment, so that the special arrangements do not affect the overall level of profit paid to contractors by Government.

Problems with the existing methodology

303. Both the MOD and the JRBAC have now identified a number of potential weaknesses with the existing methodology. These include:

A) Exceptional CP:CE ratios: The Board's report on its 2002 Annual Review identified that some 40 per cent of the cost of production occurred in CP:CE units that had exceptional CP:CE ratios which is considered to place unprecedented pressure on the existing arrangements. In addition, the contractor group average CP:CE ratio and the Reference Group ratio are now considered to be so far apart that a formula based on this relationship may no longer be fair and reasonable.

B) Cost weighting: At present the profit formula is calculated on an arbitrary 50:50 weighting as between the contractors' own CP:CE ratio and the average ratio for the contractor group. The Board has been asked to consider whether there is a better mix that might be applied.

C) Treatment of risk: At present, the profit formula recognises only two categories of risk: risk and non-risk. All but a few contracts are now priced on estimates at the outset and attract a risk rate of profit. The Board has been asked to explore a more measured approach in the formula to reflect varying degrees of risk.

D) Responding to recent developments in procurement methods: The JRBAC believes that recent developments in acquisition methods, such as the transfer of programme management and systems integration responsibilities to the contractor, have increased the importance of technological innovation and dependence on know-how and intellectual property, and that the current formula is not sufficiently responsive to these changes.

E) Materiality: At present there is no material limit on when the profit formula should be applied. The MOD pointed out that some 90 per cent (by number) of non-competitive contracts are below £300,000 and requested the Board to explore the possibility of establishing a flat rate of profit on cost for all contracts below a defined financial threshold.

F) Simplicity: The MOD and industry agree that one aim of any changes proposed by the Board should be to produce a formula or formulae that are simple and practical to apply and do not impose disproportionate administrative burdens on either Government or industry.

The aims of a revised profit formula

304. Based on the potential weaknesses identified by the MOD and the JRBAC the Board believes that any changes to the profit formula should try to address the following:

- adapt the formula so that it is more responsive to the changing nature of procurement and so that it can better manage the increasing amount of work undertaken in contracting units with exceptionally high CP:CE ratios;

- provide a mechanism for recognising varying degrees of risk;

- develop some basis for determining the weighting as between capital and cost; and

- seek to simplify, where possible, the application of the formula particularly with regard to smaller contracts.

The JRBAC proposal

305. The JRBAC believes that the level of profit on non-competitive work should be based, wholly or in part, on a return on cost of production. It recognises that to effect such a proposal it will be necessary to amend the Review Board's terms of reference.

The Review Board proposal

306. The Board recommends that the existing profit formula be changed to a formula that takes account of both capital employed and cost of production. It

proposes that the return on non-competitive contracts should be made up of three elements:

A) An allowance for the servicing of Fixed Assets used for non-competitive contracts (referred to as a ‘Fixed Capital Servicing Allowance’ or ‘FCSA’);

B) An allowance for the servicing of Working Capital used for non-competitive contracts (referred to as a ‘Working Capital Servicing Allowance’ or ‘WCSA’); and

C) After making allowances for servicing recognised capital through the above elements (A and B) (together the ‘Capital Servicing Allowances’ or ‘CSAs’), the Reference Group will have a residual profit figure (referred to as ‘Baseline Profit’). The Baseline Profit figure should be expressed as a percentage of cost of production (‘CP’) and given as an allowance on the CP of individual contracts.

The Fixed Capital Servicing Allowance or FCSA

307. The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in book fixed assets as adjusted for GACs. The finance for these assets might be expected to be provided from two sources, equity and debt, and normally such an allowance would be based on:

- long term corporate borrowing rates; and

- a premium to reflect the return required by equity providers.

308. The estimation of an appropriate equity return is a complex matter and the Board does not consider it appropriate to base this on the book value of equity as recorded in individual contracting units, for the following reasons:

- The financing structure put in place between a parent and its individual contracting units is an internal matter, not governed by normal commercial considerations, and may not reflect the equity required in the business.

- The equity recorded in a company’s accounts does not reflect the investment that may have been made in the intangible assets of that business, but investors expect a return on both the tangible and the intangible assets of a business.

- When pricing individual contracts a business will have regard to the risks of that particular contract and will seek a return that is commensurate with the risks involved.

309. Accordingly, the Board believes that the FCSA should be based on the long term borrowing rate and the issue of risk should be addressed through the Baseline Profit allowance as discussed in paragraphs 316 to 318 below.

310. On the basis that the average asset might be expected to have a life of around 15 years it seems appropriate to base the FCSA on the cost of 15 year finance, as that is reasonably representative of the average cost that might be incurred by the Reference Group. A BBB3 rated corporate bond is the lowest investment grade security and would be a reasonable benchmark. However, there are relatively few in issue in the UK and their yield may not therefore be representative. Accordingly, the Board proposes that the FCSA be based on the average cost of BBB rated corporate bonds which is currently about 1.5 per cent above the 15 year Gilt rate. This needs to be further adjusted:

- to take account of the premium that a BBB3 rated bond might need to pay; and

- to take account of the fact that bond rates command a discount for liquidity as compared to bank borrowings.

311. Taking account of the fact that the fixed assets the FCSA is intended to finance will have been acquired over a number of years and may have been financed at different rates, the Board recommends that the FCSA:

- be linked to the 7 year moving average of the 15 year Gilt rate; plus

- a 1.5 percentage point premium to take it up to the average cost of a BBB rated corporate bond; plus

- 0.5 of a percentage point to incorporate a premium for a BBB3 rating and the liquidity discount.

312. Based on the rates prevailing up to 30 November 2003, this gives an FCSA of 7.3 per cent.

The Working Capital Servicing Allowance or WCSA

313. The purpose of the WCSA is to provide contractors with an appropriate allowance for their investment in working capital and it is therefore appropriate to link the WCSA to the cost of short term funds. It is the Board's view that an appropriate short-term funding rate for the Reference Group is 1.25 percentage points above the one year LIBOR.

314. To reduce volatility the WCSA should be based on a moving average of the one year LIBOR rate. The 36 month moving average of the one year LIBOR based on rates prevailing up to 30 November 2003 was 4.42 per cent, so the appropriate WCSA should be 5.67 per cent currently.

315. From time to time a few contractors do have negative capital employed. In such cases, a negative WCSA should be computed on all of the negative capital employed and this amount should be deducted from that contractor's Baseline Profit entitlement, except where the contractor can demonstrate that the negative capital employed does not relate to non-competitive Government work.

The Baseline Profit

316. By taking the total profit earned by the Reference Group and deducting the Capital Servicing Allowances ('CSA') for financing fixed assets and working capital, the balance of the profit can be expected to represent the return the average company gets on its uncapitalised intangible assets and for the risks it assumes. This can be expressed as a percentage of the Reference Group cost of production. The Board recommends that this percentage should be used to determine the average Baseline Profit paid on the cost of production of non-competitive contracts. The calculation of the current Baseline Profit rate is set out in Section IV.

317. The Board further recommends that, for larger contracts, the Baseline Profit allowance should be adjusted to reflect the varying risk exposure of different contracts sometimes referred to as the concept of 'Value at Risk' which is an attempt to recognise that some projects will have more predictable outcomes whereas others may be highly volatile. This will help to achieve the MOD's aim of having a profit formula that provides a more measured return reflecting varying degrees of risk.

318. A risk/reward matrix which reflects the risk characteristics of different types of contracts would provide a mechanism for tailoring the Baseline Profit to the quantum of costs and risks associated with individual contracts. The concept of a risk/reward matrix is considered further in section V of this report.

Other considerations

319. One matter that needs to be addressed is that, in order to implement the proposed changes to the profit formula set out above, the terms of the 1968 Memorandum of Agreement and the Board's terms of reference require amendment.

320. The Board endorses the views of both MOD and the JRBAC that the principle of comparability remains very important, and is satisfied that the amended formula accords strictly with this principle. However, the Board considers that the structure and requirements of non-competitive defence contracts, and of contractors, have changed considerably since the 1968 Agreement, and that contractors' book capital employed is now a less significant element in that structure.

321. As recorded in paragraph 405 of the report on the Sixth General Review, the MOD and the JRBAC, in their capacities as representatives of the parties to the 1968 Memorandum of Agreement, agreed that the following provisions should apply to the current and to future reviews of the profit formula:

> 'The Board in its future reviews of the profit formula will recommend an overall target rate of return which accords strictly with the principle of comparability; that is a target rate in strict conformity with the aim of the profit formula arrangements agreed in 1968 to give contractors a return on capital employed equal on average to the overall return earned by British Industry.

> ‘The Board will in addition be expected to bring to notice in its reports any considerations which it regards as relevant to the operation of the profit formula. This would include, should the occasion arise, respects in which the Board might wish to draw attention to any perceived ill-effect for either party, or for both, deriving from strict observance of the comparability principle and to make further recommendations which should be separately identified. But any such recommendations should not be allowed to override the formal application of the comparability principle itself without prior consultation with the parties.’

322. In accordance with its terms of reference as set out above, the Board brings to notice that it is no longer appropriate to restrict comparability to a return on capital employed, and recommends that Government and industry agree that the 1968 Memorandum of Agreement and the Board’s terms of reference be amended to exclude the words ‘on capital employed’ and insert the words ‘by reference, subject to consultation with both parties, to both capital employed and cost of production’. Accordingly, the 1968 Memorandum of Agreement would read:

> ‘The Government and industry have agreed that the aim of the formula should be to give contractors a fair return; that is to say, a return equal on average to the overall return earned by British industry in recent years by reference, subject to consultation with both parties, to both capital employed and cost of production.’

and the first paragraph of the quote within paragraph 405 of the Sixth General Review would read:

> ‘The Board in its future reviews of the profit formula will recommend an overall target rate of return which accords strictly with the principle of comparability; that is a target rate in strict conformity with the aim of the profit formula arrangements agreed in 1968 to give contractors a return equal on average to the overall return earned by British industry by reference, subject to consultation with both parties, to both capital employed and cost of production.’

Conclusions

323. The Board considers that the proposed changes to the profit formula maintain the principle of comparability whilst making significant improvements to the methodology to deal with the concerns that have been identified:

- Exceptional CP:CE ratios: A growing problem with the existing formula, and a particular problem at the 2002 Annual Review, was the high value of non-competitive contracts being undertaken in contracting units with exceptional CP:CE ratios, which had a distorting effect on the operation of the profit formula. The proposed changes to the formula now mean that the overall average contractor group CP:CE ratio is not used in the formula so that the exceptional CP:CE ratio units no longer distort the overall formula. In addition, the special arrangements which were required for contractors with exceptional CP:CE ratios will no longer be necessary.

- Cost weighting: The existing profit formula uses an arbitrary 50:50 split as between the contractors' own CP:CE ratio and the average ratio for the contractor group. The proposed arrangements no longer rely on arbitrary weightings.

- Treatment of risk: Contracts currently attract either the 'risk' or 'non-risk' rate of profit and there are no other stated differentials for the various levels of risk that different types of contract will face. The Baseline Profit, under the proposed methodology, now lends itself to being adjusted for different levels of risk, and proposals for the use of a risk/reward matrix are set out in Section V.

- Simplicity and materiality: The principal complication and administrative burden of the existing formula is that each contracting unit needs to negotiate a CP:CE ratio with the MOD as the overall average CP:CE ratio of the contractor group is required to determine the applicable rate of profit. Collection of this data has proved increasingly difficult in recent years and greater reliance has had to be placed on estimates. The revised formula only requires this data in order to determine a contractor's FCSA and WCSA entitlements at the time of a contract award. Furthermore, as discussed in Section V, the Board is proposing that contracts with an estimated cost of £5 million or less should attract a single Baseline Profit rate.

- The Board considers that CP:CE data for the contractor group should continue to be collected so as to enable trends in non-competitive contracting and the overall cost of the profit formula to be monitored. However, it might be possible, on the grounds of materiality, to dispense with the requirement to agree CP:CE ratios for the large number of contractors who undertake contracts of relatively low value (except where this is required in the context of a specific contract award) as their individual CP:CE ratios are no longer required for the formula and such contracts are unlikely to have any material impact on the overall trend in non-competitive contracting. This should serve to reduce some of the administrative burden for both Government and industry.

SECTION IV

The Reference Group and the target rate of return

Introduction

401. In order to apply the comparability principle which is the aim of the profit formula, the Board needs to consider, first, the return earned by British industry and, secondly, how that return should be expressed for pricing non-competitive Government contracts. In this section the Board considers the determination of the target rate of return based on the latest available evidence of the return earned by British industry.

The Reference Group

402. Since 1968 the profit formula has been derived from a Reference Group of UK companies. The reason for having a Reference Group is to provide a measure of the return being earned by British industry so that a profit formula can be framed to produce a similar return for contractors. The revised formula discussed in Section III does not require any change in the constituents of the Reference Group, it merely requires that the formula should be based, in part, on that group's return on cost of production, with some further consideration of the differing capital structures of the Reference Group and of the contracting group. Nevertheless, MOD has requested that as part of the General Review the Board should consider whether any changes to the Reference Group should be made.

403. In general the Board has considered it appropriate to include in the Reference Group all sectors of British industry that operate in a fully competitive environment and represent the alternative uses that a contractor would have for its capital if that capital was not deployed on non-competitive contracts. This leads to a broadly based Reference Group which has the benefit of reducing volatility, making the return less influenced by the special circumstances that may affect an individual sector from time to time.

404. The constituents of the Reference Group have been considered at each review. The general principle adopted by the Board has been that all British listed companies be included in the Reference Group except where:

- the Board considers that a sector comprises companies that are so fundamentally different, in their capital structure and areas of operation, from the companies undertaking non-competitive contracts that it would be inappropriate to include that sector in the Reference Group. Sectors currently falling into this category are: banking, insurance, investment trusts, property investment, mining, oil and gas; or

- where the Board considers that a particular sector is dominated by companies that do not operate on a sufficiently competitive basis. Sectors currently falling into this category are water and power.

In addition one company, Eurotunnel plc, is excluded as an exceptional case.

405. In considering whether the Reference Group should be revised at this Review, the Board has considered the previous discussions on this issue, and in particular the suggestion that the Reference Group should be radically cut back, to a few sectors of industry which would be 'directly comparable' to non-competitive contracting. This would have a number of disadvantages – the selection would be arbitrary, with profit variable and highly dependent on a few companies; any attempt to match risks would again be arbitrary and variable through time; and, if confined to sectors closely related to defence contracting, there would be a problem of circularity. But in any case a move in this direction would be to misunderstand the comparability principle embodied in our terms of reference – namely to aim at a fair return 'equal on average to the overall return earned by British industry'. The logic of this is to match the average return which contractors could expect to achieve if they were to invest in other businesses (where the returns can be measured on a comparable basis). If there were evidence that non-competitive defence contracts were less (or more) risky than the average for the Reference Group, this would need to be addressed as a separate issue. The relative risk of non-competitive Government contracts is considered in paragraphs 416 to 418 below.

406. The Reference Group for 2001[10], compiled in accordance with the principles in paragraph 405 above, comprises 1,095 companies with a total capital employed of around £254 billion and sales of some £663 billion. We consider that this Reference Group is sufficiently large and broadly based to provide a sound basis for application of the comparability principle. It is of a similar size to Reference Groups at recent Reviews.

407. In conclusion, the Board considers that the principles adopted in defining the constituents of the Reference Group continue to provide a sound basis for implementing the comparability principle and that the present composition of the Reference Group remains appropriate.

Derivation of the target rate of return

Accounting basis for the profit formula

408. In recent years the profit formula has been available for use on either the historic cost basis or the semi-CCA basis. In its unpublished 1999 General Review the Board recognised a number of distortions and inconsistencies caused by the historic cost and semi-CCA bases and recommended that they should be replaced with the modified historic cost ('MHC') basis, based on UK GAAP, that is the historic cost basis modified, at companies' discretion, by the incorporation of revaluations of certain assets.

409. In a statement in September 1999 MOD and the JRBAC accepted the Board's recommendation concerning MHC. This statement is contained in the Board's report on its 2002 Annual Review as Appendix E.

410. However, as the elements of the profit formula have remained unchanged since the 1998 Annual Review, this will be the first review to be based on MHC.

[10] The Reference Group for 2001 includes companies' annual accounts for periods ending between 1 April 2001 and 31 March 2002.

411. The weighted average rate of return on cost of production of the Reference Group in 2001, based on published accounts[11], was 8.15 per cent. This rate of return of 8.15 per cent drawn from companies' accounts is calculated on the modified historic cost accounting basis.

412. Reference Group profitability is determined by taking account of Government Accounting Conventions. It uses the operating profit figure (i.e. before interest, tax or dividends) after adding back any amounts written off intangible assets. Equally, the capital employed of the Reference Group is determined after excluding intangible assets.

413. In Section III it is explained that the Reference Group rate of return is to be allocated as between Capital Servicing Allowances and Baseline Profit. The allocations of these items over the past three years are set out in Table 4.1, below.

Table 4.1: Reference Group 3 year average Baseline Profit

	1999/0 Reference Group £m	*2000/1 Reference Group £m*	*2001/2 Reference Group £m*	*Simple Average*
(A) Cost of Production	489,139	549,939	613,333	
(B) Capital Employed	239,088	250,924	254,113	
(C) CP:CE ratio (A÷B)	2.05	2.19	2.41	
(D) FC:WC ratio	96:4	95:5	95:5	
(E) Actual Profit (EBIT)	55,944	59,705	49,906	
(F) FCSA % (see note below)	8.98%	8.62%	8.11%	
(G) WCSA % (see note below)	7.96%	7.51%	6.92%	
(H) FCSA (Bx(D['FC']÷100)xF)	20,620	20,546	19,578	
(I) WCSA (Bx(D['WC']÷100)xG)	761	942	879	
(J) Total CSA (H+I)	21,382	21,488	20,457	
(K) Baseline Profit (E-J)	34,562	38,217	29,448	
(L) BP as % of CP (K÷A)	7.07%	6.95%	4.80%	6.27%
Total profit:				
– expressed as ROCE ((J+K) ÷B)	23.4%	23.8%	19.65%	
– expressed as ROCP ((J+K) ÷A)	11.4%	10.9%	8.15%	

Note. The FCSA and WCSA percentage figures are derived using the methodology set out in Section III, using the data applicable as at 31 March of the year concerned.

414. The reason for the decline in profitability in the most recent year relates primarily to a general increase in exceptional operating adjustments. These adjustments include, for example, reorganisation costs and other costs/gains of an exceptional nature that are recorded as adjustments to operating profit. As might be expected, the companies that have suffered most are in the internet, telecom and IT sectors.

[11] As analysed by Datastream.

415. Following the 1993 General Review it was agreed between MOD and the JRBAC that the target rate of return in the profit formula should in future be determined on a rolling average basis. Appendix I of the 1993 General Review records that MOD and the JRBAC 'would invite the Review Board to base its recommendations concerning the target rate of return in future Annual and General Reviews on a simple three year average of the returns earned by British industry for the latest year and for the two previous years.' The purpose of this was to introduce a greater degree of stability into the profit formula by reducing the volatility of the target rate caused by year-to-year fluctuations in the level of the Reference Group's profitability. Whilst this practice was introduced under the previous profit formula methodology we see no reason why it should not be, and recommend that it is, adopted for the revised methodology. The simple average of the Reference Group Baseline Profit for 1999, 2000 and 2001 is 6.27 per cent.

Relative risk of Government contracts

416. In previous reviews the Board has taken into account the risk involved in non-competitive Government contracts as compared with the risks to which companies in the Reference Group are generally exposed. There are factors which point in both directions. On the one hand, many defence contractors operate in areas of high technology and are subject to the greater risk inherent in innovation and change. On the other hand, the relative security of the work and the method of pricing have been considered to be factors which tend to diminish the risks. In the 1984 and 1987 General Reviews the Board concluded that, on balance, the risks entailed in non-competitive Government work were in general slightly less than those to which most UK companies were exposed and that this should be reflected in a small reduction in the target rate. In its 1990 report the Board concluded that recent developments, in particular an increase in the percentage of contracts placed on a risk as opposed to a non-risk basis, had increased the relative risk involved in non-competitive Government work to the extent that no reduction in the target rate should be made on this account. In its 1993 report the Board again reviewed developments in the placing and pricing of non-competitive Government contracts and confirmed its 1990 conclusion that no allowance should be made for relative risk.

417. At the 1996 General Review the JRBAC expressed a view that non-competitive Government work had become more risky owing, principally, to changing contract terms. The Board reviewed these changes and considered that they were not sufficiently weighty to require that the straightforward application of the comparability principle be distorted by introducing a relative risk allowance.

418. At the unpublished 1999 General Review the Board considered that the evidence presented to it did not support an allowance in either direction. The Board has considered the matter again at the current Review and has reached the same conclusion.

Conclusions

419. The Board has concluded that the Baseline Profit derived on the basis of strict comparability with the returns of British industry should be 6.27 per cent expressed on the modified historic cost basis.

420. Accordingly, the Board recommends that the reference group Baseline Profit figure of 6.27 per cent should be used in the profit formula arrangements. This figure needs to be adjusted before it can be applied to individual contracts, and this process is considered in the following section.

SECTION V

The recommended profit formula

Introduction

501. The Reference Group Baseline Profit on cost of production of 6.27 per cent on the modified historic cost basis as computed in the previous section needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts.

502. The Board is aware that the level of cost of production in the contractor group will be higher than that of the Reference Group, because the contractor group includes intra-group trading whereas similar trading within the Reference Group will be eliminated as consolidation adjustments in company accounts. Therefore the level of intra-group trading by the contractor group needs to be assessed and eliminated in order to maintain comparability.

503. As mentioned in Section III, the present formula recognises only two categories of risk: risk and non-risk. The Board has been asked to consider developing a methodology that recognises varying degrees of risk. The Board has also been asked to develop a formula that is more responsive to recent changes in procurement methods, such as the transfer of programme management and systems integration responsibilities to the contractor, and the effect of prime contracting which leads to a second layer of profit, first to the sub contractor and then when its costs pass through the books of the prime contractor.

