

**REVIEW BOARD  
FOR  
GOVERNMENT CONTRACTS**

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**REPORT ON  
THE 2014 ANNUAL REVIEW OF  
THE PROFIT FORMULA FOR  
NON-COMPETITIVE  
GOVERNMENT CONTRACTS  
February 2014**

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The Rt Hon Philip Hammond, MP  
Secretary of State for Defence  
Ministry of Defence  
Main Building  
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London  
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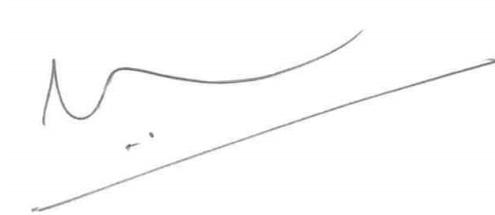
February 2014

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2014 Annual Review of the profit formula for non-competitive Government contracts.

Copies have been sent to the President of the CBI and to the Director General Exports & Commercial Strategy.

Yours sincerely

A handwritten signature in black ink, appearing to be 'John Price', written over a horizontal line.

John Price  
Chairman

## REVIEW BOARD FOR GOVERNMENT CONTRACTS

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### **NOTE:**

[Published reports usually contain a note at this point, stating whether recommendations have been accepted by the Ministry of Defence and the Joint Review Board Advisory Committee and cross-referring to an agreed statement by the parties which is presented as an addendum to this report.]

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## EXPLANATION OF TERMS AND ABBREVIATIONS

<b>Above The Line ('ATL')</b>	Companies that incur eligible R&D expenditure are entitled to enhanced R&D expenditure credits (in excess of the amount actually spent), which reduce their tax liability and are intended to encourage UK companies to undertake R&D activity, in accordance with the Corporation Tax Act 2009. Following the Finance Act 2013, with effect from April 2013, HM Treasury changed the accounting treatment of R&D expenditure credits for R&D expenditure for large companies so they can be accounted for "above the line" (ATL) at the operating profit level rather than "below the line", as previously. This treatment will be optional until April 2016, at which point the ATL treatment becomes compulsory for large companies.
<b>Acquisition Operating Framework ('AOF')</b>	A web based tool that sets out MOD's acquisition policy and practice and which can be located at <a href="http://www.gov.uk/acquisition-operating-framework">www.gov.uk/acquisition-operating-framework</a> .
<b>Adjusted Standard Baseline Profit Allowance ('ASBPA')</b>	The profit allowance on cost applicable to firm, fixed price and target cost contracts and contract amendments with an estimated or target cost of £50 million or more subject to any further adjustment in accordance with the risk/reward matrix.
<b>AIM companies</b>	Companies listed on the Alternative Investment Market in the United Kingdom.
<b>Annual return</b>	The return to the Review Board prepared by a contractor showing the profit achieved each year on its non-competitive Government contracts.
<b>Annual Review</b>	The review by the Review Board of the principal components of the Government Profit Formula, undertaken annually between General Reviews.
<b>Baseline Profit Rate ('BPR')</b>	The profit of the Reference Group after deducting allowances for the servicing of capital employed, expressed as a percentage of the Reference Group's cost of production.
<b>BBB3</b>	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 i.e. immediately above non-investment grade.
<b>CBI</b>	Confederation of British Industry.
<b>CE</b>	Capital employed.

<b>Comparability principle</b>	The aim of the Government Profit Formula is to give contractors engaged in non-competitive Government contract work a return equal on average to the overall return earned by British industry having regard to both capital employed and the cost of production.
<b>Contract Baseline Profit Allowance ('CBPA')</b>	The profit allowance on cost applicable to a specific contract after making all appropriate adjustments in accordance with the risk/reward matrix.
<b>Contractor Group</b>	A generic term for the group of contractors who are engaged in non-competitive Government work using the Government Profit Formula. The composition of the group may vary from year to year.