504. This section considers the principal steps in the development of a profit formula, which are as follows:

- the effect of trading between CP:CE units within a contractor group; and

- a risk/reward matrix to deal with varying degrees of risk including the risks associated with prime contracting.

The effect of trading between CP:CE units within a contractor group

505. As previously noted, one difference between the contractor group cost of production data and the Reference Group data is in the treatment of intra-group inter-unit trading. The level of cost of production in the contractor group will be higher than that of the Reference Group because the contractor group includes intra-group trading whereas similar trading within the Reference Group is eliminated on consolidation. Therefore the level of intra-group trading by the contractor group needs to be assessed and eliminated in order to maintain comparability. Whilst the level of such trading is not known with certainty at present, a review by the JRBAC suggests that it may be in the order of 11 per cent of the total costs of non-competitive contracts including the major prime integration contracts.

506. Part of the 11 per cent intra-group trading estimate will relate to contracts priced in excess of £50 million, and will therefore attract a reduced profit rate in

accordance with the arrangements outlined in paragraphs 511 to 519 below. The Board estimates that the 11 per cent intra-group trading figure needs to be reduced to 9.5 per cent to allow for this effect.

507. Therefore, the Baseline Profit of 6.27 per cent needs to be reduced by the revised duplicated intra-group trading figure of 9.5 per cent, giving an adjusted Baseline Profit of 5.67 per cent. The Board recommends that the Baseline Profit figure to be used for pricing non-competitive contracts should be 5.67 per cent.

508. The Board recognises that the above adjustment is currently based on certain assumptions as to the level of inter-unit trading in the contractor group, and it intends to gather additional information through the annual returns at future reviews so that this adjustment can be based on factual data in future.

The risk/reward matrix

509. MOD and the JRBAC recognise that the risk profiles of different types of contract will vary and that higher risk contracts should receive a higher target return than lower risk contracts. The parties have agreed that, to start with, the variable risk/reward matrix should be kept relatively simple to facilitate implementation and deal only with different types of work. As Government and Industry gain experience of applying this to individual contracts, the matrix can be further developed and perhaps also address varying degrees of risk in the context of different types of contracts.

510. MOD and the JRBAC were able to agree many of the components to the risk/reward matrix. However, there were certain issues which they asked the Board to resolve. These relate to:

- *The cost impact of variable profit rates.* The MOD believes the overall effect of the risk matrix should be neutral. The JRBAC does not accept this. It is the Board's view that, excluding profit adjustments relating to cost plus contracts and prime integration contracts, the cost impact of the matrix should be broadly neutral and that any assessment should be made over a number of years.

- *Review and Monitoring.* Both parties are agreed that these arrangements need to be monitored and reviewed regularly but were unable to agree on the frequency of such reviews. The Board considers that the matrix should be reviewed annually in order that it can be refined and developed. However, as already noted, any review of the cost impact of the matrix should be assessed over an extended period covering a number of years, although the data should be gathered annually by MOD to facilitate such an assessment.

- *Estimating contingencies.* The parties have asked for the Board's view as to whether the variable risk/reward matrix should include any direct link to estimating contingencies in contract prices. The Board's view is that, whilst it is possible that contracts that have a higher level of contingencies may also be eligible for a higher rate of profit, the level of contingencies should remain a matter for negotiation according to the circumstances of the particular contract.

- *Post development work, Minor development work and Modification programmes in respect of established technologies.* The parties were unable to agree on where this type of work should be incorporated in the matrix. The Board recommends that 'After design certification, support activities involving routine document maintenance and simple analysis of existing designs' and 'Post development work, Minor development work and programmes involving minor modification of established technologies' should all be classified as low risk, but 'Modification Programmes including proposals for, and analysis of, extensive changes to existing design in respect of established technologies and Fault management' be classified as standard risk.

- *Innovative contracting arrangements.* The JRBAC considers that innovative contracting arrangements relating to either the support/service provision contracts or development/systems integration work should be recognised as high risk/high added value and be included in the matrix in the +10% category. The MOD does not regard this as a category that deserves recognition in its own right. In the Board's view innovative contracting arrangements would in most cases relate to contract type. As the parties have agreed not to introduce different types of contract into the matrix at this time, innovative contracting arrangements should be excluded from the initial arrangements, but issues relating to contract type should be introduced into an expanded matrix at the earliest opportunity.

- *Significant transfer of logistics risk.* Again this is a category of support/service provision contracts that the JRBAC would wish to see in the matrix as a high risk/high added value factor attracting a profit rate of +10%. The MOD does not agree. Subsequent to their discussions, the JRBAC suggested an alternative which is to add 'Significant integration risk' as a high risk category in the support/service provision type of work in addition to being an agreed category for development/systems integration type of work. The Board considers that significant integration risks are most likely to arise in the context of large prime contracts involving significant sub contracting and these are considered separately below (paragraphs 512 and 513).

511. The revised formula is based partly on cost of production, and the Board is concerned that as sub-contracts pass up through a prime contractor's books they will attract a second layer of profit, with no automatic mechanism to make compensating adjustments as is the case under the existing formula. Changes in procurement methods are likely to mean that the contractor group undertakes more subcontracting than the reference group and will therefore achieve a higher overall return than the reference group.

512. The Board also believes that there are differences in risk as between the prime's own costs and those of subcontractors that pass through its books and that this needs to be recognised. It is the Board's considered view that any competent

contractor should and would be able to lay off a significant element of risk relating to work that it sub contracts to others which can be the only reason for the subcontractor being entitled to a profit on its share of the work. Under the concept of 'value at risk' outlined in paragraph 317, there is no justification for a contractor to receive the full profit allowance on work that has been sub contracted to others and where some of the risk associated with that work should have been 'laid-off'.

513. Conversely, the Board is satisfied that a competent prime contractor brings specialist contract management and risk management skills to bear which enable it to take the risks of integrating and managing all the sub contracts – risks that hitherto would have been left with the customer. This justifies a higher profit allowance on the prime's own costs.

514. Having received input from MOD and the JRBAC, the Board considered that, on all contracts with a value of £50 million or more where at least 50 per cent of the work is undertaken through major second tier sub contracts (third party or intra group) providing reasonably complete systems or reasonably self contained units that will need to be incorporated or integrated into the final product or service:

- the rate of profit on the prime contractor's added value should be 25 per cent above the baseline rate of profit as adjusted for the type of work in accordance with the risk/reward matrix; and

- the rate of profit paid to the prime on the costs it incurs on all sub contracts should be at a rate of 50 per cent below the baseline rate of profit as adjusted for the type of work in accordance with the risk/reward matrix.

515. The Board invited MOD and the JRBAC to help develop guidance on what sub contracts should be deemed to be 'major second tier sub contracts (third party or intra group) providing reasonably complete systems or reasonably self contained units that will need to be incorporated or integrated into the final product or service'. After discussions between the parties the MOD advised the Board that the level of definition suggested by the JRBAC had made the subject far more complex and its implementation potentially impracticable. It therefore proposed that the reduced level of profit should apply where over 50 per cent in value is sub contracted outside the relevant unit whatever the precise nature of that sub contract work. It defined a sub contract as any bought-in component or service.

516. In the light of MOD's proposal, the JRBAC argued that flexing the profit rate of large and important contracts on the basis of some arbitrary definition of 'relevant sub contracts' was too blunt an instrument. Instead, it proposed that the rate of Baseline Profit for prime integration contracts, as defined, should be based on a direct assessment of the circumstances of the individual contract. With the MOD now encouraging the use of three-point estimates, the JRBAC suggested that one of the key factors to be taken into account should be an assessment of the 'value at risk' based on the variation between the mid-point cost estimate and the cost estimate that has a 90 per cent likelihood of not being exceeded.

517. The MOD pointed out that three-point estimates have only recently been introduced and could not be relied upon to provide a robust measure of the risks associated with prime contracting.

518. The Board reiterated its view that, in the context of a profit formula that is based on cost of production, the rate of profit on a prime contractor's own 'added value' costs needs to be above the average Baseline Profit rate. Conversely, the costs of sub contracts that pass through its books, and on which the sub contractors should have absorbed some of the risk in the overall contract, should provide the prime contractor with a return below the Baseline Profit allowance. It acknowledged that both MOD and the JRBAC had concerns as to the practicalities of implementing the Board's proposals and, in particular, the broader definition of sub contracts suggested by MOD could reduce profits on prime contracts by far more than the Board had intended. Accordingly, the Board suggested that the parties agree to some simpler interim arrangement whilst the Board continues to explore ways of developing a more refined proposal for the future.

519. After further discussions, the parties agreed that as most prime contracts are likely to be reasonably large, the standard Baseline Profit rate applicable to all contracts or contract amendments with a value of £50 million or more should be reduced to reflect the fact that such contracts are likely to include significant levels of sub contracting. Based on estimates of the likely average mix of sub contracting costs to the prime's own added value, it was agreed that this reduction should be 30 basis points. Accordingly, the Board recommends that, as an interim arrangement, the standard Baseline Profit rate applicable to all firm or fixed price contracts or contract amendments with a value of £50 million or more should be 5.37 per cent subject to any adjustment in accordance with the risk/reward matrix and the target Baseline Profit rate for all TCIF contracts or contract amendments with a value of £50 million or more should also be 5.37 per cent.

520. Whilst recommending this interim arrangement, the Board is keen to continue to work with the parties to develop a more refined proposal after giving further consideration to:

- whether the three point estimating procedures now being introduced can provide a robust measure of the risks associated with prime contracting;

- whether the risk/reward matrix should be expanded to deal with certain defined types of sub contracts;

- whether the Board's original proposals could be implemented by refining the definition of relevant contracts so that it was not too wide but still capable of implementation; and

- any issues and concerns raised by the parties in the light of actual experience in implementing the interim arrangement.

521. Subject to the agreement of the parties, the Board intends to undertake this further work during the course of the next Annual Review.

522. The risk/reward matrix, based on those components already agreed between the parties and incorporating the Board's recommendations in paragraphs 510 to 521, is as follows:

FLEXIBLE PROFIT ADJUSTMENT (TO STANDARD BASELINE PROFIT ALLOWANCE)			
Type of Work	*Standard Rate -10%*	*Standard Rate*	*Standard Rate +10%*
Supply	• Follow on and repeat orders for production/ supply involving existing specification. • Repeatable quality	• Interrupted production • Typical/normal production orders	• First production batch for a new requirement with significant development/ production overlap • One-off high technology procurement
Support/ Service Provision	• Clearly defined specification • Repeatable quality • Reactive support/repairs, maintenance or ongoing contracts	• Initial repair and support order • Customer specified repair and maintainability standards • Support requirements not fully defined	• Long term commitment to Service and Capability provision to a defined output standard
Development	• After design certification, support activities involving routine document maintenance and simple analysis of existing designs • Post development work, minor development work and programmes involving minor modification of established technologies	• Development work • Contractor accepts full responsibility for performance and integration • Modification Programmes including proposals for, and analysis of, extensive changes to existing design in respectof established technologies • Fault management	• High Technology or Specialist skills or new concepts

NOTES

1. Deciding on the appropriate rate on individual contracts should depend on a balance of factors. The underlying principle should be that the majority of activity should attract the standard rate of profit unless there are strong characteristics to indicate otherwise. Where there are strong characteristics indicating otherwise the profit rate applicable to that contract shall be the rate that is applicable to the majority of activity.
2. The risk matrix set out above should apply to contracts with an estimated cost in excess of £5 million. Contracts below this amount should receive the standard rate of risk (or non-risk) profit.
3. Cost-plus (ie non-risk) contracts should attract the Standard Profit Allowance less 25 per cent in all instances. The risk matrix set out above does not apply to cost-plus contracts.
4. The Baseline Profit rate applicable to firm or fixed price contracts and contract amendments with a value of £50 million or more should be 30 basis points less than the standard rate subject to any adjustment in accordance with the risk/reward matrix.
5. The Target Baseline Profit on TCIF contracts and contract amendments:
   - should be based on the Standard rate for contracts or contract amendments with a target cost below £50 million; and
   - should be based on the Standard rate less 30 basis points for contracts or contract amendments with a target cost of £50 million or more.
6. The aim of the variable profit rate arrangements should be to achieve a broadly neutral cost impact for MOD, assessed not on an annual basis but over a time period covering a number of years. The assessment should not include contracts that are dealt with in accordance with notes 4 and 5 above.
7. The variable profit arrangements and their application on individual contracts are to be reviewed and monitored on an annual basis in order that the arrangements can be refined and developed.

Examples

523. Appendix E illustrates the application and structure of the profit formula revised in accordance with the Board's recommendations. It also contains guidance on some of the terms used in the matrix.

Future reviews

524. The Board recommends that there should continue to be comprehensive triennial General Reviews at which any matter connected with the profit formula can be raised. There should also be Annual Reviews which should normally be limited to examination of:

- the profitability of the Reference Group;
- the level of CSAs;
- any available data on the level of sub contracting in the contractor group and in the Reference Group ; and
- the effect of intra-group inter-unit trading.

525. Exceptionally, it may be that either or both parties ask the Board to consider additional issues in an Annual Review. If one party objects to the Board considering an additional issue at the request of the other party the Board will invite representations from both parties on the question of whether the Board should consider it.

526. In this Review the Board has recommended significant changes to the profit formula arrangements and expects that these changes could give rise to some additional implementation issues that come to light during practical contract negotiations. The Board wishes to make clear that it will be acceptable for the parties to make representations about any feature of the new profit formula or of other proposals so that the Board can review the operation of the new system, alongside further work to refine the interim arrangement outlined in this section, at the next Annual Review.

SECTION VI

Recent Profits on Non-competitive Government Contracts

Introduction

601. There are two sources of information on the profits achieved on non-competitive Government contracts; first the annual returns that contractors submit directly to the Board and secondly the post-costing data gathered by MOD.

602. In aggregate terms, the post-costing data and annual returns might be expected to reveal comparable results as they both seek to record the profitability of profit formula contracts. However, owing to apparent inconsistencies between the two sets of data the Board undertook a study[12] to see how far they could be reconciled. It found that there were fundamental differences in coverage that meant that the two sets of data could not be reconciled. They are prepared on different timescales, they are recorded differently and different samples are used. Nevertheless, the examination did not reveal any significant systematic differences in the measurement of profit in the two sets of data.

Annual returns

603. The Board last reported on annual returns in its unpublished 1999 General Review, which contained analysis up to 1996. Government suspended its consideration of the 1999 General Review pending its own review of the profit formula methodology and, during this period, annual returns have not been collected.

604. For this review the Board has asked contractors for annual returns for 2000 and 2001. It has received 13 returns for each year and, by coincidence, the aggregate non-competitive sales in the returns totalled £2.7 billion for both 2000 and 2001. For comparison, the Board received 22 returns for 1996, representing aggregate non-competitive sales of £1.6 billion. Non-competitive contracts placed in recent years were:

Non-competitive Government contracts placed

	£m
1994/95	2,434
1995/96	1,722
1996/97	4,767
1997/98	2,027
1998/99	2,818
1999/00	3,099
2000/01	3,809
2001/02	4,065

[12] 1998 Annual Review paragraph 502.

605. Annual figures for contracts placed and annual returns are not directly comparable as there will be a time lag between a contract being placed and the work being carried out. However, they provide an indication of the coverage.

606. The annual return calls for an analysis of the contractor's turnover and profits for each CP:CE unit between the risk and non-risk categories of non-competitive Government contracts, and all other work. The profitability of non-competitive Government work is expressed as a return on capital employed, using the relevant CP:CE ratio agreed between MOD and the contractor for that year. The costs applicable to Government contracts are reported after adjustments necessary to comply with the Government Accounting Conventions. The actual results for each year are compared with an average profit formula target rate, calculated by the contractor from the target rates applicable to the contracts performed in that year. The return includes a report from the contractor's auditors.

607. The returns reflect the results of contracts priced on both the historic cost and semi-CCA bases but the combined results of both categories can only be expressed on the historic cost basis. The results disclosed by the annual returns for the years 1996, 2000 and 2001 are summarised as follows:

Summary of Annual Returns
(rate of return on capital employed, historic cost basis)

	Contractors' weighted average actual rates %	Weighted average of target rates applicable to contracts %	Variance %
1996			
Risk work	41.1	23.7	17.4
Non-risk work	5.2	21.7	-16.5
Risk and non-risk work	39.0	23.6	15.4
2000			
Risk work	19.45	25.40	-5.95
Non-risk work	-4.47	16.99	-21.46
Risk and non-risk work	16.54	24.38	-7.84
2001			
Risk work	3.56	24.90	-21.34
Non-risk work	-43.94	19.50	-63.44
Risk and non-risk work	-2.04	24.27	-26.31

608. It can be seen that there is considerable variation in the results for individual years. Annual returns are provided to the Board on a confidential basis and, without divulging confidential information, we can provide the following explanations that we have received for some of the variances shown in these figures:

- 1996 risk contracts: The principal explanation for the variance is that a small number of large contracts were completed in 1996 and a significant part of the profit on those contracts was recognised in the year.

- 2001 risk contracts: The principal cause of the variance is that two major contracts that were completed in the year incurred significant cost overruns.

- Non-risk contracts: In the normal course, it should not be possible to make a loss on a non-risk contract but contractors have been reporting significant variances and losses. From the explanations provided it appears that the principal causes for the variances are:

  – contractors being unable to recognise profits in their accounts evenly over the period of the contract; and

  – agreements between MOD and the contractors that certain large or exceptional allowable costs should be amortised and recovered over several years.

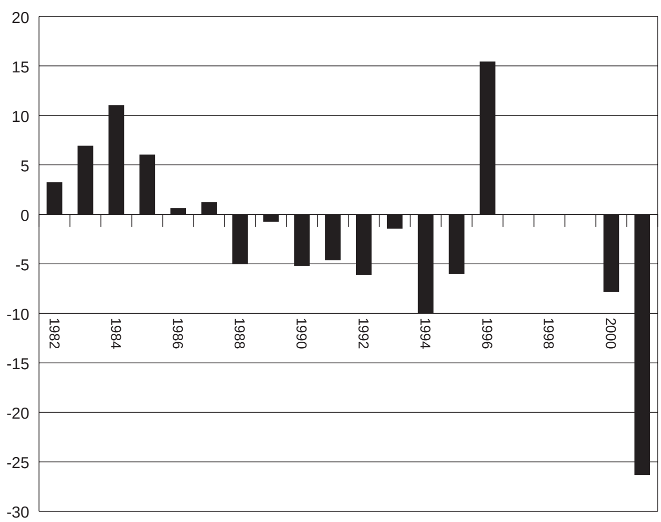
  Variances occurring for either of these reasons would be expected to be compensated for in earlier or later years.

609. Whilst the returns for the most recent year show a significant adverse variance, individual contractors can have a significant effect on the results in any particular year. It is therefore better to consider the results over longer periods. The following chart shows the pattern of returns earned in recent years:

Variance of actual returns from the target rate

Year	%
1982	3.2
1983	6.9
1984	11.0
1985	6.0
1986	0.6
1987	1.2
1988	-5.0
1989	-0.7
1990	-5.2
1991	-4.6
1992	-6.1
1993	-1.4
1994	-10.0
1995	-6.0
1996	15.4
1997	No returns
1998	No returns
1999	No returns
2000	-7.8
2001	-26.3

Variance of actual returns from the target rate



610. As returns were not collected for 1997, 1998 and 1999 it is not possible to draw any conclusions about the recent underlying trend although it does seem that the volatility of returns may have increased and the Board intends to monitor the situation at future reviews. Contractors with profit formula contracts with an annual value exceeding £5m currently provide annual returns to the Board on a voluntary basis and the Board recommends that provision of returns to the Board should be included in a DEFCON as a requirement for all applicable contractors.

Post-costing data

611. Post-costing is a review by MOD of the actual costs incurred on a contract, for comparison with the costs as estimated at the time when the price of the contract was agreed. Post-costing is designed to assist MOD in contract pricing by providing a check on the accuracy of pricing procedures and to provide a guide to follow-on pricing. It is intended that the post-costing data should be agreed between MOD and the contractor, but the JRBAC has expressed concerns that post-costing results do not always reflect an agreed final position, as the parties see little benefit in negotiating the position if it will not result in a refund or affect follow-on contracts. If the sharing arrangements discussed in paragraphs 635 to 644 are adopted, then it seems likely that parties will have a renewed interest in agreeing accurate post-costing data.

612. The Board has now received post-costing data from MOD for all contracts that were post-costed in 2001 and 2002. This data, together with comparative data for contracts post-costed in 1999 and 2000, is set out below.

613. The Board recommends that post-costing data analysis should show TCIF contracts separately from other contracts. TCIF contracts are designed to cope with a range of outturn costs, and any variation from the target outturn cost will be shared between the parties in accordance with the agreed shareline. Therefore, it is not appropriate to include these contracts in an analysis of other contracts, where cost under and overruns all fall to the contractor. The Board's recommendation is reflected in the analysis of the data shown below.

TCIF contracts post-costed by MOD

	1999	*2000*	*2001*	*2002*
Total of contracts post-costed				
(a) Number	1	2	7	Nil
(b) Value	£3m	£11m	£646m	Nil

614. Contracts other than TCIF contracts are analysed in the tables below.

All contracts, excluding TCIF contracts, post-costed by MOD				
	1999	*2000*	*2001*	*2002*
Total of contracts post-costed				
(a) Number	52	28	77	28
(b) Value	£551m	£453m	£1,250m	£738m
of which the following were not fully analysed:				
(a) Number	8	2	3	4
(b) Value	£103m	£43m	£22m	£66m

Analysis of all contracts fully analysed by MOD (excluding TCIF contracts)					
		1999	*2000*	*2001*	*2002*
A	Contracts where +/- 5 per cent accuracy was achieved:				
	(a) Percentage by number	34%	38%	41%	46%
	(b) Percentage by value	45%	40%	73%	71%
B	Contracts where +/- 10 per cent accuracy was achieved:				
	(a) Percentage by number	57%	73%	78%	88%
	(b) Percentage by value	63%	78%	93%	98%
C	Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (ie cost underrun):				
	(a) Number	13	17	42	11
	(b) Value	£107m	£312m	£599m	£218m
D	Contracts where target cost exceeded cost outturn by More than 10 per cent (ie cost underrun):				
	(a) Number	16	6	11	2
	(b) Value	£153m	£78m	£70m	£13m
E	Contracts on which refunds were negotiated by MOD in the light of the post-costing results:				
	(a) Number	15	Nil	10	Nil
	(b) Value	£122m	Nil	£112m	Nil
	(c) Amount of refund	£7.2m	Nil	£3.9m	Nil
F	Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (ie cost overrun):				
	(a) Number	12	2	16	10
	(b) Value	£174m	£9m	£537m	£437m
G	Contracts where cost outturn exceeded target	3	1	5	1
	cost by more than 10 per cent (ie cost overrun):	£14m	£11m	£22m	£3m

615. The following tables show the average returns on capital earned on risk contracts for which post-costing was completed in the five year period to 2002.

Post-costing: Average Return on Capital for Contracts Priced on Historic Cost

Year post-costing completed	*Value*	*Contract target ROCE*	*Actual return on intended capital*	*Variance*	*Actual return on actual capital*	*Overall variance*	*Variance adjusted for refunds*
	£m	*%*	*%*	*Percentage Points*	*%*	*Percentage points*	*Percentage Points*
A	*B*	*C*	*D*	*E*	*F*	*G*	*H*
1998	435	30.1	31.0	+0.9	25.6	-4.5	-7.9
1999	329	30.0	44.1	+14.1	51.4	+21.4	+12.3
2000	323	20.0	38.1	+18.1	35.9	+15.9	+15.9
2001	952	28.8	31.6	+2.7	33.1	+4.3	+2.6
2002	404	17.3	17.2	-0.1	23.0	+5.7	+5.7

Post-costing: Average Return on Capital for Contracts Priced on Semi-CCA

Year post-costing completed	*Value*	*Contract target ROCE*	*Actual return on intended capital*	*Variance*	*Actual return on actual capital*	*Overall variance*	*Variance adjusted for refunds*
	£m	*%*	*%*	*Percentage Points*	*%*	*Percentage points*	*Percentage Points*
A	*B*	*C*	*D*	*E*	*F*	*G*	*H*
1998	537	13.6	15.9	+2.3	16.1	+2.5	+2.1
1999	118	12.3	23.4	+11.1	31.1	+18.8	+16.1
2000	87	12.9	19.8	+6.9	22.8	+9.9	+9.9
2001	276	14.9	21.3	+6.4	24.8	+10.0	+9.9
2002	267	19.2	21.8	+2.6	22.7	+3.45	+3.45

616. The contract target return is calculated by applying the profit formula to the contractor's CP:CE ratio. A variance on a fixed price contract can arise if:

- actual costs are different from those used in the pricing estimate. This difference results in the return shown in column 'D' above, and the variance shown in column 'E'; and/or

- the outturn capital employed required on the contract is different from that indicated by the CP:CE ratio used for pricing. This difference causes the figures in column 'D' above to be increased or decreased to those shown in column 'F'.

617. The overall variance between the target return on the intended capital at the time of price fixing ('C') and the actual outturn return on the actual outturn capital employed on the contract ('F') is shown in column 'G'. Column 'H' shows the

overall variance (‘G’) after adjusting for refunds negotiated by MOD. The above tables suggest that the profit variances appear to be reducing.

Timely submission of post-costing data

618. MOD has asked the Board to consider whether any measures should be taken to improve the timely submission of post-costing certificates by industry noting, that despite the problem being highlighted by the Board in its 1990 Report, it remains an issue of major concern.

619. MOD has proposed that:

- The due date for submission of post-costing data should be six months from submission of a formal Post-Costing request by MOD, or six months after delivery of the articles, whichever shall occur later.
- There should be a retention of 2 per cent of the contract value on all risk contracts valued at £10 million or above.
- For contracts valued below £10 million, the retention should only apply in the event that MOD formally notifies the contractor at least six months before the due date that a post-costing certificate is required.
- The retention should be released on the earlier of MOD completing its audit of the certificate, or six months after receipt of the certificate, unless the certificate, or elements thereof, have been formally returned on the grounds of insufficient information.
- Late submission of post-costing data should be defined as 12 months from the due date of submission or final delivery of articles, whichever is later.
- In the event that a certificate is received late, only 1 per cent of the retention should be released with the balance being a permanent deduction from the contract.

620. MOD believes that the contractor and the Authority should seek to agree to the use of ‘interim’ cost certificates to facilitate timely submission of post-cost data, particularly where the element of cost still subject to estimates is less than 2 per cent of the total contract value. On major or long duration contracts, annual cost certificates with estimated certificates for the final year should be encouraged and, in return, the MOD would be prepared to consider how the 2 per cent payment retention should operate on such contracts.

621. The JRBAC argues that the variability of contract types and the nature of defence contracting make it impossible to agree a set of rules which can encompass all circumstances. The JRBAC believes there will be practical difficulties with implementing the MOD’s proposals because of varying lengths of contracts and the likelihood of contract amendments and extensions. It also considers that a 2 per cent retention is too high and that a permanent deduction on late submission is unreasonable.

622. The Board is concerned that delays in the submission of post-costing data have now persisted for over a decade, and as shown by the table below, the problem has been increasing.

Year	*No. of contracts with cost data outstanding*
1996	96
1997	117
1998	153
1999	176
2000	199
2001	178
2002	173

623. In the circumstances, the Board endorses MOD's proposal for a retention of 2 per cent to encourage the timely submission of post-costing certificates. It recommends that this retention should be made from the final payment, or set of payments, that will be due under the contract and are large enough to cover the retention monies.

624. The Board notes MOD's willingness to consider how the retention should operate on very large or long duration contracts, but believes this should only be necessary in very few instances, if any, as the retention is to be made from the final payments due under any contract. The Board does not accept the JRBAC's contention that the variability of defence contracts makes it impossible to agree a set of rules to cover all circumstances, but believes that there needs to be scope to vary the rules in a handful of contracts with particularly exceptional circumstances.

625. The Board agrees that the retention should be released on the earlier of MOD completing its audit of the certificate, or six months after receipt of the certificate, unless the certificate, or elements thereof, have been formally returned within two months on the grounds that it provides insufficient information.

626. The Board endorses MOD's proposal that the due date for submission of post-costing certificates should be six months from submission of a formal post-costing request by MOD, or six months after delivery of the articles, whichever shall occur later. We also agree that it should be in the interests of both parties to:

- use 'interim' cost certificates to facilitate timely submission of post-costing data where the element of cost still subject to estimates is less than 2 per cent of the total contract value or as agreed between the parties; and

- use annual cost certificates, and estimated certificates for the final year, in the case of large, and particularly long-run, contracts where collating the data on termination can be a difficult task.

627. The Board further recommends that, where rates or other issues have not been agreed with MOD, interim cost certificates should be used to avoid delay.

628. In recommending the retention arrangements the Board is aware that contractors may have to deploy additional working capital which on large contracts could be significant, even though the retention does not affect the interim payment arrangements over the life of the contract and is only deducted from the final payments. Accordingly, the Board recommends that contractors should be entitled to claim a working capital servicing allowance at the prevailing rate on the amount of the retention from the date of the final payments from which the retention was deducted until the retention is released, provided that:

- there is to be no entitlement in respect of the period from the due date for submission and the actual date of submission if later; and
- a contractor who makes a late submission (as defined in paragraph 634) forfeits the right to make this claim.

629. In the interests of simplifying administration the Board recommends that this entitlement to claim a working capital allowance be restricted to where the allowance under a contract would amount to at least £10,000.

630. The Board also recommends that, in the interests of equity, where a contractor makes a late submission and eventually has to make a refund to MOD, the MOD should be entitled to make a claim equivalent to the working capital servicing allowance, at the prevailing rate, on the amount of any refund, from the date when the claim became late, as defined, up to the date when the refund is made, provided that:

- the claim for the period when MOD undertakes its audit is restricted to a maximum of six months allowance unless the certificate or elements thereof had been formally returned on the grounds of insufficient information; and
- once the audit has been completed the allowance should start to accrue again during any period where the parties negotiate the quantum of the refund.

631. Again, in the interests of simplifying administration no claim may be made by the MOD where the allowance under a contract would amount to less than £10,000.

632. Taking account of the foregoing recommendations the Board does not believe that any change is required to the GAC's. Indeed, the Board recommends that:

- any amounts received or paid by contractors by way of working capital allowances should not be included in CP when pricing future contracts; and
- the amount likely to be retained pending the submission and audit of a cost certificate must not be added to CE when determining the working capital servicing allowance at the time of pricing the contract.

633. With regard to MOD's proposal for a permanent deduction for late submission of cost data, the Board is concerned that some contractors might view this as an alternative to preparing a cost certificate. It also feels that in the light of the disallowed working capital allowance for late submission, and the further obligation to pay the equivalent of a working capital servicing allowance on any eventual refund if a contractor makes a late submission, any further deduction would be unduly harsh. It is hoped that the arrangements being proposed will lead to significant improvements in the submission of post-costing data but, if this still remains a concern, the Board may wish to review its decision.

634. For the purposes of the foregoing provisions, the Board recommends that late submission be defined as one that is not received within 12 months of the due date.

Sharing unconscionable profits and losses

635. MOD contended that the results of post-costing have consistently demonstrated that contractors in aggregate undercut the costs as estimated at the time of pricing. It proposed that there should be a mechanism for the automatic sharing of profits once a predetermined profit level has been reached. This would enable MOD to secure refunds without having to demonstrate to the Board that there has been a lack of equality of information.

636. The JRBAC's principal concern was that any sharing should be applied to cost over and underruns. It considered that the arrangements should be symmetrical so that, for example, if MOD's share of a cost underrun is £5 million, then its contribution towards a cost overrun of the same magnitude should also be £5 million. The JRBAC also considered that MOD's concerns could be met by the increased use of TCIF contracting.

637. The Board has considered these, and other, arguments put forward by the parties, at some length. The Board accepts MOD's argument that post-costing appears to show that contractors in aggregate have consistently beaten the target cost, and therefore recommends that automatic asymmetric sharing arrangements should be applied to 'unconscionable' profits and losses.

638. The Board draws a distinction between TCIF arrangements and these proposed arrangements:

- TCIF and other similar arrangements are (and should continue to be) used where there is considerable uncertainty as to the likely final outcome and where the cost estimate is more a target than a reliable estimate of cost.

- The proposed arrangements are for firm/fixed price contracts where the contractor should have the risk and the reward of any cost under-runs or over-runs. In the Board's view the rationale behind any sharing arrangement on firm/fixed price contracts can only be, and is, that it would not be in the interests of either the Government or the defence industry for a contractor to make unconscionable profits or losses. Having regard to this underlying rationale, the Board recommends that the profits and losses that should be shared are those that are defined as 'unconscionable'.

639. The Board considers that unintended profits or losses amounting to more than 5 per cent of the contract value are likely to be very substantial when compared to the target profit, and recommends that unconscionable profits and losses, for the purposes of these sharing arrangements, be defined as follows:

- Unconscionable profit: that proportion of any unintended profit that exceeds five per cent of the contract value.

- Unconscionable loss: that proportion of any unintended loss that exceeds five per cent of the contract value.

640. In recommending a structure for the sharing arrangements, the Board is concerned that the arrangements should not encourage inefficient behaviour and nor should they create an undue administrative burden. The Board therefore recommends that:

- unconscionable profits and losses should be shared in the proportions 75:25 as between MOD and the contractor;

- the arrangements should apply to all firm/fixed price contracts with a contract price in excess of £5 million. Alternative arrangements, such as TCIF, may be adopted with the agreement of both parties; and

- the amount of any payment under these sharing arrangements should exceed £250,000 before it becomes payable.

641. The current procedures would continue to apply for contracts valued at less than £5 million except where the parties agree otherwise at the time of contract pricing. The Board intends that the new sharing arrangements should be kept under review in the light of future post-costing results.

642. The Board's recommendations relating to the sharing arrangements can be illustrated by a simple example:

Estimated cost	92
Profit allowance	8
Contract value	100
Unconscionable equals 5 per cent of contract value	

Cost outturn	*Total P/(L)*	*Addl. Profit/ (total loss)*	*Unconscionable P/(L)*	*MOD's share*	*Contractor's P/(L)*
52	48	40	35	26	22
57	43	35	30	23	21
62	38	30	25	19	19
67	33	25	20	15	18
72	28	20	15	11	17
77	23	15	10	8	16
82	18	10	5	4	14
87	13	5	-	-	13
92	8	-	-	-	8
97	3	-	-	-	3
102	(2)	(2)	-	-	(2)
107	(7)	(7)	(2)	(2)	(6)
112	(12)	(12)	(7)	(5)	(7)
117	(17)	(17)	(12)	(9)	(8)
122	(22)	(22)	(17)	(13)	(9)
127	(27)	(27)	(22)	(17)	(11)
132	(32)	(32)	(27)	(20)	(12)

Note: The above table provides a simple illustration of the proposed shareline, ignoring the de minimis limits.

643. The Board recognises that there could be circumstances where there is serious inequity that is not remedied by application of the standard sharing arrangements. Therefore the Board is prepared to accept references of individual contracts that fall within the standard sharing arrangements, and will look to see if there are wholly exceptional circumstances that justify a departure from the arrangements. Such exceptional circumstances might include:

- in the case of either the contractor or the Authority, the fact that there is evidence to support the view that there was inequality of information at the time of pricing; or

- in the case of the contractor, evidence that the excess profits arose through its innovation or use of new technology that could not have been foreseen at the time of pricing; or

- in the case of the Authority, evidence to support the view that the losses arose as a consequence of the contractor willingly and recklessly pricing the contract in the knowledge that it could rely on the sharing arrangements, or evidence to support the view that the contractor was seriously negligent or incompetent in carrying out the contract.

644. A reference under these circumstances would follow the same procedures as a normal contract reference under the 1968 Memorandum of Agreement, and in accordance with the Agreement '… the Board shall assess whether the price negotiated was fair and reasonable and, in the light of this assessment determine whether any payment should be made by one of the two parties to the reference to the other and, if so, how much.'

SECTION VII

The Accounting Conventions for Non-Competitive Government Contracts

Introduction

701. The costs and capital employed on non-competitive Government contracts are determined by the application of prescribed Government Accounting Conventions[13](‘GACs’). These conventions are applied by MOD to the figures in contractors’ accounts to ensure that there is uniformity in the methods of calculating costs and capital employed, consistent with the basis of the profit formula.

702. The GACs have been developed over many years, with successive amendments to reflect particular issues which have been relevant at particular times. In the Board’s view the time has come for a fundamental review of the text of the GACs with the aim of eliminating material that is no longer relevant, and producing a consolidated statement of the conventions that can more easily be used by those concerned with the pricing of Government contracts. The Board has previously suggested such a review to MOD and the JRBAC and, following the major revisions to the profit formula arrangements contained in this Report, the Board recommends that such a review should be undertaken at the next annual review. In this report the Board has confined its recommendations for amendment of the GACs to the issues raised by MOD and the JRBAC in their submissions to the Board.

Rationalisation and site closure costs

703. The allowability of rationalisation and/or site closure costs is considered under GAC 1(D)4, and the JRBAC has sought some further clarification concerning the extent to which these costs may be recovered from MOD through allowable overhead costs.

704. Under GAC 1(D)4, reasonable net costs on rationalisation and/or plant closures may be included in attributable costs. However, when no work is transferred to other production facilities within the same group it will not always be possible to recover such costs through overhead recovery rates. As part of the discussions relating to this Review, MOD agreed that it would be prepared to consider such costs when agreeing the contract price for the final batch(es) – for example, by including in the contract costs an estimate of the rationalisation costs. The JRBAC agreed that if subsequent batches do occur, then the price of those subsequent batches should reflect the fact that rationalisation costs have been claimed under a previous contract. The Board believes it is preferable that the parties should address the issue of rationalisation costs at the time of pricing so that retrospective adjustments to the contract price can be avoided.

705. MOD and the JRBAC agreed that where a site is closed an appropriate allocation of the costs may be recovered in the overheads of other sites in the same group. The Board recommends that the following text, which was proposed by MOD and the JRBAC, should be added to GAC 1(D)4:

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[13] See Appendix G and Explanation of Terms.

'Where a site is closed, the attributable net rationalisation and/or plant closure costs should be recovered in the overheads of the other sites in the same group gaining work as a result of the site closure. For this purpose "site" and "group" should be taken to include Joint Venture arrangements. The amount of the costs would be subject to agreement on a case by case basis between MOD and the contractor'.

PV product development costs

706. The JRBAC contended that there should be a change in the way in which contractors recover Private Venture Product Development ('PVPD') costs from MOD. Currently a contractor is allowed to recover a proportion of its development costs as a cost to be included in the product price, providing such costs are separately identified to discrete projects. The JRBAC claimed that the guidance document on the recovery of these costs was written in 1970 and the nature of products has since changed, making it increasingly difficult to separately identify and recover such costs as a discrete charge. It has suggested that in future all PVPD costs relating to a product group should be recovered by a charge to current total output of that product group.

707. MOD recognised that the existing system can cause difficulties but was unwilling to switch to the JRBAC's proposed system without receiving enhanced rights over the products involved. There was no substantive progress in these discussions.

708. The Board recognises that the JRBAC's proposal would reduce contractors' administrative burden but is not convinced by the overall argument. The revised system would result in MOD incurring development charges on programmes in which it does not wish to participate, and there appears to be a gulf between the rights required and offered in return for MOD's additional funding. The Board recommends that the GAC's and the Guidance Document on this subject should remain unchanged. However, the Board suggests that in individual instances where MOD agrees that it will benefit from a particular PVPD programme, the parties should agree that the programme should be treated in the same way as applied research for cost recovery purposes.

Advance payments

709. The JRBAC has noted that most payment arrangements with MOD now involve milestone payments, which might on occasion become due in advance of cost being incurred. It has sought clarification concerning the treatment of such payments.

710. The Board has consulted with both MOD and the JRBAC on this matter and recommends that the final sentence of GAC 4(A)2(e) should be amended as follows:

'Prepayments by the Government *on non-competitive contracts, calculated after adjusting the contractor's work-in-progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes,* are deducted except where otherwise agreed.'

Valuation of work-in-progress

711. The JRBAC contended that the WIP element of capital employed may be understated if the contractor's accounting policy is to write-off some element of overheads (eg General & Administrative costs). The JRBAC has suggested that, in circumstances where there are amounts excluded from WIP in the company's accounts but allowable in overheads billed to MOD, the excluded amounts should be added to WIP for the purpose of calculating CE.

712. MOD agreed with the principles outlined by the JRBAC. The Board recommends that the following wording, which was proposed by MOD and the JRBAC, should be used in GAC 4(A)2(b):

> 'The net balance sheet figure for stocks and work-in-progress is included in capital employed~~.~~ *at an historical cost valuation subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by auditor attestation.* If a company has not already done so in its balance sheet, ~~cash~~ interim payments on account of work-in-progress are deducted therefrom *in accordance with 4(A)2(e).*'

Cash

713. Under the existing GAC 4(A)1(e) cash 'demonstrably surplus to requirements' may be excluded from assets for the purpose of calculating a contractor's capital employed. The JRBAC has contended that many contractors are part of large conglomerates and do not have an independent cash balance representative of the CP:CE unit's requirements. It has argued that contractors should have an assumed level of cash, calculated as a proportion of the unit's cost of production.

714. MOD's current practice is to exclude all cash deposits, on the basis that contractors will earn interest on cash deposits and it would therefore be unfair to include such cash in capital. Contractors would, in effect, earn profit on the same asset twice.

715. Under the proposed revised profit formula methodology any working capital balance would attract the WCSA, which is based on recent interest rates. The Board considers that MOD's current interpretation of GAC 4(A)1(e) is appropriate for use under the proposed revised profit formula methodology.

Pension costs

716. The JRBAC raised concerns that a new accounting standard relating to pension costs might have a distorting effect on the profit formula. The Board recognises that this may cause a problem and recommends that the matter should be addressed by a joint working party (including the Review Board Secretariat, the JRBAC and MOD) when details of the new accounting standard become available.

SAYE and other share incentive schemes

717. In addition to the pension cost issue, the JRBAC raised concerns that a new accounting standard relating to SAYE and other share incentive schemes might have a distorting effect on the profit formula. As for pensions costs, the Board recommends that this matter should be addressed by a joint working party when details of the new accounting standard become available.

The 1999 General Review

718. The MOD's consideration of the Review Board's report on the 1999 General Review was suspended and a statement was issued by MOD and the JRBAC in September 1999[14]. The statement included agreement that the following amendments and/or clarifications of the GACs contained in the 1999 General Review should be applied:

- in GAC 1 delete "to make the following adjustments" and insert "to adopt costs charged in accordance with UK GAAP subject to the following adjustments"

- in GAC 4, after the "period under review", insert "on a basis consistent with the company's accounts in accordance with UK GAAP"

- the treatment of Bonuses paid in cash or kind shall be in accordance with the clarification provided by paragraphs 605-608 of the Board's report on the 1999 General Review [included in Appendix G to this report]

719. The Board recommends that the these amendments and/or clarifications should be accepted formally, subject to the following further amendments for additional clarification and consistency:

- replace the preamble to GAC 1 with "In assessing contractors' claims for overhead costs on non-competitive Government work current practice is to *adopt the costs charged in the contractors' accounts subject to any adjustment required in order to comply with UK GAAP and subject to* ~~make~~ the following *further* adjustments:"

- amend the first sentence of GAC 1(D)1 to read "The amount to be included for depreciation should ~~exclude backlog and~~ be calculated at the …"

- amend the penultimate sentence of GAC 1(D)1 to read "… profit or loss on disposal calculated by reference to the book value of the asset arrived at on the basis of ~~4(A)2(a)~~ *GAC 4".*

[14] See Appendix D.

- qualify the preamble to GAC 4 with "… under review *(based on the company's accounts subject to any adjustment required in order to comply with UK GAAP)*, adjusted for the following where relevant:"

- amend GAC 4(A)2(a) to read "… ~~adjustments in balance sheets to values of tangible or intangible fixed assets (other than goodwill) arising from revaluation may be included in capital employed, provided they are consistent and reasonable~~. ~~Alternatively, and subject to the same proviso, values of tangible and intangible fixed assets, calculated in accordance with the principles laid down in Statement of Standard Accounting Practices 16 (now withdrawn) and attested by the company's auditors, may be substituted for statutory balance sheet values~~. Investment …"

- amend GAC 4(A)2(c) to read "Patents and trade marks may be included in capital employed ~~on the basis described in 4(A)2(a)~~ *on a consistent and reasonable basis* to the extent …"

Revised statement on the Government Accounting Conventions

720. Appendix F is a revised statement of the Government Accounting Conventions, incorporating the amendments recommended in paragraphs 703 to 719 of this report.

Guidance published in the Board's previous Reports, and the earlier profit formulae

721. Appendix G sets out certain passages from the Board's General Review and Annual Review reports that have dealt with the Government Accounting Conventions and other aspects of price fixing. It is hoped that this document may be helpful in facilitating reference to past statements by the Board concerning interpretation of the GACs and other aspects of pricing arrangements.

722. Appendix H summarises the profit formulae that have applied since 1968.

APPENDIX A (see paragraph 101)

THE MEMORANDUM OF AGREEMENT

The text of an agreement between the Government and the CBI in February 1968 regarding the establishment of the Review Board for Government Contracts.

The Background

1. On 26th February, 1968, the Chief Secretary, HM Treasury, announced to Parliament that the Government had reached agreement with industry on new arrangements for placing and pricing the non-competitive Government contracts covered by the existing profit formula. He stated:-

> ‘The Government and industry have agreed that the aim of the formula should be to give contractors a fair return on capital employed; that is to say equal on average to the overall return earned by British industry in recent years. The yardstick will be the average of industry’s earnings over the last seven years for which figures are available – 1960 to 1966. This gives a figure of 14 per cent on capital employed...
>
> ‘The Government recognise the importance of fair profits for their contractors ... and accept the view that fixed prices freely negotiated should in general not be retrospectively modified ... Nevertheless, arrangements must be made to deal with excessive profits, given that there is no competitive check on the agreed prices...
>
> ‘Agreement has been reached on a proposal to set up an impartial Review Board, and to secure acceptance of its rulings by a new contract condition. Both sides could refer contracts where profits of 27.5 per cent or more on capital employed and losses of 15 per cent or more had been made, to establish whether any reimbursement or compensation was justified. In exceptional cases, the Board might review contracts referred to it by either side within these percentages, where there was evidence that prices had not been fair and reasonable.
>
> ‘In addition to reviewing individual contracts and giving rulings which both sides would agree in advance to accept, the Review Board would also be given the task of collating the evidence for a review of average earnings on contracts. For this purpose, the Review Board would act in an advisory capacity. A review after three years, which could relate actual earnings on this work to the latest trends in overall average earnings of British Industry, would be in the interest of both sides.’

2. It was subsequently agreed between the Government and the Confederation of British Industry (from now on in this paper called the CBI) that the Review Board should also carry out an Interim Review on certain topics. The Annex to this paper deals with this review.

3. This paper sets out the terms of agreement reached between the Government and the CBI covering the establishment of the Review Board, its functions, and related matters.

Establishment and Administrative Arrangements

4. The Board shall be known as 'The Review Board for Government Contracts' – from now on in this paper called the Review Board. It shall be independent of both the Government and industry.

5. (a) The Review Board shall consist of a Chairman and four other Members.

(b) The Treasury[15] and the CBI shall each nominate two independent candidates for appointment as Members, and shall consult each other to ensure that both these nominations and also the nomination for the Chairmanship are acceptable to both parties.

(c) The Treasury shall appoint the Chairman and other Members. Subject to (d) and (e) below these appointments shall be for a period of not less than three and not more than five years. These appointments may be renewed.

(d) Appointments may be terminated by the Treasury after consultation with the CBI.

(e) Members may resign at any time by giving notice in writing to the Treasury.

(f) Casual vacancies, caused for example by resignation, shall be filled after consultation between the two parties as provided in (b) above.

6. The Secretariat necessary to service the Review Board shall, unless and until the Review Board shall recommend otherwise, be provided by the engagement of a firm of professional accountants, whose terms of appointment and terms of reference shall be determined by agreement between the Review Board, the Government and the CBI. If the Review Board recommends that it should employ other professional advice or staff of its own, the number, pay and conditions of these staff shall also be determined by agreement between the said three parties.

7. The arrangements for accommodating the Review Board and supporting staff shall be agreed between the Review Board, the Government and the CBI.

8. The Government shall determine, after consultation with the CBI, the remuneration of the Chairman and other Members of the Review Board.

[15] The Treasury's functions in relation to the Review Board were assumed by the Ministry of Defence in 1986.

Costs

9. The arrangements for meeting the running costs of the Review Board will be determined by agreement between the Treasury and the CBI in consultation when appropriate with the Review Board.

10. Costs incurred by Government departments, by contractors or by sub-contractors arising from reference of individual contracts or sub-contracts to the Review Board shall lie where they fall and those incurred by contractors or sub-contractors will be regarded as allowable costs in arriving at overhead rates.

Procedure

11. Subject to the arrangements set out below and agreed between the Treasury and the CBI as necessary for the review of individual contracts and sub-contracts and for the General Review, the Review Board shall determine its own procedures and all other matters not otherwise provided for in this paper.

Government Accounting Conventions

12. The evidence to be submitted by Departments, contractors and sub-contractors for the review of individual contracts or sub-contracts and by the Government and industry for the General Review shall be computed in accordance with the Government's accounting conventions. For individual contracts and sub-contracts the relevant conventions shall be those used in the pricing. If, as a result of the Interim Review by the Review Board, or discussions between the Government and the CBI adjustments are made to the conventions, such adjustments will be reflected in the annual returns as from a date agreed by the Government and the CBI.

Functions – Review of Individual Contracts and Sub-Contracts

13. In fulfilling its function of reviewing and giving rulings on individual contracts and sub-contracts, the Review Board will consider only Government profit formula risk contracts or sub-contracts, and further will consider only such contracts or sub-contracts as may be referred to it in accordance with the provisions of paragraphs 15, 16 and 17, of this paper. When a reference is made to it, the Review Board shall assess whether the price negotiated was fair and reasonable, and in the light of this assessment determine whether any payment should be made by one of the two parties to the reference to the other and, if so, how much.

14. For the purpose of interpreting the general direction given in paragraph 13 above and subject to the provisions of paragraphs 15, 16 and 17 below:-

(a) Government profit formula risk contracts comprise those contracts placed with contractors by Government departments which:-

(i) incorporate a condition (normally Standard Condition 48 in Form CCC/Stores/1) covering availability of information and requiring the contractor to provide information to the department on request in connection with post-costing investigation of the contract; and

(ii) include in the price an allowance for profit calculated at the rate for the time being applicable to risk work, that is to say at the rates set out in paragraph 4 of the Treasury's paper entitled 'Profit Formula Review – Arrangements agreed with industry to be applied from 26th February, 1968', or any such variation of that rate as may be determined in accordance with paragraphs 6 and 7(i) of that paper.[16]

(b) Government profit formula risk sub-contracts comprise sub-contracts placed by contractors for the purpose of and in connection with their own fulfilment of Government profit formula risk contracts, and such other sub-contracts as may be specified by the department under the terms of any contract. Sub-contracts placed by acceptance of the lowest competitive tender, or to which the non-risk rate of profit applies under sub-paragraph 13(c) of the Treasury's paper referred to in sub-paragraph (a)(ii) above, are not Government profit formula risk sub-contracts.

15. Government profit formula risk contracts will incorporate a condition (normally Standard Condition 50[17] in Form CCC/Stores/1) covering reference of the contract to the Review Board in certain specified circumstances: such a reference may be made either by the Government department or by the contractor or jointly by both these parties to the contract. Government profit formula risk sub-contracts of a value exceeding £100,000 (or on occasion of a lower value) may incorporate a similar condition: if so, the sub-contract may be referred to the Review Board either by the Government department concerned in the related main contract or by the sub-contractor or jointly by both.

16. A contract or sub-contract incorporating a condition such as is mentioned in paragraph 15 above may be referred to the Review Board by any party entitled to make such a reference if it appears from post-costing that a profit of or exceeding 27.5 per cent on capital employed or a loss of or exceeding 15 per cent on capital employed has been made on the contract or sub-contract in question. These figures do not of themselves involve any presumption of whether any payment should be made by one of the two parties to the reference to the other; it is not practicable to define a level at which profit automatically becomes excessive or loss unconscionable.

17. In exceptional cases, although the profit or loss made by the contractor or sub-contractor was not such as to justify a reference under the terms of paragraph 16 above, any party entitled to make a reference may do so if it considers that the achievement of a fair and reasonable price was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

18. For the purposes of paragraphs 13, 15, 16 and 17 above, and for acting upon the provisions in the conditions in contracts and sub-contracts which relate to

[16] This amendment to the original text of paragraph 14(a)(ii) was agreed between the Government and Confederation of British Industry on 14th September, 1971

[17] At MOD Standard Conditions have been replaced by DEFCONs

making references to the Review Board, notice of a reference to the Review Board shall have effect only on and from the date on which it is received by the Review Board's Secretariat and also only if:-

(a) the notice is in writing, identifying the parties to the reference, the contract or sub-contract being referred, and the specific circumstances which have occasioned the reference; and

(b) except when the reference is made jointly by both the Government department on the one hand and the contractor or sub-contractor as the case may be on the other hand, the party making the reference has simultaneously sent a copy of the notice to the other party to the reference.

19. In considering any reference to it of any individual contract or sub-contract, the Review Board shall have especial regard to:-

(a) the information available to the department, and to the contractor or the sub-contractor as the case may be, when the price was fixed; and

(b) the standard of efficiency with which the contract or sub-contract was performed.

20. Either party to a reference or both parties jointly may bring further considerations to the attention of the Review Board if these could in their view have a bearing on its deliberations. Relevant considerations might include for example:

(a) the degree of risk involved in performing the contract or sub-contract;

(b) the record of profits achieved or losses sustained by the contractor or sub-contractor on Government profit formula work over recent years;

(c) in references of sub-contracts by the department or the sub-contractor, respective responsibilities of the department, the contractor and the sub-contractor for the situation leading to the reference.

21. In connection with a reference to it of an individual contract or sub-contract, the Review Board may have occasion to consider a contingency provision which had turned out after post-costing to have been unnecessary in whole or in part. The Review Board shall examine such a provision only from the aspect of the situation at the time of price fixing and in doing so shall have especial regard to:-

(a) whether the contingency provision was openly declared and agreed at price fixing and accepted then by reference either to the need for a similar provision in a comparable previous contract or to previous experience or the length or complexity of the contract or the degree of technical innovation involved in the performance of the contract; and

(b) whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

22. The Treasury and the CBI have agreed the following framework, within which the Review Board would determine its own procedures, for the reference to the Review Board of individual contracts and sub-contracts:-

(a) The two parties to a reference shall present their evidence in writing to the Review Board and make it available to the other party. The Review Board shall decide whether it wishes the two parties to present further evidence whether written or oral, and whether it wishes to call for evidence from the main contractor on a sub-contract under reference, or from a sub-contractor when a main contract is under reference.

(b) References of individual contracts or sub-contracts may be examined and determined by the Chairman and two other members only one being a Member nominated by the Treasury and the other a Member nominated by the CBI.

(c) The Review Board shall give its decision on a reference in a written report signed by the Chairman to the parties to the reference. A copy shall be made available to the Treasury. In the event of disagreement between the other Members as to the quantum of an award, the Chairman's decision shall prevail. If any decision is not unanimous this shall not be revealed.

(d) The Review Board shall publish an annual report on its work. Decisions on all individual cases referred to it shall be included, with an assessment of the general considerations (in particular those listed in paragraph 19 above) which led to these decisions. The Review Board will not be obliged to publish the names of the contractors or sub-contractors concerned in these decisions. If the Review Board decides in any particular case to identify the parties to the reference it shall inform them of this decision in advance of publication of the annual report.

23. It will at all times remain open to Government departments and contractors/sub-contractors to agree to settle between them in any way any matter arising out of a contract/sub-contract which could be or has been referred as provided above to the Review Board. Whenever such a settlement is agreed upon, whether or not a reference has already been made to the Review Board and whether or not the terms of the settlement involve payment, any party to the settlement may report its terms to the Review Board for information. Any such report will, unless the parties to the settlement agree otherwise, be confined to statements of fact and will whenever possible be in a form agreed between the parties as part of the terms of the settlement.

Functions – The General Review

24. The Government and the CBI have agreed that the Review Board shall carry out a General Review which shall cover:-

(a) Industry's overall average earnings in the period 1st January, 1969 to 31st December, 1971 (based on contractor's annual accounts for the three financial years ending in that period), and at three yearly intervals thereafter, on Government contracts to which the revised profit formula referred to in paragraph 1 above applies, taking risk contracts and non-risk contracts separately.

(b) The revised profit formula referred to in paragraph 1 above (or the profit formula as further revised in the light of any subsequent modifications) in order to ascertain whether its use has achieved:-

(i) the general intention of giving overall average earnings on Government profit formula work equivalent to the overall average earnings of manufacturing industry on its other work, on the assumption that the necessary statistics on the latter can be made available to the Review Board to enable the appropriate comparison to be made;

(ii) the specific aim for the period under review which the profit formula rates in force at the time of the review are intended to achieve (for the period up to the first review the agreed yardstick is a figure of 14 per cent on capital employed).

This review – from now on in this paper called the General Review – will result in a written report from the Review Board to the Treasury, containing its recommendations for future action. The report will be made simultaneously available to the CBI for consideration by industry. The Government and the CBI have agreed that the report will form the basis for discussion between them.

25. It is the intention of the Treasury and the CBI that the following information, required to enable it to carry out the General Review, should be made available to the Review Board:-

(a) Annual returns from contractors selected by the Review Board accompanied by a copy of their audited financial accounts. (Departments will disclose the pattern of the contracts they place with the contractors engaged in profit formula work in the form and detail required by the Review Board to enable it to obtain adequate coverage of the field in determining those contractors from whom such reports will be required. The names of these contractors will then be passed to the CBI which, in conjunction with the trade associations concerned, will use its best endeavours to ensure that each contractor provides the Review Board with an annual return to enable the General Review to be carried out.)

(b) These annual returns, made out in the form required by the Review Board, shall be accompanied by a report from the contractor's auditors and shall comprise:-

(i) A statement, analysing the financial accounts figures for sales, cost of sales and profit or loss (expressed as a percentage on cost of sales) under the following headings:-

(A) Government profit formula work priced under the new arrangements, divided between work which incorporates:-

(1) the risk rates of profit; and

(2) the non-risk rates of profit.

(B) Other work.

(ii) If it is not apparent on the return, a reconciliation of the figures on the statement with the audited financial accounts.

(iii) A statement showing the total of adjustments in respect of contracts invoiced in prior years.

(iv) A statement on the adjustments made to the figures on the return in order to comply with Government accounting conventions.

(v) A statement showing the overall average ratio of cost of production to capital employed (CP:CE ratio) in the year, as computed for the purpose of Government contracts, confirming that they have been agreed with the Government departments concerned, or recording that the figures have not been agreed or that items are in dispute.

(vi) A statement showing the basis on which apportionments have been made in the annual return as between Government profit formula risk contracts and non-risk contracts and other work.

(Notes for the guidance of contractors in completing their annual returns will, in due course, be agreed between the Review Board, the Government and the CBI.)

26. The Review Board will, on the basis of these annual returns, provide the Government with annual reports setting out the overall average percentage of profit related to average capital employed divided as between risk and non-risk contracts for the contractors furnishing returns; no return so made by any individual contractor will be made available in any way to any Government department.

27. The Review Board shall, on the basis of these annual returns and its annual reports to the Treasury based on these returns, review the Government profit formula at three-yearly intervals. In conducting these General Reviews the Review Board may take account not only of the submissions made to it by the Government and those organisations representing industry generally or any particular industry but also of any representations made to it by any person or body it wishes to consult. The Review Board, taking account of the effect of the Governments accounting conventions, shall then advise whether:-

(a) the Profit Formula has achieved its agreed objective for the three years under review in the light of the evidence of actual earnings on Government profit formula work, both risk and non-risk;

(b) the agreed objective requires any modification;

(c) the profit formula rates for the risk and non-risk work require modification for the next three years in the light of its advice on (a) and (b) above.

APPENDIX B (see paragraph 108)

THE PROFIT FORMULA AGREEMENT

Profit Formula Review – arrangements agreed with industry to be applied from 26th February, 1968

Aim of the formula

1. The Chief Secretary informed the House of Commons on 26th February, 1968 that the Government and industry had agreed that the aim of the formula to be applied to non-competitive Government contracts should be to give contractors a fair return on capital employed; that is to say, a return equal on average to the overall return earned by British industry. The yardstick which it has been agreed shall be used for the period up to the first General Review (see paragraph 6 below) is the average of industry's earnings over the last seven years for which figures are available. These figures, which are derived from Board of Trade figures adjusted by the Monopolies Commission to the historic cost basis, are:

1960	16.6%
1961	14.0%
1962	12.6%
1963	13.5%
1964	14.7%
1965	13.9%
1966	12.0%

The unweighted average for the seven years 1960 to 1966 comes to 13.9%. This gives the yardstick of 14% on capital employed (that is, 13.9% rounded) to which the Chief Secretary referred in his statement.

2. The Government has expressed the view that in non-competitive Government contracts, the accounting conventions which it adopts for the purpose of computing capital employed and for determining what expenditure can properly be included in costs have the effect of yielding to contractors a higher return than would be the case if the accounting conventions employed by industry were adopted. The Government therefore wishes to adopt a lower figure than 14% when computing a return on capital employed based on the Governments accounting conventions. This view has not been accepted by industry and, as stated in paragraph 7 below, this matter is being referred for early decision to the Review Board for Government Contracts. As a compromise pending this decision, and without prejudice to the principle involved, a return on capital employed of 13.33%, computed on the basis of the Governments accounting conventions, has been agreed for the purpose of pricing non-competitive Government contracts, and this memorandum is based on this figure.

Background to the new profit rates

3. The modified formula rates are based on the following points:

(a) The 14% yardstick is to apply to risk and non-risk Government work taken together.

(b) There must be an adequate differential between the rates for risk work and those for non-risk work: it follows that the rate for risk work must be above the target and that for non-risk work below it.

(c) The average Cost of Production: Capital Employed ratio for contractors engaged in profit formula work is 1.33:1.

(d) Non-risk work is one-third of the total of profit formula work.

(e) The existing Government accounting conventions are to remain in force.

At the end of three years all these points will be reviewed by the Board. Points (c) and (e) are to be reviewed before then.

New profit formula

4. A new profit formula, expressed in the terms of the Governments accounting conventions will be applied to non-competitive Government contracts let on or after 26th February, 1968. The new rates set out below will be applied to risk contracts priced under the new Standard Conditions and to non-risk work provided it is carried out after that date on contracts for which no arrangement for profit had then been agreed.

Risk work:
11% on capital employed plus 3% on cost, providing (on the basis of the 1.33:1 ratio referred to in paragraph 3(c) above) an average rate of 15% on capital employed.

Non-risk work:
8% on capital employed plus up to 3% on cost for efficiency, 1.5% being the intended average addition on cost. This provides (on the basis of the 1.33:1 ratio referred to in paragraph 3(c) above) an average return of 10% on capital employed.

For risk work the full 3% on cost will be allowed (see paragraph 13(d) below), whereas for non-risk work it is intended that half the efficiency allowance of 3% on cost should be allowed for average efficiency with up to the full 3% being given for more than average efficiency and the allowance reduced below 1.5% or withheld only when circumstances so warrant.

In converting the foregoing formula rates to the percentages on costs which are to be applied to the costs of individual contracts the rate on capital employed should be converted by application of each contractor's ratio of capital employed to cost of production, computed on the basis used hitherto. For the information of contractors, illustrations are to be given by the CBI in the form shown in the Appendix hereto [the form suggested is no longer appropriate and has been replaced by the illustrations at Appendix E].

The above rates replace the previous profit formula which was in force prior to 26th February, 1968:

> *Risk work:*
> 7.5% on capital employed plus up to 4% on cost, with a ceiling on capital employed of 15%.
>
> *Non-risk work:*
> 7.5% on capital employed plus up to 2% on cost, with a ceiling on capital employed of 10%.

Contingencies

5. The Government and industry have agreed that under the new contract conditions providing for equality of information and post-costing it will still be necessary to include reasonable and justifiable contingency provisions in estimated costs for the purpose of fixing prices based on estimates. In order as far as possible to avoid both over-estimating and under-estimating contingency provisions, the following principles should be taken into account by both sides:

(a) Equality of information and post-costing do not lessen the need for contractors to include reasonable contingency provisions in their price estimates, but increase the need for these provisions to be separately identified and justified by reference to previous experience, the length of the contract, its complexity, or the degree of technical innovation involved.

(b) It is intended that the prices negotiated should on average result in profits being earned at the rates set out in paragraph 4 above, and that higher rates should be achieved in contracts carried out with above average efficiency, but consistent over-provision for contingencies cannot be regarded as a legitimate means of attaining above average profits.

(c) There may be occasions when a contingency provision openly declared and agreed at price fixing and accepted by reference either to the need for a similar provision in a comparable previous contract or to any of the reasons listed in (a) above turns out after post-costing to have been unnecessary in whole or in part. In such cases, the basic consideration is whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

(d) If there is too much uncertainty to enable fair and reasonable prices to be fixed with appropriate contingency margins incorporated, the use of incentive contracts with profit sharing provisions should be considered.

Review

6. In order to review the effect of the new arrangements after they have been in operation for three years, it will be essential to review the evidence of industry's

actual average earnings on Government non-competitive risk contracts and non-risk contracts so as to relate them to:

(i) the aim that the formula should achieve the average earnings of 14% referred to above;

(ii) the most recent appropriate evidence of the average earnings of British manufacturing industry.

For this purpose a Review Board for Government Contracts is to be established, comprising members nominated by the Government and by industry. Arrangements will be made for Government contractors to submit reports annually to the Board showing the average profits derived on non-competitive risk and non-risk Government contracts. At the end of three years the Board will conduct a comprehensive review of the formula and make recommendations to the Government. This review and subsequent reviews will consider both the target and the formula rates required to achieve it. The Board will not make available to the Government any of the contents of the reports received from individual firms, but the average results for all firms will be notified by the Board to the Government.

Interim Review

7. In addition to the comprehensive review mentioned above, which will be concerned with the level of profits actually achieved under the new formula, the Government and industry have agreed to accept the conclusions of the report which the Board will be requested to make, not more than a year after it is set up, upon the following matters:

(i) The difference of view between the Government and industry which is referred to in paragraph 2 above, and what consequential adjustment, if any, is needed to be made to the formula set out in paragraph 4 above so as to arrive at the agreed 14% target. If the Board decides that a change in profit rates in the formula set out in paragraph 4 above is required, then the profit rates will be adjusted prospectively either upwards or downwards for contracts placed after the date of the Board's decision and up to the date of the comprehensive review. Apart from any adjustments arising under this and the next three sub-paragraphs, no other adjustments to the profit rates will be made pending the full and comprehensive review referred to in paragraph 6 above.

(ii) Whether a change is needed in the ratio of cost of production to capital employed of 1.33:1 which has been previously agreed (see paragraph 3(c) above).

(iii) Whether certain costs which are at present not accepted as charges to Government contracts should in future be so accepted, and whether the allowances for depreciation included in costs should be based on the depreciation charges made by contractors in their accounts instead of by reference to Inland Revenue rates.

(iv) Whether any, and if so what, change should be made in the treatment of (a) investment grants for the purposes of assessing the capital employed by Government contractors and (b) investment grants and other selective incentives for the purposes of overheads – if the discussions which have already been started between industry and the Treasury have not resolved this problem.

Excessive profits and unconscionable losses on risk contracts

8. Since it is not practicable to define a level at which profit automatically becomes excessive or loss unconscionable, owing to widely varying circumstances from case to case, it has been agreed that the Review Board should consider individual contracts referred to it by either side where the profit made comes to 27.5% or more on capital employed, or the loss on capital employed comes to 15% or more. These figures do not themselves involve a presumption of reimbursement. But in such cases, or in exceptional cases within these percentages where either side considers that the achievement of a fair and reasonable price was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete, it will be for the Board to determine the level of any reimbursement by or to the contractor. All risk contracts will in future contain a clause binding both parties to accept the decision of the Board.

Equality of information and post-costing

9. Risk contracts placed on or after 26th February, 1968 will incorporate new contractual conditions giving the Government the right to equality of information and post-costing of individual contracts. Equality of information will be provided for in a new version of Standard Condition No. 43, 'Condition No. 43 – Price Fixing (revised July 1968)', of Form CCC/Stores/1, and post-costing will be covered in a Standard Condition, 'Condition No. 48 – Availability of Information' to be inserted in Form CCC/Stores/1. It is intended that as a result of equality of information the Government and the contractor will be in the same position at the time the price is fixed. The Government will not normally expect more information from a contractor than is available to him up to the time of fixing the price. The Government must have access to information adequate for price fixing purposes. In general, this will be information from the contractor's normal accounting system. The Government will therefore limit any demand for further information to what can reasonably be shown to be necessary for price fixing purposes. [At MOD, SCs 43 and 48 have been replaced by DEFCONs 643 and 648, see Explanation of Terms.]

Use of Standard Conditions [At MOD, Standard Conditions have been replaced by DEFCONs, see Explanation of Terms]

10. SC 43 1968 edition will be used where prices have not been agreed at the time the contract is made whenever it is the intention to negotiate an incentive price arrangement, including a fixed price, as soon as practicable.

SC 48 may be used:

(i) in conjunction with SC 43 or

(ii) in contracts on which fixed prices were agreed at the time the contract was made, except in the following circumstances:

a. where the price had been determined as a result of competitive tendering;

b. for purchase of proprietary articles for which a competitive general market price exists;

c. in contracts of small value. The minimum of £25,000 for sub-contracts is an indication of this intention, but it is not possible to define small value for all contracts; it must depend on the circumstances of the contract.

This can only be a general statement and cannot cover all situations which vary with individual contracts. A combination of circumstances may occur in one contract requiring individual consideration. Since it will often be impossible to foresee future circumstances, it will be usual to include SC 48 in all contracts except those specified at (a), (b) and (c) above and also except in contracts containing SC 54 or Form 6/77. In any case, the inclusion of the conditions in any particular contract remains a matter of negotiation between the parties.

Exercise of post-costing rights

11. The post-costing rights under SC 48 will be exercised for the following purposes only:

(i) In pricing follow-on contracts, as an essential element in equality of information.

(ii) To enable departments to check the accuracy of their estimating procedures.

(iii) To provide the information for a selective scrutiny of the outcome of particular contracts so that reference may be made by either side to the Review Board.

It does not necessarily follow that the right to post-cost must always be exercised whenever this condition is included in the terms of a contract; there should be selectivity, so that no undue burden is placed either on departments or on contractors.

Transitional arrangements for risk contracts

12. (a) Contracts placed but not priced before 26th February, 1968. Departments are authorised to use the new risk rates on contracts placed before 26th February, 1968 but unpriced at that date, provided that they are satisfied that the contractor has voluntarily given access to equality of information within the terms of the revised Standard Condition 43 in Form CCC/Stores/1.

(b) Follow-on contracts placed on or after 26th February, 1968. If the contractor is prepared to volunteer post-costing information on the previous contract (to be used solely to establish the new price, not to judge the profit on the previous price), it would be possible to fix the price for the follow-on contract early. If the contractor is not prepared to concede voluntary post-costing information, departments may not find it possible to fix prices early and may have to issue an 'Instruction to Proceed' incorporating the revised SC 43.

General Provisions

13. (a) Both the Government and industry attach considerable importance to the need to fix prices as early as practicable. Where there is unreasonable delay in fixing prices, there will in the last resort be a right to appeal to Ministers by contractors.

(b) In all cases where pricing is possible in advance of work, fixed prices (or incentive target price arrangements) should be used. In other cases fixed or incentive target prices should be negotiated as soon as practicable.

(c) Cost plus arrangements with non-risk rates, which have disadvantages in lack of incentive to both sides, should be reserved for those contracts where there is no alternative. The non-risk rate is applicable only to cost plus contracts and for negotiating the fee in cost plus fixed fee for profit. Cost plus contracts subject to a maximum price are risk contracts.

(d) It is the intention to identify risk contracts at the time when instructions are given to proceed and, having made the initial decision to price on estimates, not to vary the allowance for risk because of delays in agreeing prices.

Effective date of future adjustments to the profit formula

14. The Government and industry have agreed that if adjustments of the profit formula rates upwards or downwards are required after future reviews, including the interim review, these adjustments should be applied in the same way to contracts which are not complete in the sense that the price has not been fixed. Adjustments would therefore apply to:

(a) risk contracts where no price arrangement has been agreed on the date the adjustments take effect;

(b) non-risk work carried out after that date for which no arrangement for profit has been agreed by that date.

APPENDIX C (see paragraph 113)

1968 MEMORANDUM OF AGREEMENT AND THE FUNCTIONS OF THE REVIEW BOARD

Joint Statement by the Ministry of Defence and the Joint Review Board Advisory Committee – November 1991

1. Discussions have been held between the Ministry of Defence (acting on behalf of HMG) and the Joint Review Board Advisory Committee Negotiating Team (acting on behalf of industry) about the functions of the Review Board.

2. Both parties (the MOD and the JRBAC) agree to the continuation of the 1968 Memorandum of Agreement and the retention of the Review Board. These provide the significant mutual benefits of a fair rate of return on capital employed (based on the principle of comparability), the employment of agreed accounting conventions, a mechanism for dealing with cases of 'excess' profits or 'unconscionable' losses and equality of information when fixing prices.

3. The MOD and the JRBAC agree that, notwithstanding the existing requirement for the Board to recommend a single figure for the target rate of profit, the 1968 Agreement provides the scope for direct negotiations between the parties following receipt of the Review Board's report. Both parties wish to adopt new arrangements to facilitate such negotiations.

The New Arrangements

4. Important changes to the modus operandi of the Board will be made to encompass the above. In future:

(a) The Board will continue to collect and analyse data and to receive submissions from both parties as in the past.

(b) Following (a) the Board will submit its report to the parties indicating inter-alia the range within which (or if more appropriate the level at which) in the opinion of the Board, based on the principle of comparability (but taking into account and separately identifying any other relevant considerations in accordance with the agreement set out in paragraph 405 of the Report on the Sixth General Review), a target rate of return fair to both parties should be established, and the profit formula which should result from this.

(c) This Report will be provided by the Board to both parties on a strictly confidential basis.

(d) Representatives of both parties will convene to discuss the Report and will seek to agree a target rate of return and resultant profit formula, consulting the Board as necessary on matters of facts or interpretation or as otherwise agreed by both parties and:

(i) if agreement is reached, notify the Board accordingly;

(ii) should agreement not be reached the MOD will decide the target rate of return, and the profit formula, having regard to the recommendations of the Board, its negotiations with the JRBAC and any other factors. Before announcing its decision the MOD will advise industry of the proposed rate and the reasons for arriving at such rate and will allow industry the opportunity to present its case at more senior level in the Ministry should it elect to do so.

(e) Once a target rate of return and profit formula have been established under these arrangements, the MOD will announce the result, notify the Board and arrange publication of the Board's Report to include in an annex the final profit formula whether agreed under 4(d)(i) or determined under 4(d)(ii).

5. The new arrangements will apply, in principle, to the negotiation of prices for all non-competitive Government contracts.

6. It should be noted, however, that the MOD has advised the JRBAC of its intention to adopt a more market-orientated approach to the negotiation of prices for its high value non-competitive contracts (which the MOD presently intends to define as those worth more than £10 million) before these are placed, and that it expects the parties to these contracts to have due regard to the Government Accounting Conventions and profit formula but also take into account any other factors which they may consider relevant. The arrangements for placing and pricing these high value contracts will be the subject of discussions between the MOD and Industry and will be considered by the Review Board in its Seventh General Review (see below).

7. The parties agree that, except for the changes described in paragraph 4 above and any other changes resulting from the discussions referred to in paragraph 6 above, the functions and procedures of the Board should continue as at present.

The Next Review

8. The Board will be asked to undertake a further review of the profit formula based on the arrangements as described above. The parties believe that the next review (the Seventh General Review) should commence this year, and should consider, inter-alia, the following:

(a) Whether it would be appropriate, and practicable, to widen the Reference Group to include non-UK companies.

(b) Whether it would be more appropriate for comparability to be assessed at each review (whether general or annual) on a rolling average basis (perhaps over a period of at least three years) than on the present annual basis.

(c) Whether the target range should have regard to forecast trends in profitability of the Reference Group.

(d) The proposed new arrangements for placing and pricing high value contracts (see paragraph 6 above) and whether, in particular, it would be appropriate to revise the present arrangements for ensuring there is equality of information at the time of pricing and/or to amend present definitions of ‘excess’ profit and ‘unconscionable’ loss for such contracts.

Subsequent Reviews

9. The parties expect that after the Seventh General Review, the Board will revert to its previous pattern of triennial General Reviews, with limited Annual Reviews in the intervening periods.

APPENDIX C: ANNEX I

THE PRINCIPLE OF COMPARABILITY

Extract from paragraph 405 of the Report on the Sixth General Review

In their capacities as representatives of the parties to the 1968 Memorandum of Agreement, MOD and the JRBAC agreed that the following provisions should apply to the current and to future reviews of the profit formula:

> 'The Board in its future reviews of the profit formula will recommend an overall target rate of return which accords strictly with the principle of comparability; that is a target rate in strict conformity with the aim of the profit formula arrangements agreed in 1968 to give contractors a return on capital employed equal on average to the overall return earned by British Industry.'
>
> 'The Board will in addition be expected to bring to notice in its reports any considerations which it regards as relevant to the operation of the profit formula. This would include, should the occasion arise, respects in which the Board might wish to draw attention to any perceived ill-effect for either party, or for both, deriving from strict observance of the comparability principle and to make further recommendations which should be separately identified. But any such recommendations should not be allowed to override the formal application of the comparability principle itself without prior consultation with the parties.'

APPENDIX D (see paragraph 110)

STATEMENT ISSUED BY MOD AND THE JRBAC CONCERNING THE 1999 GENERAL REVIEW AND ALSO THE ACCOUNTING BASIS TO BE USED FOR THE PROFIT FORMULA

1. The Government's consideration of the Review Board's report on the 1999 General Review of the Government profit formula has been suspended, pending the outcome of a review by Government of whether the profit formula continues to offer the best mechanism for rewarding contractors undertaking work on non-competitive Government contracts.

2. In order to facilitate pricing of non-competitive contracts in the intervening period, the following arrangements will apply:

– the Review Board's recommendations contained in the 1996 General Review of the profit formula accepted by Government on 1 April 1996 as supplemented and/or amended by

(a) the Review Board's recommendations contained in the 1998 Annual Review of the profit formula accepted by Government on 6 May 1998; and

(b) the following amendments to and/or clarification of the Government Accounting Conventions recommended in the Review Board's 1999 General Review (not yet published):

– in GAC 1 delete "to make the following adjustments" and insert "to adopt costs charged in accordance with UK GAAP subject to the following adjustments"

– in GAC 4, after the "period under review", insert "on a basis consistent with the company's accounts in accordance with UK GAAP"

– the treatment of Bonuses paid in cash or kind shall be in accordance with the clarification provided by paragraphs 605-608 of the Board's report on the 1999 General Review

– to the existing "Explanation of Terms" should be added the following:

– SORP – Statement of Recommended (Accounting) Practice relating to specialised sectors.

– UITF 17 – Urgent Issues Task Force Abstract 17 Employee Share Scheme. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment of various issues.

– UK GAAP – UK Generally Accepted Accounting Practice. There is no formal definition of UK GAAP, but in simple terms it means compliance with UK company law and accounting standards (including UITF abstracts and SORPs).

V D Taylor	S L Porter MCIPS FRAeS
Chairman	Director General Commercial
Joint Review Board Advisory Committee	Ministry of Defence

September 1999

APPENDIX E (see paragraph 523)

THE RECOMMENDED PROFIT FORMULA – ILLUSTRATIONS

Prepared by the Review Board for Government Contracts – February 2004

This appendix provides:

- some illustrations on the use of the recommended profit formula to determine the profit allowance for individual contracts; and
- some guidance on the application of the risk/reward matrix.

Illustrations

Set out in Annex I to this appendix are a range of illustrations on the application of the recommended profit formula assuming:

(a) a CP:CE ratio of 3:1 and a Baseline Profit at the standard rate

(b) a CP:CE ratio of 6:1 and a Baseline Profit at the standard rate

(c) a CP:CE ratio of 1.5:1 and a Baseline Profit at the standard rate

(d) a CP:CE ratio of 1.5:1 and a Baseline Profit 10 per cent below the standard rate

(e) a CP:CE ratio of 1.5:1 and a Baseline Profit 10 per cent above the standard rate

Annex II to this appendix provides an illustration on the application of the recommended profit formula on contracts with a value of £50 million or more.

Guidance

The following guidelines have been agreed by MOD and the JRBAC to give an indication of the types of activity that are intended to fall into the various categories set out in the risk/reward matrix. It is intended that this guidance be expanded over time in the light of actual experience.

Supply contracts:

Production that does not relate to a proven 'type' or 'mark' should attract the standard rate +10 per cent.

'Interrupted production' applies in instances where interruption in production has resulted in significant set-up costs having to be incurred and where significant skills retraining is also required.

The profit rate for spares contracts will depend on the particular circumstances. For example, the first production batch of spares might attract a profit rate of the standard rate plus 10 per cent unless the spares order follows on after the contract for the supply of the first batch of equipment and the spares specification remains unchanged in which case it would be expected to be classified as a repeat order attracting the standard rate less 10 per cent. A spares contract which follows sometime after the supply of the equipment and involves some modification to the specification is likely to attract the standard profit rate.

The term ‘Repeatable quality’ would typically relate to ‘build to print’ contracts involving proven processes.

Contracts for support/service provision

The term ‘Repeatable quality’ would typically relate to standard processes such as routine maintenance.

The term ‘High maintainability standards’ will typically reflect contracts for bespoke or rapid response.

Contracts involving ‘Long term commitment to Service and Capability provision to a defined output standard’ attract the standard profit rate plus 10 per cent provided the commitment is to the overall capability and not just to certain elements.

Development contracts

The term ‘Minor development’ would typically apply where the development has little or no effect on the performance or functionality of the product or service.

‘Development work’ in the ‘standard profit rate’ category is likely to require something in excess of minor modifications and might be typified by, say, the requirement for new design certification.

APPENDIX E: ANNEX I

ILLUSTRATIONS OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA

	Example 1	*Example 2*	*Example 3*	*Example 4*	*Example 5*
CP:CE ratio calculation:					
(A) Fixed capital (50%)	1,500,000	750,000	3,000,000	1,500,000	1,500,000
(B) Working capital (50%)	1,500,000	750,000	3,000,000	1,500,000	1,500,000
(C) Total capital (A + B)	3,000,000	1,500,000	6,000,000	3,000,000	3,000,000
(D) Total cost of production	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000
(E) CP:CE ratio is therefore (D/C)	3	6	1.5	3	3
CSA calculation:					
(F) FCSA	7.30%	7.30%	7.30%	7.30%	7.30%
(G) FC proportion (A)	50.00%	50.00%	50.00%	50.00%	50.00%
(H) (F x G)	3.65%	3.65%	3.65%	3.65%	3.65%
(I) WCSA	5.67%	5.67%	5.67%	5.67%	5.67%
(J) WC proportion (B)	50.00%	50.00%	50.00%	50.00%	50.00%
(K) (I x J)	2.84%	2.84%	2.84%	2.84%	2.84%
(L) CSA (H + K)	6.49%	6.49%	6.49%	6.49%	6.49%
(M) CSA as percentage of CP ((C x L)/D)	2.16%	1.08%	4.33%	2.16%	2.16%
Individual contract price:					
(N) Contract CP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
(O) Baseline Profit	5.67%	5.67%	5.67%	5.10%	6.24%
(P) CSA (M)	2.16%	1.08%	4.33%	2.16%	2.16%
(Q) Total formula payments (O + P)	7.83%	6.75%	10.00%	7.26%	8.40%
(R) Total formula payments (N x Q)	78,300	67,500	100,000	72,600	84,000
(S) Total contract price (N + R)	1,078,300	1,067,500	1,100,000	1,072,600	1,084,000

Explanation:
The table shows examples of the profit formula payments payable on a contract with costs of £1,000,000, in a variety of circumstances. Example 1 assumes that the standard baseline profit of 5.67% is applicable and the contractor's CP:CE ratio is 3:1. Examples 2 and 3 illustrate how payments will change for contractors with varying CP:CE ratios. Examples 4 and 5 illustrate how payments change for contracts in the risk matrix (see Section V) attracting Baseline Profit 10 per cent below and 10 per cent above the standard rate.

APPENDIX E: ANNEX II

ILLUSTRATION OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA UNDER THE SPECIAL ARRANGEMENTS FOR CONTRACTS IN EXCESS OF £50 MILLION

Contractor's CP:CE ratio:			
(A) Fixed capital (80%)		24,000,000	
(B) Working capital (20%)		6,000,000	
(C) Total capital (A + B)		30,000,000	
(D) Total cost of production		90,000,000	
(E) CP:CE ratio is therefore (D/C)		3:1	
CSA calculation:			
(F) FCSA		7.30%	
(G) FC proportion (A)		80.00%	
(H) (F x G)		5.84%	
(I) WCSA		5.67%	
(J) WC proportion (B)		20.00%	
(K) (I x J)		1.13%	
(L) CSA (H + K)		6.97%	
(M) CSA as percentage of CP ((C x L)/D)		2.32%	
Individual contract price:			
(N) Contract CP		75,000,000	75,000,000
(O) Baseline Profit rate	5.67%		
(P) Reduction for contracts over £50m	0.30%		
(Q) Standard Baseline Profit (O – P)		5.37%	
(R) CSA (M)		2.32%	
(S) Total formula payments (P + Q)		7.69%	
(T) Total formula payments (N x S)		5,767,500	5,767,500
(U) Total contract price (N + T)			80,767,500

Explanation:
Section V includes an explanation of the 30 basis point reduction to the Baseline Profit for contracts with a value over £50 million. The above table illustrates the profit formula elements payable to the prime contractor on one of these contracts, the reduction is shown in row (P). The illustration assumes a £75 million contract and a CP:CE ratio of 3:1. It also assumes that standard Baseline Profit is not adjusted by the risk/reward matrix for this contract.

APPENDIX F (see paragraph 720)

ACCOUNTING CONVENTIONS FOR NON-COMPETITIVE GOVERNMENT CONTRACTS

Incorporating the revisions recommended in this report

Overhead Costs Attributable to Government Work

1. In assessing contractors' claims for overhead costs on non-competitive Government work current practice is to adopt the costs charged in the contractors' accounts subject to any adjustment required in order to comply with UK GAAP and subject to the following further adjustments:

1(A) Items which are normally totally excluded:

1(A)1 Generally, any expenditure of a capital nature, any general reserves not allowable for tax purposes and any distributions of profit.

1(A)2 The cost of raising and servicing capital, including short-term financing and finance leases, as the capital so raised is serviced out of profit.

1(A)3 Bad debts and any provision therefore, unless they arise on Government sub-contracts.

1(A)4 Discounts allowed on sales, which are treated as abatements of selling prices.

1(A)5 Insurance of credit and goods in transit and any other related to civil work risks for which cover is not required in the case of Government work.

1(A)6 Agents' commissions. These are regarded as charges recoverable against the particular civil sales that result from these expenses.

1(A)7 Outward carriage of finished products. Most Government contracts are priced ex-works: in other cases the cost of delivery would be directly charged.

1(A)8 After Sales Service (where attributable to a specific product).

1(A)9 Notional transactions.

1(A)10 Unnecessary, extravagant or wasteful outlays (the contractor is entitled to a full written explanation on the exclusion of this type of expenditure). In cases where only a small proportion of a contractor's turnover is made up of non-competitive Government contracts, there is a presumption that all expenses are reasonably incurred.

1(A)11	Loss of profits insurance (profit element only).
1(A)12	Royalties and licence fees where these can be identified as direct costs.
1(A)13	Costs related to assets excluded from capital employed in accordance with 4(A)1 below.
1(A)14	Subscriptions and donations of a political nature.
1(B)	Items which may be partially excluded:
1(B)1	Costs that are exceptional or abnormal in size and incidence may be spread over a period exceeding one year but not normally exceeding three years to mitigate the impact of substantial yet admissible costs. Costs spread forward in this way will be eligible for inclusion in capital employed under 4(A)2(G). Examples of this are:
1(B)1(a)	Compensation payments of an abnormal nature. If substantial, yet admissible, some forward spread may be necessary.
1(B)1(b)	Lump sum additions to pension schemes: generally allowed on the Inland Revenue basis (but spread over a number of years if substantial).
1(B)2	Research and Development is dealt with in accordance with a Guidance Document agreed between the Government and the Confederation of British Industry (Annex 1 to this Appendix).
1(B)3	Marketing and selling expenses (including salaried salesmen's commissions).
1(B)3(a)	Items listed as 1(A)3 to 8 above are types of cost which are commonly classed as marketing and selling expenses and which should be charged direct to particular contracts and thus generally excluded from attributable costs.
1(B)3(b)	All contractors should classify their marketing and selling expenses, as far as possible, in the same way. The precise degree of analysis required will vary from contractor to contractor and the details should be agreed with the Department concerned, but the following general classification is recommended:
1(B)3(b)(i)	Market research and advertising (of all kinds including exhibitions etc.).
1(B)3(b)(ii)	Selling expenses, analysed under
1(B)3(b)(ii)a.	Salaries and commissions (to staff) and retainers (to agents).

1(B)3(b)(ii)b.	Overheads (direct and administrative).
1(B)3(b)(ii)c.	Travelling expenses and entertainment.
1(B)3(b)(iii)	Technical and liaison, analysed under -
1(B)3(b)(iii)a.	Salaries and commissions (to staff).
1(B)3(b)(iii)b.	Overheads (direct and administrative).
1(B)3(b)(iii)c.	Travelling expenses and entertainment.

Where appropriate, expenses should include associated overheads. Where a group has a separate company or companies for the purpose, inter alia, of marketing products at home or abroad, the relevant marketing and selling expenses of such company or companies should be taken into account in arriving at the total expenses for which analysis is required.

1(B)3(c) As far as possible each of these categories of expenses should be identified to, and allocated to, appropriate product groups, except in those particular cases where it is realistic and appropriate to identify and allocate them to specific products. One or other such method of allocation should be practicable at least for a substantial proportion of the total expenditure, and any small proportion that cannot be so allocated should be susceptible to apportionment on an appropriate basis. The criteria that will determine that way in which the allocation or apportionment of any particular item of expense is to be made will depend on the facts of each case. The aim should be to ensure that the share of the total expenses borne by each product group or product fairly reflects the correct incidence of costs falling on the product groups or products which the expenditure was designed to benefit. What will constitute appropriate product groups or products must likewise depend upon the circumstances. Groupings as already established for his own purposes by a particular contractor and a contractor's established practices should be disturbed only when this is necessary to achieve a fair result.

1(B)3(d) Subject to the Department concerned being satisfied, having regard to all the circumstances, (i) that the method of classification, allocation and apportionment of expenses adopted by the contractor is fair and reasonable, and (ii) that no part of the expenses was unreasonably incurred, the full amount of the marketing and selling expenses charged should be accepted in calculating the overhead rate applicable, for Government pricing purposes, to each product group or product as the case may be.

1(B)4 Intra-group charges may be partially disallowed to the extent that they exceed actual costs incurred by the group, including depreciation on relevant assets.

1(C) Items treated as reducing overhead costs:

1(C)1 Credits, grants or refunds generally, in relation both to overhead items and also to direct cost items where the credit cannot be identified to a particular contract.

1(C)2 Shipbuilders' relief which will however continue to be treated as a direct credit to the contract price.

1(D) Other items:

1(D)1 The amount to be included for depreciation should be calculated at the contractor's own rates, provided they are consistent, reasonable, and relate to the tangible fixed asset values included in capital employed. The depreciation charge should either be calculated by reference to fixed asset values which have been reduced by the amount of investment grants, building grants or other capital grants received or, if it is calculated by reference to gross fixed asset values, then it should be reduced by the amount of deferred credit transferred to revenue in respect of such grants. In the year of disposal of a tangible fixed asset, the relevant depreciation charge should be adjusted to take account of any profit or loss on disposal calculated by reference to the book value of the asset arrived at on the basis of GAC 4. Amortisation of development expenditure carried forward should be treated as costs to be recovered under paragraph 6(b) of the Guidance Document at Annex 1.

1(D)2 General stock losses and obsolescence, including provisions which cannot be charged directly either to Government or civil work, should be included in attributable overhead costs. This convention requires that the contractor's costing system must provide for the isolation of those stock losses which are directly attributable to civil contracts as well as those that are attributable to Government contracts.

1(D)3 Redundancy payments in accordance with the rates laid down by statute will be included in attributable costs; reasonable redundancy payments in excess of such rates should also be included, provided they are made under the terms of a bona fide scheme.

1(D)4 Rationalisation and/or Plant Closures

Reasonable net costs incurred on rationalisation and/or plant closures should be included in attributable costs. Such costs may include:

1(D)4(a) Redundancy payments;

1(D)4(b) Employee relocation expenses;

1(D)4(c) Job creation scheme costs;

1(D)4(d) Transfer costs for equipment;

1(D)4(e) Education/learner costs on transferred work;

1(D)4(f) Disruption costs – waiting and idle time;

1(D)4(g) In the case of total or near total closure of a unit, excess or unabsorbed overheads.

Rationalisation and/or plant closure costs should be offset/supplemented by profits/losses from the disposal or alternative use of related assets, calculated on the following basis;

1(D)4(a) Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits should exceed such costs MOD should not be entitled to share in the excess.

1(D)4(b) The net profit/loss from asset disposals should be calculated by reference to the net book value of the asset concerned on a historic cost accounting basis, whether or not that basis has been used for non-competitive contract pricing purposes. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed.

1(D)4(c) Profits/losses should be calculated for this purpose at the time that rationalisation or plant closure takes place, based on sale proceeds, forecast sales proceeds or alternative use valuation as appropriate. Either party should be permitted to re-open this calculation within a limited period, if the assumptions upon which the original calculation was based prove to be materially inaccurate; such period should be a matter for agreement between MOD and the contractor, but should not, except in the exceptional case, extend more than five years after the date from which the asset concerned is excluded from capital employed for CP:CE ratio purposes.

Substantial net costs may be spread over a period of up to three years in accordance with clause 1(B)1.

Where a site is closed, the attributable net rationalisation and/or plant closure costs should be recovered in the overheads of the other sites in the same group gaining work as a result of the site closure. For this purpose "site" and "group" should be taken to include Joint Venture arrangements. The amount of the costs would be subject to agreement on a case by case basis between MOD and the contractor.

2. It will be appreciated that it is not possible to produce an exhaustive list covering all the adjustments which may from time to time be required in computing overheads on non-competitive Government contracts. Nor is it possible to lay down absolutely fixed rules, given the varying circumstances prevailing within the

different organisations. Whenever partial disallowance of any specific items of expense is proposed, whether under 1(B), 1(D) or 2, the contractor is entitled to a full written explanation of the reason for the proposed disallowance.

Capital Employed

3. For the purpose of computing a contractor's capital employed the aim will be to identify the most relevant unit of a contractor's business relative to the contract (e.g. subsidiary company, sub-group, division, geographical location etc.). If, exceptionally, separate figures cannot reasonably be made available the capital employed is calculated for a contractor's business as a whole.

4. Provided no further adjustment has taken place in Group Accounts, a contractor's total capital employed is taken as the average of his total net assets as shown in the relevant balance sheets for the entity as described in convention 3 above for the period under review (based on the company's accounts subject to any adjustment required in order to comply with UK GAAP), adjusted for the following where relevant:

4(A) Assets

4(A)1 Exclude:

4(A)1(a) Goodwill (an investment in aid of future profits) and preliminary expenses.

4(A)1(b) Adverse (debit) balance on profit and loss account.

4(A)1(c) Investments in shares and securities being capital not employed in the business.

4(A)1(d) Shares held in and permanent loans to subsidiary companies (trading balances are included in capital employed) being capital not employed in the business of the parent Company.

4(A)1(e) Cash demonstrably surplus to requirements (i.e. short term investments; deposits; and cash demonstrably in excess of the amount required for working cash resources for day to day operations).

4(A)1(f) Land and buildings not in occupation and plant and machinery demonstrably not in use where held for speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposal of surplus assets.

4(A)2 Other adjustments (these may result in either an addition to or a deduction from balance sheet figures, according to the circumstances):

4(A)2(a) Investment grants, building grants, other capital grants and depreciation are to be deducted from gross asset values for capital employed purposes whatever the basis of valuation used. Where intra-group charges fall to be considered under convention 1(B)4 it may be necessary to include an appropriate proportion of the value of the asset concerned. Where fixed assets have been acquired under finance leases, which are capitalised in accordance with the requirements of Statement of Standard Accounting Practice 21 or any successor, the assets will be treated for all purposes as if they had been purchased by the contractor. The total amount included in the balance sheet as being due to the lessor in relation to the costs of the asset will be treated as capital employed i.e. not deducted from assets.

4(A)2(b) The net balance sheet figure for stocks and work in progress is included in capital employed at a historical cost valuation subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by auditor attestation. If a company has not already done so in its balance sheet, interim payments on account of work in progress are deducted therefrom in accordance with 4(A)2(e).

4(A)2(c) Patents and trade marks may be included in capital employed on a consistent and reasonable basis to the extent that a company can demonstrate that they are 'live' and contribute to its earnings, although not shown in the company's balance sheet.

4(A)2(d) Development expenditure – mainly on private venture work – may be included in capital employed up to the value shown in the balance sheet 'net' of provisions provided orders have been received, or are likely to be received, for the product under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.

4(A)2(e) Advance payments received from customers prior to the company's performance of the sales contract are treated as capital employed, i.e. not deducted from assets, subject to an appropriate transfer being made from advance payments to progress payments, in accordance with the billing arrangements of the contract wherever possible, or failing that, pro-rata to the value of work-in-progress in the same proportion as the total advance payments bear to the contract price. Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed. Prepayments by the Government on non-competitive contracts, calculated after adjusting the contractor's work in progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted except where otherwise agreed.

4(A)2(f) Certificates of tax deposit purchased before the effective date for implementation of the recommendations of the Fifth General

Review [1987] are included as capital employed up to, but not exceeding, an estimate of two years' outstanding liability for tax. All certificates purchased after that date are excluded from capital employed.

4(A)2(g) Where semi-capital items are written off to overheads, some spread over several years may be called for. Any amount not written off at a balance sheet date will be included as an asset in capital employed subject to any adjustment required to take account of the revaluation of fixed assets.

4(A)2(h) The net balance sheet figure for debtors is included in capital employed, although balance sheet figures of debtors will be adjusted for increases or decreases becoming known after the balance sheet date, due to any revision of prices. Such adjustments may relate to non-Government contracts as well as to Government contracts of all kinds.

4(B) Creditors and other general adjustments:

4(B)1 All loans which are interest-bearing are admissible as capital employed – i.e. not deducted from assets. On occasion a non-interest bearing loan is encountered, and it is a matter of judgement as to whether or not this is deductible from assets.

4(B)2 Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed moneys such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.

4(B)3 Mainstream corporation tax and deferred taxation are treated as capital employed. Liabilities to make payments in respect of group relief should be treated in the same way.

4(B)4 Launching aid is usually treated as a creditor in computing capital employed, and as such is deducted from launching costs as the equivalent of cash on account of work done.

4(B)5 Declared and proposed dividends are treated as capital employed.

4(B)6 Provisions for future cost liabilities where excluded from allowable costs should be allowed in capital employed whether or not they fall due within one year of the balance sheet date. Provisions for diminution in the value of assets should be deducted from the assets concerned.

Cost of Production

5. The cost of production should be computed for the same operating unit for which capital employed is computed. Inter alia, it should:

5(A) Include:

5(A)1 Direct costs – direct wages, materials, bought out equipment, sub-contractors' and other direct charges.

5(A)2 Indirect costs – including overheads as well as all exclusions made in determining overheads attributable to Government work with the exceptions set out in 5(B) below.

5(B) Exclude:

5(B)1 Capital expenditure.

5(B)2 The cost of raising and servicing loan capital.

5(B)3 Appropriation of profits, e.g. dividends, corporation tax.

5(B)4 Notional transactions.

5(B)5 Costs related to assets excluded from capital employed in accordance with 4(A)1 above.

5(B)6 Discounts allowed on sales, which are treated as abatements of selling prices.

5(B)7 Unnecessary, extravagant or wasteful outlays excluded from overheads under 1(A)10 above.

5(B)8 Loss of profit insurance premiums (profit element only).

5(B)9 Compensation payments of an abnormal nature to the extent that they are excluded under 1(B)1(a) above.

5(B)10 Lump sum additions to pension schemes to the extent that they are excluded under 1(B)1(b) above.

5(B)11 Subscriptions and donations of a political nature.

5(C) Credits, grants or refunds dealt with under 1(C)1 above should be deducted from cost of production.

6. The foregoing conventions aim to establish a definite set of guidelines, which have been formulated with a view to the acceptance, wherever possible, of a contractor's accounts figures in computing capital employed and cost of production. It will be observed, however, that the conventions recognise that the accounts figures for certain items may require some adjustment. There are no

absolute and final figures for capital employed and cost of production which can be computed according to fixed and inviolable rules. Just as some items in company accounts are a matter of judgement and opinion as to the amount to be included so it is with capital employed and cost of production. Where, in such cases, there are no absolute rules, some judgement is called for.

APPENDIX F: ANNEX I

PRIVATE VENTURE RESEARCH AND DEVELOPMENT EXPENDITURE GUIDANCE DOCUMENT

Definitions

1. As a first step in determining the principles for admission of expenditure for pricing purposes, it has been necessary to define certain expressions as precisely as possible. In particular, it has been considered essential to establish a line of demarcation between research on the one hand and development on the other. It is also important to distinguish development from production.

2. These definitions are set out below:-

Private Venture Research and Development Expenditure	Expenditure which is not directly chargeable to the Government or any other customer under the terms of a specific contract.
Basic Research	That type of research which is directed towards increase of knowledge. In such research the primary aim of the investigation is a fuller knowledge or understanding of the subject under study rather than any practical application thereof.
Applied Research[1]	That type of effort which normally follows basic research and which attempts: (i) to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, systems and techniques; or (ii) generally to advance the state of the art.
Product Development[1]	A systematic programme of work, going beyond basic and applied research, which is directed towards the creation of a new or improved product, system, component, or material substantially in a form in which it could be marketed, but excluding any manufacture beyond the completion of the prototype stage of the new or improved product.

Recording, Classification and Attribution of Expenditure

3. Contractors will classify in their accounting records all expenditure on research and development in accordance with the definitions in paragraph 2 above. The expenditure will include relevant indirect costs. Any such expenditure which is

[1] Work on a technology demonstrator may be either applied research or product development depending on whether or not it stops well short of the stage at which it could be marketed.

not in the nature of private venture as defined above is not considered further in this paper.

4. Private venture research and development expenditure will then be attributed as closely as possible to the product groups or, where this is realistic and appropriate, to the specific products which the expenditure is designed to benefit. Product groupings already established for his own purposes by a contractor will normally be adopted and will be disturbed only when this is clearly necessary to achieve a fair attribution of the expenditure.

5. The principles described in paragraphs 3 and 4 above will also apply to expenditure incurred by a contracting group at a central research and development establishment including those cases where this is operated by a separate company.

Recovery of Expenditure

6. When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing rules, the following principles for its recovery will, subject to the qualifications contained in paragraphs 7 to 13 below, normally apply:-

(a) Basic and applied research which by their nature are not exclusively identified with individual products but are directed towards the benefit of a product group as a whole, will be regarded as costs to be recovered by charge to current total output of the product group. This will normally be effected by the admission in overheads of expenditure which is attributable to the product group to which such overheads are applicable. Alternatively, where it is more expedient and in accordance with sound accounting principles, the parties may agree to adopt some other basis of recovery having a broadly similar effect such as, for example a charge per unit of output or a percentage charge to the costs of output.

(b) In the case of product development, recovery will be by direct charge to the product concerned, or, where appropriate, a range of products making use of the development. The direct charge should be a fair apportionment of the contractor's unfunded private venture product development costs (whether or not these have been carried forward in the contractor's accounts) calculated on the basis of the past sales and a realistic forecast of future total sales of the product or product group concerned. Abortive product development expenditure admitted for recovery under paragraph 10 below will be recovered on the basis set out in paragraph 6(a) but excluding such expenditure directly funded by a Government department or other customer. Direct funding by a Government department or other customer would generally be evidenced by the obligation to pay compensation for the use of new designs, processes or materials generated under the contract.

7. It will be a condition of admitting private venture research and development expenditure for recovery on Government contracts (whether in overheads or otherwise) that the Department concerned be satisfied:-

(a) having regard to all the circumstances, that the classification, allocation and apportionment of expenses adopted by the contractor is fair and reasonable; and

(b) that any unreasonable, unnecessary, extravagant or wasteful expenditure is excluded.

Expenditure attributable to an agreement between the contracting Department and a contractor which specifically limits the amount of the Department's contribution (including those cases where the limit is expressed as a share to total expenditure) will not, unless specifically provided for in the agreement, normally be recoverable through overheads on Government contracts.

8. The fact that a contractor may have adopted a particular accounting treatment for research and development expenditure in his financial accounts will not, in itself, prejudice the appropriate recovery of such expenditure on Government contracts.

Abortive Expenditure

9. Abortive research expenditure should be treated in the same way as any other research and be admitted for recovery on the principle described in paragraph 6(a) above.

10. Expenditure on product development considered reasonable by the Department but which proves abortive or is otherwise irrecoverable (for example, because of inadequate sales of the product concerned) will be admitted for recovery in Government non-competitive contracts only to the extent that the development had potential benefit to the Department concerned and subject to the provisions of paragraphs 4, 6, 7 and 14 of this document.

Timing of Recovery

11. A further problem arises when, because of the long time span or fluctuating level of some research and development programmes, it becomes impossible to reach final decisions on the treatment for pricing purposes of certain expenditure at a time when, for example, it is necessary to settle an annual overhead rate negotiation or to fix production prices which will be subject to post-costing.

12. In such circumstances it should be possible for an agreed amount of such 'undecided' expenditure to be carried forward for decision as to recovery to be made in a future period.

13. If also carried forward in the financial accounts of the contractor, such expenditure will rank as capital employed for profit rate purposes. If, however, the expenditure is written-off, it will cease to rank as capital employed and the relevant costs should also be excluded from costs of production until the period in which the treatment of the expenditure is agreed.

Conclusion

14. It is considered that the arrangements stated above will in all normal circumstances result in the overhead rate or rates applicable for Government pricing purposes reflecting an appropriate share of private venture research and development expenditure. It is recognised, however, that there may be cases (for example, if the Department derives a significant benefit from product development expenditure which is abortive or otherwise irrecoverable or the contractor derives a disproportionate benefit from Government financed research and development) where an appropriate adjustment may be necessary to avoid a result which would be manifestly unfair either to the Department or to the contractor.

APPENDIX G (see paragraph 721)

RECOMMENDATIONS AND GUIDANCE PUBLISHED IN THE BOARD'S PREVIOUS REPORTS

Introduction

Previous reports issued by the Board contain various recommendations and guidance which are of assistance in interpreting the rules relating to the pricing of non-competitive Government contracts. Some contractors have experienced difficulty in obtaining copies of previous reports and the JRBAC has requested that certain sections should be reproduced in this report. In this appendix we have reproduced various extracts which we consider likely to be of continuing relevance.

The subjects included in this appendix are:

Relevant CP:CE Units
Fifth General Review (1987), paragraphs 86-88

86. The Board has consistently advocated the introduction of more relevant units of contractors' businesses for the purpose of determining CP:CE ratios, viewing this as a means of improving the practical application of the profit formula. This was the main recommendation of the special study of capital employed which was undertaken at the first Annual Review, a recommendation accepted by both the Government and the JRBAC. In that study the Board took the view that what constitutes the appropriate unit would depend on the circumstances. In most cases it would be a business division, but in others it might be an individual Government

project or a contractor's Government work as a whole. The Board continues to hold these views.

87. The principal reason for adopting more relevant units is to improve the measurement of the capital employed on Government work. In doing this, the commercial realities of contractors' businesses should be reflected in the definition of the more relevant units. For example, if two parts of a contractor's business are doing Government work independently of each other and with separate contracts, it will be appropriate to agree that they operate as separate CP:CE units. If one part of a contractor's business is effectively acting as sub-contractor to another, it may be appropriate to agree a separate CP:CE ratio for each part. But if the business comprises an integrated manufacturing operation spread over a number of locations, it will probably be inappropriate to agree separate CP:CE ratios. The MOD have the power to ensure that proposals for more relevant units properly reflect commercial realities.

88. The MOD have told us that progress has been made in establishing more relevant units for CP:CE purposes since the publication of the report on the Fourth General Review early in 1985. Discussions with four contractors have led to the introduction of an additional 26 units. These changes were all reflected in the provisional average CP:CE ratio recorded by the MOD in respect of 1985/6. The MOD added that in their view this process had been taken as far as was practicable at present but would be kept under review. The Board notes this progress and hopes that the MOD's continuing review will lead to further advances.

Service Companies
Fifth General Review (1987), paragraphs 101-103

101. The JRBAC have submitted that service companies are treated unfairly under the existing formula, both because of their generally low proportions of risk work and their generally high CP:CE ratios. They argued that, where the bulk of the costs incurred is labour related, pricing should be by analogy with commercial prices; contractors should also receive profit on cost on bought-in units, equipment and sub-contract work. The Government responded that, since the Fourth General Review, the reference group had been broadened to include almost all sectors of industry and that it would be inappropriate to exclude from the application of the profit formula a sector of the defence industry which was itself not excluded from the reference group.

102. The JRBAC's proposals suggest a special treatment for a particular section of contractors' units. Creation of such a separate class of defence contractor would be inconsistent with the present principle of variable profit rates for different contractors, in total giving an average profit equal to the target rate of return. Further, it would be necessary to define "a service company". Given the wide variety of such companies, we consider that this would be impracticable. There are already arrangements designed for those contractors with exceptional CP:CE ratios.

103. We reject the JRBAC proposals.

Disallowance of Overheads
Fifth General Review (1987), paragraphs 104-106

104. The JRBAC complained to us that the MOD were endeavouring to restrict overhead rates in what they described as an arbitrary manner, contrary to the Government Accounting Conventions. The JRBAC's complaint was that the restriction took the form of an arbitrary limitation of increases in overhead rates, for example by reference to inflation, or of an arbitrary disallowance of specific categories of overheads. The JRBAC provided a report of a recent survey of 23 major contractors, according to which almost two-thirds had experienced MOD attempts to limit year-on-year increases in overheads and almost half experienced the disallowance of specific overheads. The reported reductions in overheads sought by the MOD varied between 1 per cent and 6 per cent; and the reductions agreed varied between 0.5 per cent and 5 per cent. The JRBAC acknowledged that the impact of such restrictions was small but they believed that the practice was growing.

105. The MOD's view was that the contractors affected were few in number and that the amount of the reductions achieved was relatively minor. The MOD, in aiming for value for money, would continue to examine closely any increase in overheads which was disproportionately high in relation to the previous year, particularly where the MOD were the contractor's major customer. Any restriction of overheads would be discussed with the contractor concerned.

106. The Government Accounting Conventions give the MOD the power to exclude expenditure which is unnecessary, extravagant or wasteful; we believe it right that this power should be exercised in appropriate cases but when it is, the contractor is entitled to a full written explanation. The Board recommends that such exclusions ought to be justified by reference to the circumstances of the individual case, rather than solely by reference to some rigid criterion, such as the change in the retail price index. The Board intends to keep this subject under review and will be prepared to receive evidence at the next Annual Review.

Seventh General Review (1993), paragraphs 625-627

625. The JRBAC complained to us that there was an increasing tendency for MOD to disregard the overhead rates computed by application of the Government Accounting Conventions and to apply its own maximum limit to the overhead rate that it is prepared to agree. This situation has arisen through the increase in calculated overhead rates that has in some instances resulted from reductions in throughput caused by the changed pattern of defence procurement. Such increases in overhead rates may well, the JRBAC contend, be unavoidable because some overhead costs are incapable of being reduced in line with a fall in activity; the resulting increase in unit costs should be accepted for pricing purposes.

626. In the Board's view this issue should be dealt with in accordance with the Government Accounting Conventions. The conventions provide (in Clause 1(A)10) for the disallowance of "unnecessary extravagant or wasteful outlays". If in the reasonable judgement of MOD a contractor were to be at fault in not reducing overhead expenses to match foreseeable reductions in the level of activity, such expenditure would fall to be disallowed in whole or in part under Clause 1(A)10.

The conventions provide that in these circumstances the contractor is entitled to a full written explanation of the exclusion. They also provide that in cases where only a small proportion of a contractor's turnover is made up of non-competitive Government contracts, there is a presumption that all expenses are reasonably incurred. In our opinion any disallowances of costs of the kind referred to by the JRBAC should be considered and dealt with under Clause 1(A)10 of the conventions and any disallowance should be justified by reference to the particular circumstances of the individual case, rather than by reference to some overall criterion such as the change in the retail price index.

627. Turning to a different aspect of overhead costs, the JRBAC has again proposed that the role of the Review Board should be extended to include that of arbitrator in disputes between MOD and individual contractors concerning the allowability of overhead costs. This issue was raised in the Sixth General Review, when our conclusion was that it would not be sensible to extend the Board's role in this way. We have seen no evidence which causes us to alter the view which we expressed in 1990.

Accounting for Pension Costs
Sixth General Review (1990), paragraphs 712-715

712. Accounting for pension costs has been changed by the recent introduction of an accounting standard, SSAP 24. This standard seeks to recognise the cost of providing pensions on a systematic and rational basis over the period of the employees' service, in contrast to the previous practice of using the cash payment to determine the charge in the year.

713. Both MOD and the JRBAC have accepted that in principle pension costs should in future be accounted for in accordance with SSAP 24. However, the MOD expressed concern to us that there might be some particular circumstances in which this might not be consistent with fair and reasonable contract prices. For example where an actuarial surplus arises in a contractor's pension scheme, the benefit in terms of future reductions of the contractor's costs may under SSAP 24 be spread over a number of years, notwithstanding that there may be an immediate distribution of the surplus or a short term contribution 'holiday'; MOD submitted that in such a case it would be more equitable for the effect on costs, and hence on contract prices, to be recognised at the same time as the benefit is received by the contractor in cash.

714. The intention of SSAP 24 is to provide a fair and consistent basis for the calculation of pension costs, and in our view its introduction should in general be welcomed. If however the application of SSAP 24 in any particular case produces results that can be regarded as manifestly unfair, we would expect an appropriate adjustment to be made. The possible need for such equitable adjustments is recognised in GAC 2, which provides also that the contractor is entitled to a full written explanation of the reason for any disallowances under that convention. Alternatively, GAC 1(B)1 provides for the spreading over a number of years of costs that are exceptional in size and incidence. In our view, therefore, MOD have adequate safeguards under the current GAC's to enable them to be satisfied that pension costs are fairly recorded.

715. There may be a transitional problem arising from the introduction of SSAP 24 where a contractor takes an adjustment to pension costs in the form of a 'prior year adjustment' in his accounts. We consider that the amount of any such adjustment which would otherwise have been a charge or credit to attributable overheads should be included in overheads, if necessary spread over a future period according to a plan agreed between MOD and the contractor.

Marketing and Selling Expenses
Seventh General Review (1993), paragraphs 605-613

605. The treatment of marketing and selling expenses was raised as an issue in the Sixth General Review in 1990. For the past twenty years the convention has been that such expenses should be allocated or apportioned to products or product groups on an appropriate basis, and that provided MOD are satisfied that the method of classification, allocation and apportionment adopted by the contractor is fair and reasonable and that the expenses were reasonably incurred, marketing and selling expenses should be included in the overhead rate applicable to each product or product group as the case may be. Two principal issues were raised in the Sixth General Review. The first concerned the methods of establishment of product groups for the purpose of allocating and apportioning expenditure. MOD submitted that contractors did not attach sufficient importance to the establishment of realistic and reasonable product groups; guidance was needed on criteria to be considered by contractors for the establishment of such groups. The second point, also raised by MOD, was more fundamental in character. They questioned whether, having regard to the changed pattern of MOD business since the basis of the current convention was established, the present arrangements could any longer be regarded as appropriate. They suggested a move to a revised convention under which all expenditure on marketing and selling activities was excluded from overheads on non-competitive work.

606. These issues were not resolved in the Sixth General Review but it was agreed that a joint working party should be established, following that review, to consider these matters further and to report their conclusions to MOD, the JRBAC and the Review Board.

607. In the Board's view, the subject of effective marketing and selling by defence contractors has assumed even greater importance with the changes in the pattern and volume of defence procurement foreshadowed in the Government White Paper "Options for Change". As existing domestic markets shrink, contractors must, if they are to remain viable, be successful in developing new markets for their products; this will help to keep production costs, and hence the prices of the products purchased by MOD, at acceptable levels.

608. The working party established following the Sixth General Review concentrated its attention upon the principles and methodology for the establishment of appropriate product groups for the allocation and apportionment of expenditure. The working party concluded that there were essentially two approaches to defining a product group. These were:

(a) *Market-driven:* a product group consists of products designed for one market; the market may be defined by reference to products which use the same technology or products designed for a similar purpose, or by reference to the identity or geographical location of the potential customers;

(b) *Production-driven:* a product group consists of products which share common overhead costs derived from shared production activities.

609. It appeared to the working party that the basis of the issue between MOD and contractors is that MOD wish to follow the market-driven approach to identification of product groups whilst contractors contend that the production-driven approach is generally the more appropriate. In the working party's view each of the two approaches could be appropriate in particular cases; the decision must depend upon the circumstances. The working party identified the information which would be relevant to this decision and proposed a standard framework of analysis which could be used for this purpose. The working party recommended that the next step should be for the Review Board to apply the suggested approach to a sample of three case references which would be jointly referred to the Board by MOD and the contractors concerned, with the aim of developing more detailed guidance on the criteria for selection of product groups in particular cases.

610. The working party's approach has been endorsed by MOD and the JRBAC and we recommend that this subject should be pursued, in the way proposed by the working party, following the completion of this review. The Board will play its part in considering and adjudicating upon the three case references, on the basis that the contract parties in each case agree in advance to accept the Board's conclusions. This, in the Board's view, is a necessary condition if the process of considering case references is to have its intended effect of providing authoritative guidance which will enable further cases to be settled without the Board's involvement. [It should be noted that MOD and the contractors were unable to identify appropriate cases which could be referred to the Board so the case references did not take place.]

611. The MOD have more recently informed the Board that a review of its policy towards the admission of marketing and selling expenses has resulted in two decisions:

a) that the general level of marketing and selling expenses admitted into overheads for non-competitive contracts must, taking one year with another, be restricted to the current average level as a proportion of total admissible costs of production; and

b) that it is not appropriate for the Ministry to accept the costs of entertainment in the costs of its non-competitive work and that entertainment costs will therefore be specifically excluded.

MOD have also proposed some detailed amendments to the recommended classification of marketing and selling expenses set out in clause 1(B)3(b) of the Government Accounting Conventions; these amendments are currently the subject of discussion with the JRBAC.

612. It is far from certain at this stage what the practical impact of the first of the two foregoing decisions will be. It will clearly be difficult for MOD to exercise

effective control over the general level of marketing and selling expenses admitted in overhead costs, given that contractors' overhead rates are agreed piecemeal throughout the year. It is not clear what significance should be attached to the words "taking one year with another". It is possible that MOD's enforcement of an aggregate limit for such expenses could result in the arbitrary disallowance of a contractor's costs which had been reasonably incurred and would be allowable under the Government Accounting Conventions. Such a result would clearly not be equitable. Moreover we find it hard to reconcile the additional measures for control of marketing and selling expenses with MOD's policy of simplification of the procedures for placing and pricing non-competitive contracts, following the staff reductions that have been announced.

613. Both elements of MOD's proposals set out in paragraph 611 represent unilateral initiatives to change the Government Accounting Conventions, outside the normal framework for determining the Conventions which has been established since 1968. Neither the JRBAC nor the Board were consulted in advance. The JRBAC have expressed their objections to both of MOD's proposed changes. In these circumstances the Board cannot endorse the proposals in paragraph 611. In particular, the Board considers that an overall financial limitation such as that set out in paragraph 611(a) has no place in the Government Accounting Conventions which define the accounting rules applicable to individual contractors.

Rationalisation and Closure Costs
Seventh General Review (1993), paragraphs 618-624

618. The reductions in defence procurement expenditure which have followed the recent developments in international relations and the Government's "Options for Change" White Paper have brought into focus a new issue relating to the Government Accounting Conventions – the treatment of rationalisation and closure costs. The current statement of the conventions includes a clause relating to redundancy costs but the conventions do not deal specifically with major rationalisation and plant closures, which may entail significant costs apart from redundancy payments, as well as realisations from disposal of surplus assets.

619. Both MOD and the JRBAC are agreed that reasonable rationalisation and plant closure costs should be allowed in overheads. In the Board's view an amendment to the Government Accounting Conventions is required in order to establish this general principle. There is one important issue concerning which the parties are not in agreement: the extent to which the allowable rationalisation and closure costs should be offset by any profit or proceeds from disposal of related assets.

620. The contentions of the parties on this issue may be summarised as follows. The JRBAC contend that the amount credited as an offset against rationalisation costs should be the profit from the disposal of any related assets, restricted to the depreciation previously allowed for Government pricing purposes; any profit or proceeds from subsequent alternative use of assets not immediately disposed of should not be taken into account; and profit should be quantified using the accounting convention (historic cost or semi-CCA) adopted for pricing purposes. MOD's view is that the entire sales proceeds from disposal of assets should be offset

against rationalisation costs and that profit or proceeds from subsequent alternative use should not be ignored.

621. The Board's conclusions on these issues are as follows:

(a) Rationalisation and plant closure costs should be offset by profits from disposal or alternative use of related assets. Such profits should only be taken into account up to the amount of rationalisation costs; if profits should exceed rationalisation costs MOD should not be entitled to share in the excess.

(b) It is the net profit rather than the gross proceeds from asset disposals which should be taken into account. Such profit should be calculated by reference to the net book value of the asset concerned on a historic cost accounting basis, whether or not that basis has been used for non-competitive contract pricing purposes. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed.

(c) Profits should be calculated for this purpose at the time that rationalisation or plant closure takes place, based on sale proceeds, forecast sales proceeds or alternative use valuation as appropriate. Either party should be permitted to re-open this calculation within a limited period, if the assumptions upon which the original calculation was based prove to be materially inaccurate; such period should be a matter for agreement between MOD and the contractor, but should not extend more than five years after the date from which the asset concerned is excluded from capital employed for CP:CE ratio purposes.

622. To recognise the admissibility of rationalisation and plant closure costs and the matters dealt with in the preceding paragraph, we recommend that an amendment should be made to the Government Accounting Conventions to introduce a new clause 1(D)4 as follows:

"Rationalisation and/or Plant Closures"

Reasonable net costs incurred on rationalisation and/or plant closure should be included in attributable costs. Such costs may include:

(a) Redundancy payments;

(b) Employee relocation expenses;

(c) Job creation scheme costs;

(d) Transfer costs for equipment;

(e) Education/learner costs on transferred work;

(f) Disruption costs – waiting and idle time;

(g) In the case of total or near total closure of a unit, excess or unabsorbed overheads.

Rationalisation and/or plant closure costs should be offset/supplemented by profits/losses from the disposal or alternative use of related assets, calculated on the following basis:

(a) Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits should exceed such costs MOD should not be entitled to share in the excess.

(b) The net profit/loss from asset disposals should be calculated by reference to the net book value of the asset concerned on a historic cost accounting basis, whether or not that basis has been used for non-competitive contract pricing purposes. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed.

(c) Profits/losses should be calculated for this purpose at the time that rationalisation or plant closure takes place, based on sale proceeds, forecast sales proceeds or alternative use valuation as appropriate. Either party should be permitted to re-open this calculation within a limited period, if the assumptions upon which the original calculation was based prove to be materially inaccurate; such period should be a matter for agreement between MOD and the contractor, but should not extend more than five years after the date from which the asset concerned is excluded from capital employed for CP:CE ratio purposes.

Substantial net costs may be spread over a period of up to three years in accordance with clause 1(B)1."

623. The Board also considers that clause 1(D)3, which deals with redundancy costs, needs revision. The current clause is as follows:

"Reasonable redundancy payments in excess of the rates laid down by statute, made under the terms of a bona fide scheme, should be included in attributable costs."

This clause was introduced at a time when companies could reclaim all or part of their statutory redundancy payments from national funds and the wording now appears ambiguous. We recommend that it should be revised to the following:

"Redundancy payments in accordance with the rates laid down by statute will be included in attributable costs; reasonable redundancy payments in excess of such rates should also be included, provided they are made under the terms of a bona fide scheme".

624. There remains one aspect of the problem which concerns the Board – the treatment of net rationalisation costs of a contractor who decides or is obliged to discontinue the manufacture of defence products. Such costs would not be recoverable under the Government Accounting Conventions, which only determine

the admissibility of such costs in the prices of non-competitive Government contracts. We asked both MOD and the JRBAC for their reaction to this potential problem and neither party was aware of any such instance. On that basis we do not consider that any specific provision in the Government Accounting Conventions would be warranted but we would expect such a case to be dealt with equitably by MOD were it to arise, and that the liability of MOD to pay a contribution towards rationalisation costs would not be a consideration in determining where future contracts should be placed.

NAPNOC Contracts
Seventh General Review (1993), paragraphs 701-709

701. NAPNOC ("No Acceptable Price No Contract") is the term used to describe a recent initiative by MOD to introduce new arrangements for the placing and pricing of certain high value non-competitive contracts. A paper prepared by MOD giving a general description of the new arrangements is set out in Appendix F [included within this Appendix]. The NAPNOC arrangements came into effect in July 1992 and a small number of contracts have already been placed on this basis, although important aspects of the NAPNOC contractual terms have still to be defined. Discussions are in progress between MOD and the JRBAC with the aim of resolving the outstanding matters.

702. A central feature of the NAPNOC initiative is that the contracts concerned should be priced before they are placed. This should be to the benefit of both MOD and contractors. MOD will have certainty as to its financial liability before a project is committed. Contractors would also know precisely where they stand in commercial terms and will have the maximum incentive to reduce their costs and thereby increase their profitability. MOD's long-term objective is to increase the percentage by value of contracts priced at the outset from the current level of approximately 50 per cent to 75 per cent.

703. The Review Board has consistently stressed the importance of achieving earlier pricing of non-competitive risk contracts and has urged MOD and contractors to identify and overcome obstacles to early pricing. We welcome this aspect of the NAPNOC initiative as a very significant step in the right direction.

704. The main practical problem to be addressed by MOD and contractors is the management of the increased risk that is inherent in a move to earlier pricing. Contractors have a higher degree of risk to the extent that there is a greater degree of uncertainty over the costs to be incurred on a contract. There must be an expectation that the outturn of NAPNOC contracts will show a greater degree of variability than would be the case if prices were not agreed until later. This also creates risk for MOD: risk that a contractor might earn a profit which would appear excessive. The achievement of earlier pricing with an acceptable degree of risk will require precise specification of projects. Established pricing mechanisms, such as target cost contracts, are then available to determine the sharing of risk between MOD and the contractor.

705. One controversial feature of MOD's NAPNOC proposals, which is not necessarily connected with earlier pricing, is that the profits on the larger NAPNOC

contracts will not be wholly determined by reference to the profit formula. The key passage in MOD’s paper is as follows:

> “The estimated rate of profit allowed in contracts placed under these new arrangements will be for negotiation between the Ministry and the contractor, and will be based partly on the Government profit formula ... but also on the circumstances of each contract. Factors which may be taken into account on either side will include the technical and financial risk, the timeliness of pricing and the nature of the pricing mechanism. The Ministry has made proposals to industry about these new arrangements, which would apply only to contracts above the initial NAPNOC threshold of £10m.”

706. The fact that certain NAPNOC contracts will not be priced wholly by reference to the profit formula raises the question of whether and to what extent the other elements of the package of arrangements embodied in the 1968 Agreement will apply to such contracts. In particular, the applicability to NAPNOC contracts of the following arrangements needs to be determined:

(a) Equality of information (standard condition 43 and DEFCON 3)

(b) Post-costing (standard condition 48)

(c) Reference to the Review Board (standard conditions 50 and 51)

(d) The Government Accounting Conventions

(e) The monitoring of contract outcomes through inclusion in annual returns to the Review Board.

707. Reacting to MOD’s new arrangements for NAPNOC contracts, the JRBAC have made the following statement:

> “The JRBAC remain fully committed to pricing non-competitive risk contracts at the earliest practical date and, where possible, before contract award. They are also prepared, despite significant concerns about the practicability of MOD’s proposals and the uncertainty of funding arrangements for the considerable pre-contract expenditure that may be involved, to discuss with MOD the means of bringing NAPNOC contracts placed by MOD within the framework of arrangements agreed in 1968 and to join in the process of considering the appropriate amendments to the standard conditions of contract. However the JRBAC consider the intended application to the bulk (by value) of all MOD risk contracts of profit rate variations represents a potentially serious erosion of the balance of fairness to both parties that was achieved in the original 1968 Agreements and that suitable guidelines for variation from profit formula rates will need to be agreed with MOD with the intention of retaining the objective of the 1968 Agreements of providing overall earnings on all work priced by reference to the profit formula, which must include contracts priced before contract award and contracts priced at non-standard profit rates, consistent with the comparability principle. The JRBAC note that MOD are firmly committed to their new pricing policy; however, in the absence at the present time of

any firm agreement between JRBAC and MOD on the parameters of, and procedure for agreeing, variations from formula rates, the JRBAC consider that any attempted imposition by MOD on a contractor of a 'non-standard' risk rate of profit entitles that contractor to review the applicability to that contract of standard conditions SC43 and Defcon 3, SC48, SC50 and SC51 and it will so advise industry"

708. Many matters concerning the introduction of NAPNOC are presently unresolved and are under discussion between MOD and the JRBAC. The Board looks forward to being informed by the MOD and JRBAC of the outcome of these discussions, and would then, if the parties so desired, be prepared to offer its views on the particular points raised in paragraph 8(d) of the Joint Statement of November 1991 between MOD and JRBAC [see Appendix C]. In the meantime, so far as references to the Review Board are concerned, it may be of assistance to the parties if the Board gives an indication of its thinking at this stage. If the parties to a NAPNOC contract agree to include a contract condition, similar to standard condition 50, providing for reference by either party to the Review Board, the Board will make every effort to oblige the parties by considering the reference of the contract should that arise. However, the Board may find it impracticable to determine an equitable outturn for a contract not priced according to the profit formula unless the various considerations by which the profit margin has been arrived at have been quantified by agreement between the parties.

709. The MOD and the JRBAC have agreed that NAPNOC contracts should be included in annual returns to the Board by contractors, and see no need for them to be separately identified. But unless non-competitive contracts not priced according to the profit formula are identified by contractors in annual returns, the Board will be unable to carry out satisfactorily the function assigned to it of determining whether the use of the formula has achieved the general intention of giving overall earnings on profit formula work consistent with the comparability principle.

Seventh General Review (1993), Appendix F

Note by MOD dated October 1992 setting out their position on NAPNOC contracts

Introduction

1. Non-competitive risk contracts now account for less than one-third of our procurement expenditure compared with two-thirds a few years ago. We shall maintain the pressure for competition wherever possible but there will remain a significant proportion of non-competitive expenditure. Our arrangements for the pricing of non-competitive contracts will therefore continue to be very important.

2. During the past few years we have steadily improved the timeliness of our non-competitive risk pricing, but in 1991 only about 50% by value of such contracts were priced at the outset, and over 25% by value were still not priced at the half-way stage. Our long-term objective, for achievement within 5 years, is to price at least 75% by value of such contracts before these are placed.

3. This will be a challenging task. It is difficult to estimate the cost of high technology work within the limits of accuracy required by public accountability,

and the pricing process is vulnerable to delay. Specifications may be late, price quotations may not arrive on time and resource problems may delay the Ministry's estimating work. For various reasons, it is often difficult to reach agreement on overhead rates and price negotiations can easily lose their momentum as soon as contract is placed and work begins. There is then a steady increase in the availability of work in progress data, which is always difficult to interpret, and this causes further delay as both sides try to use their data to support their position. Because of the sums of public money at stake, the concern by both the Ministry and industry about profit margins, and the other problems inherent in the pricing process, negotiations are often delayed until projects are well under way and the margin for error in pricing has reduced to an apparently acceptable level. This approach inevitably pays more regard to what the work will cost in prevailing circumstances than what it should cost in an efficient environment, and so fails to maximise the incentive to efficiency.

4. If we are to succeed in our objective of pricing contracts before they are placed there will need to be a radical change in the joint management by Government and industry of the pricing process. Success is in our mutual interests. If prices are negotiated at the outset the Ministry will know its financial liability before it is committed to the work and will be able to budget more effectively. Contractors will know precisely where they stand in commercial terms, and will have maximum incentive to improve their profitability by efficient performance. The resultant gains in productivity will further increase competitiveness, with probable benefit in export markets. These benefits will not come easily, but if we both put effort into planning further ahead, are more selective in our choice of price methods and can improve our confidence in the quality of pricing data it should be possible to meet the objective. We must however aim to do this without increasing the administrative burden on either side. This will be essential as industry strives to reduce its overheads and the Ministry comes to terms with a substantial reduction in its own workforce in the next few years.

5. The Ministry regards these new arrangements as consistent with the principles of the 1968 Agreement, but is ready to discuss with industry any necessary revisions to the wording of the Agreement and related documents, including standard conditions of contract.

The New Arrangements

6. Our new approach will require a change of culture as well as changes to management procedures and pricing methods. Success will depend upon the efforts of both sides, and the Ministry has begun a constructive dialogue with Industry about the problems of implementation.

7. These new arrangements have become known as the "no acceptable price, no contract" (NAPNOC) initiative. Other terms have been used, such as "reference pricing". The latter has raised fears in industry that the Ministry may be tempted to use inappropriate pricing yardsticks. We therefore prefer to use the expression early pricing of non-competitive risk contracts, to be achieved in accordance with the principles described in this note.

8. We have applied these new arrangements to all major (high value) non-competitive risk contracts and contract amendments placed or issued from the end

of June 1992. Some features of the new approach were earlier applied to an initial batch of requirements.

9. For the time being we are defining major (high value) contracts and amendments as those which are expected to be worth over £10m. This threshold should capture almost half by value of our non-competitive risk expenditure but will involve a very small proportion of our contracts, so keeping any additional burden on the Ministry and industry during the learning period within acceptable limits. We shall be reducing this threshold to £1m as soon as we have sufficient experience of the new arrangements [the threshold was reduced as from 1 July 1993]. Even then there are unlikely to be more than about 200 NAPNOC contracts out of 6000 or so profit formula – based contracts placed each year. We believe that once both sides have learned to plan further ahead the effort required in the negotiation of prices under these new arrangements should be no more, and perhaps less, than under our present arrangements. Time pressure will concentrate the minds of the negotiators, and there will be less cost data to complicate the negotiating process whilst retaining the obligation on both parties to provide equality of information. Apart from better management of the pricing process the key to success will be management of the pricing risk – see below.

Pricing at the Outset

10. "No acceptable price no contract" will mean exactly that. The Ministry needs to know its financial commitment before work begins and industry will benefit from incentive terms which apply to the entire contract. The Ministry is firmly committed to this new policy and is introducing the necessary changes to its own procedures for management of the specification and pricing process, including where appropriate consideration of the nature and timing of contracts. Industry too will need to consider its procedures for pricing management. Such new procedures should minimise the risks to project timescales, but if delay in reaching agreement on acceptable price and other contract terms means delay in commencement of new programmes then this is a sacrifice the ministry is ready to make.

Management of Pricing Risk

11. The new arrangements will only succeed if the pricing risk can be kept within reasonable limits. Otherwise industry will be forced to pad price quotations with large contingencies, and failure to agree acceptable prices will lead to projects being delayed or cancelled. Pricing risk can only be controlled if work is properly defined by mature, stable and comprehensive specifications (including an acceptance specification), and we shall need to put more effort into this important task at an earlier stage than we have managed in the past. The technical and financial risks will then need to be fully assessed by recognised methods so that realistic decisions can be made about an appropriate pricing mechanism. Early discussion will be needed with Industry about the project stages (which for development programmes must always include an adequate period for project definition) which will be required to manage the progressive reduction and transfer of risk. This may necessitate changes to the nature and timing of contracts. Improved discipline will then be required on specification changes, and their translation into contract amendments.

12. Following risk assessment we must be more selective in our choice of pricing mechanisms. This should be guided by the uncertainty in the cost estimate

for each stage in a programme or for each type of contract, and discussions on risk will be an essential early step in negotiations. We will not always expect to negotiate fixed or firm prices. These will normally be appropriate for follow-on production contracts, but for development and/or initial production it will sometimes be more appropriate to negotiate a target cost incentive [fee] arrangement, linked to a maximum price. A well designed target cost arrangement effective from the outset of a new project will normally be preferable to a fixed or firm price agreed at a much later stage in the work. The variables can be chosen to suit the circumstances, but we must guard against negotiating delay caused by over-ambitious attempts to make such arrangements too sophisticated. Complex models should be kept for the highest value projects. A moderate, single gradient shareline linked to a realistically attainable target cost should suffice for most projects.

Management of the Pricing Programme

13. Under these new arrangements Ministry project managers are being asked to bring forward their planning for new requirements and thus to give earlier warning of the need for new contracts. This should lead to an earlier start on the preparation of specifications, and to earlier price programming by contracts staffs. The pricing programme review meetings held with major contractors will have an important role in the allocation and management of resources for this purpose. Forward overhead rates and CP:CE ratios, based on up to date accounting information, will be important components of these arrangements, and will need to be agreed in good time, normally for a contractor, division or site as a whole but in the case of some high value projects for an individual contract. A timetable for negotiations leading to contract placement by the target date will need to be agreed between everyone concerned in both the Ministry and industry. On the Ministry side this process will be led by the Assistant Director of Contracts, working in collaboration with his AEPS [Accounting Estimating and Pricing Services] colleagues and the project manager. Senior management on both sides will need to review progress, and be prepared to intervene where necessary, if programme delays are to be avoided.

Basis for Cost Estimates

14. Based on full equality of information, the Ministry will prepare its price calculations on a “should cost” estimate provided by AEPS staff which will, as now, be based wherever possible on the contractor’s own estimates. These estimates will assume acceptable levels of efficiency by reference, for example, to the efficiency achieved by other contractors on similar work, or to other widely accepted standards or relevant comparators. The Ministry will be ready, without breaching confidentiality in respect of other firms, to justify its estimates and to continue the current practice of discussing deviations between AEPS and Contractors’ estimates during price negotiations. The negotiation of overhead rates (or of the allowance to be included in prices for overhead costs in the absence of agreed rates) will be particularly difficult during a period of industrial rationalisation and reducing workload. The Ministry’s position in such negotiations will be governed by the usual criteria about the reasonableness of costs in relation to the efficiency of contractors, including the efforts being made by contractors to rationalise their operations and to remove any excess capacity. The Ministry will not expect “green-field site” prices from established companies but will expect to pay prices which are based on the efficient use of labour and facilities. Companies which are unable

(for whatever reason) to achieve acceptable levels of efficiency must expect the Ministry to conclude that their prices do not provide adequate value for money.

Equality of Information

15. The Ministry will continue to apply the principle of equality of information to the negotiation of all contract prices, including those agreed before contracts are placed. The Ministry will seek a new Equality of Information Statement in relation to each non-competitive risk pricing on a contract. It will also seek in selected cases to undertake a post-pricing review at an appropriate point during the course of work, to be facilitated by a revised version of SC48 to be negotiated with industry. The object of such reviews will be to establish whether or not the pricing assumptions were correct, and to learn appropriate lessons for future outset pricing. The Ministry will retain its rights under SC48 to post-costing individual contracts and under SC50/51/52 to refer cases of excess profit or inequality of information to the Review Board if negotiations fail to produce a satisfactory result. Industry's rights under SC50/51/52 will also be unchanged. Discussions are underway with industry on all these issues.

Profit

16. The estimated rate of profit allowed in contracts placed under these new arrangements will be for negotiation between the Ministry and the contractor, and will be based partly on the Government profit formula to be determined under the new arrangements agreed between the Ministry and the JRBAC, but also on the circumstances of each contract. Factors which may be taken into account on either side will include the technical and financial risk, the timeliness of pricing and the nature of the pricing mechanism. The Ministry has made proposals to industry about these new arrangements, which would apply only to contracts above the initial NAPNOC threshold of £10m.

Sub-Contracts

17. Where it is expected that the Ministry will be involved in the direct pricing of non-competitive sub-contracts valued in excess of the threshold (at present £10m) for these new arrangements, the same principles will apply. Prime contractors will be required to cooperate in ensuring that sub-contractors, including any foreign contractors, supply the necessary information in good time to ensure that price negotiations for all work under the prime contract can take place before the target date for placement of the prime contract.

18. Prime contractors will be required to supply 'make or buy' information and to organise sub-contract competitions under appropriate scrutiny by the Ministry and in sufficient time to ensure that prices are agreed before the target date for placement of the prime contract. Management of the sub-contract pricing process will be an important part of the overall management of pricing.

Thresholds for Reference to the Review Board

19. Because pricing risk will be managed by the choice of pricing method, the Ministry does not expect a significant increase in the average variation between target and outturn profit for NAPNOC contracts compared with other risk contracts. It therefore sees no reason to change the present definition (10% variance on estimated cost) of cases which might be referred to the Review Board, assuming such a definition is still necessary. The Ministry is doubtful about this. The Board

has decided that it will only consider cases in which either party believes there was inequality of information at the time of pricing, and there has never been a referability threshold for cases of this kind. It would therefore be appropriate to remove the thresholds altogether. If they are retained, there will need to be an agreed interpretation of their application to target cost contracts because reference in these cases will only be appropriate if outturn profit deviates from target profit by more than 10% of target cost. (The present definitions were designed for fixed or firm price contracts.) Cases will of course continue to be settled without reference to the Review Board wherever possible.

1995 Annual Review, Addendum paragraph 3 (this relates to MOD's proposal in paragraph 16 of Appendix F of the Seventh General Review, for NAPNOC contract profit rates to be based partly on the Government Profit Formula and partly on the circumstances of each contract)

Para 3c. The two sides concluded, after discussion, that the complexity of the proposed scheme for variable profit on contracts outweighed its possible advantages. The MOD and the JRBAC have therefore agreed that contracts should continue to be priced at profit formula rates. No further action is proposed.

Employees' Profit Sharing Schemes
Interim Review (1971), paragraphs 31-32

31. According to the current Convention, payments under employees' profit sharing schemes are normally totally excluded from attributable costs. Several contractors have submitted that this is unrealistic, because it is common in industry for certain employees to be remunerated partly by a basic salary and partly by a percentage of profits. Such schemes are, it is contended, merely a method of arriving at employees' total remuneration, the whole of which should be included in attributable costs.

32. We agree with the contractors that where payments under employees' profit sharing schemes are simply an element of an employees' normal remuneration the payments should be included in attributable costs. In some cases, however, such schemes are more of the nature of a distribution of profits and the payments should be excluded. The Government representatives suggested that a suitable test to determine the true nature of a scheme might be whether the payments were accepted by the Inland Revenue as charges against the company's profits for tax purposes, and we consider that this would be a fair basis on which to treat these costs.

Review Board Assistance to Resolve Disagreements
1996 General Review, paragraph 310

310 … We consider that disagreements over contractual terms should be capable of being resolved between the parties and that a process of discussion between those involved in contract negotiations is the best way of achieving a mutually acceptable outcome. The Board would, at the request of both parties, be prepared at any time to take evidence on such an issue and give an advisory recommendation if agreement cannot be reached otherwise. The Board suggests to both parties that their negotiations over issues concerning contractual terms should take into account the general principle of comparability upon which the profit formula is based. So

far as appropriate, the contractual terms of Government contracts, as well as the profit formula, should reflect general commercial arrangements accepted by parties to comparable competitive contracts.

Trigger points for eligibility of a contract for reference to the Board. (supersedes paragraph 16 of the 1968 Memorandum of Agreement)
Fourth General Review (1984), paragraph 207.

207. We concur with the suggestion of both sides that the trigger points should be redefined on the basis of the variance between estimated and outturn costs. We recommend that a contract should normally be eligible for reference to the Board where outturn costs vary from estimated costs by 10 per cent or more. The provision in paragraph 17 of the 1968 Memorandum of Agreement, permitting reference of exceptional cases notwithstanding that the profit or loss lies within the trigger points, should be retained.

Bonuses paid in cash or in kind
1999 General Review, paragraphs 605-608.

605. The JRBAC and MOD provided submissions on the subject of bonuses paid in cash or in kind. The JRBAC contended that in the absence of any specific relevant GAC, there has been some doubt as to the correct treatment for pricing purposes of costs and assets associated with incentivised pay structures. There has been an increase in the use of bonuses paid to employees involving various means of payment, for example profit related pay schemes, bonus payments or employee share schemes.

606. MOD expressed three principal concerns, which we paraphrase:

- that bonuses might increase salary bills above a level that is ‘fair and reasonable’;

- that such bonuses might constitute a distribution of profits, which would be disallowable under GAC1(A)1; and

that the issue of new shares to employees constitutes a notional cost to the company, and as such is disallowable under GAC1(A)9.

607. We note the JRBAC’s request for clarification, but do not consider that this matter requires any amendment to the GACs. In paragraphs 31 and 32 of the Board’s Interim Review in 1971, the principle was set out that ‘where payments under employees’ profit sharing schemes are simply an element of employees’ normal remuneration the payments should be included in attributable costs’. Paragraphs 31 and 32 of the Interim Review are reproduced in Appendix H. For clarification, we confirm that the cost of providing benefits such as shares or benefits in kind should be treated in the same way as ‘payments under employees’ profit sharing schemes’. The principal reason for our decision is that charges made in accordance with UITF Abstract 17 ‘Employee Share Schemes’ will be treated as costs in the accounts of the Reference Group and should be treated as allowable costs for pricing purposes on the grounds of comparability. Therefore, the cost of

shares issued to employees at favourable prices should be arrived at in the manner prescribed by UITF 17.

608. We note MOD's concerns. Regarding the first point, MOD has the remedy under GAC1(A)10 which enables it to exclude 'unnecessary, extravagant or wasteful outlays'. If a bonus is of such magnitude that it falls into this category, rather than being an element of normal remuneration, then MOD will be able to exclude it. Regarding the second point, we envisage that in an exceptional case MOD will be able to exclude a bonus as being a distribution of profits. This could be the case where it can be demonstrated that the owners of an owner-managed business have taken an element of 'profit distribution' through a share or bonus scheme, rather than through a dividend. We do not accept MOD's third point – that the issue of new shares to employees constitutes a notional cost. Any issue of shares at less than full value constitutes a real cost to a company's shareholders.

APPENDIX H (see paragraph 722)
PREVIOUS PROFIT FORMULAE

The following are the profit formulae which have applied since the current profit formula regime was introduced in 1968:

Historic Cost Profit Formulae

Implemented	*Risk: Capital based profit element %*	*Risk: Cost based profit element %*	*Non-risk: Capital based profit element %*	*Non-risk: Cost based profit element %*	*Assumed percentage of risk contracts %*	*Weighted average return on capital %*
Feb 1968	11.0	3.0	8.0	1.5	66.6	14.0
Aug 1970	12.0	3.0	8.0	2.0	66.6	14.3
Feb 1975	10.8	5.4	9.9	2.7	66.6	18.0
Oct 1977	14.0	4.0	11.5	2.0	60	20.2
April1984	8.5	3.2	6.5	2.5	63.6	15.5
May1985	9.28	3.09	7.14	2.38	63.6	17.0
July 1987	11.3	4.4	8.6	3.4	71.4	21.0
July 1990	10.75	5.54	8.27	4.26	90	21.0
March 1993	9.7	4.6	7.5	3.5	90	19.0
April 1994	9.35	4.2	7.2	3.25	90	18.2
April 1995	9.45	4.1	7.3	3.15	90	18.5
April 1996	9.7	4.25	7.5	3.25	95	19.3
April 1997	10.55	4.05	8.1	3.1	97.5	20.95
April 1998	11.2	3.45	8.55	2.65	98.6	22.2

Historic Cost Arrangements for Contractors with Exceptional Ratios (Note 2)

Implemented	*Upper cut-off CP:CE ratio*	*Risk: Return on cost of production %*	*Non-risk: Return on cost of production %*	*Lower cut-off CP:CE ratio*	*Risk: Return on capital employed %*	*Non-risk: Return on capital employed %*
April 1984	5.24	4.8	3.75	1.31	Note 2	Note 2
May1985	6.00	4.65	3.5	1.5	Note 2	Note 2
July 1987	7.65	5.9	4.5	0.85	15.0	11.5
July 1990	5.82	7.4	5.7	0.65	14.35	11.05
March 1993	6.36	6.15	4.7	0.71	12.95	10.0
April 1994	6.63	5.6	4.35	0.74	12.45	9.6
April 1995	6.96	5.45	4.2	0.77	12.6	9.75
April 1996	6.93	5.65	4.35	0.77	12.95	10.0
April 1997	7.8	5.4	4.15	0.87	14.05	10.8
April 1998	9.6	4.6	3.55	1.07	14.9	11.4

Semi-CCA Profit Formulae (Note 1)						
Implemented	*Risk: Capital based profit element %*	*Risk: Cost based profit element %*	*Non-risk: Capital based profit element %*	*Non-risk: Cost based profit element %*	*Assumed percentage of risk contracts %*	*Weighted average return on capital %*
April 1984	6.0	3.0	4.6	2.3	63.6	11.0
May1985	6.55	2.92	5.04	2.25	63.6	12.0
July 1987	7.5	3.75	5.8	2.9	71.4	14.0
July 1990	7.17	4.40	5.51	3.38	90	14.0
March 1993	6.95	3.95	5.35	3.05	90	13.55
April 1994	7	3.8	5.35	2.95	90	13.7
April 1995	7.5	3.85	5.75	2.9	90	14.7
April 1996	7.6	3.9	5.85	3.0	95	15.1
April 1997	7.85	3.6	6.05	2.75	97.5	15.7
April 1998	7.85	3.05	6.05	2.35	98.6	15.65

Semi-CCA Arrangements for Contractors with Exceptional Ratios (Note 2)						
Implemented	*Upper cut-off CP:CE ratio*	*Risk: Return on cost of production %*	*Non-risk: Return on cost of production %*	*Lower cut-off CP:CE ratio*	*Risk: Return on capital employed %*	*Non-risk: Return on capital employed %*
April 1984	4.0	4.5	3.5	1.0	Note 2	Note 2
May1985	4.48	4.4	3.4	1.12	Note 2	Note 2
July 1987	6.0	5.0	3.9	0.67	10.0	7.7
July 1990	4.89	5.85	4.5	0.54	9.55	7.35
March 1993	5.25	5.25	4.05	0.58	9.25	7.1
April 1994	5.55	5.05	3.85	0.62	9.35	7.15
April 1995	5.88	5.15	3.95	0.65	10	7.65
April 1996	5.91	5.2	4.0	0.66	10.15	7.85
April 1997	6.6	4.8	3.65	0.73	10.5	8.05
April 1998	7.71	4.05	3.15	0.86	10.45	8.05

Notes:
Note 1 – The Semi-CCA formula was introduced at the Fourth General Review in 1984.
Note 2 – Since the Fourth General Review in 1984 special provisions have applied to contractors with exceptionally high or low CP:CE ratios. 'Exceptionally high' was defined at the Fourth General Review in 1984 as twice the assumed average CP:CE ratio; this was redefined at the Fifth General Review in 1987 as three times the average. Contractors with exceptionally high ratios receive a fixed return on cost of production equivalent to the return on cost of production applicable to contractors at the 'exceptional' cut-off point. 'Exceptionally low' was defined at the Fourth General Review in 1984 as half the average; this was redefined at the Fifth General Review in 1987 as one-third of the average. At the Fourth General Review it was stated that in these circumstances MOD and the contractor should enter into 'special negotiations'. At the Fifth General Review it was recommended that contractors with exceptionally low ratios should receive a fixed return on capital employed equivalent to the return on capital employed applicable to contractors at the 'exceptional' cut-off point.

ADDENDUM

AGREED STATEMENT BY MOD AND THE JRBAC

MAY 2004

2003 GENERAL REVIEW

1. We accept as a package the Board's Recommendations as set out in Section II of its report on the 2003 General Review. The changes recommended should be introduced with effect from 1st July 2004. The delay in implementation has been due to the extensive nature of the changes recommended by the 2003 General Review.

2. As indicated in its report, at the next Annual Review the Board will assess the operation of the new system. This assessment will include examination of available data concerning the Review and the development of the Risk Reward Matrix.

3. We believe that the above package represents a fair basis for assessing profit in the future.

4. There will continue to be comprehensive triennial General Reviews at which any matter connected with the profit formula can be raised.

Signed
V D Taylor
Chairman
Joint Review Board Advisory Committee

Signed
S L Porter
Director General Commercial
Ministry of Defence

Review Board for Government Contracts

2003 General Review

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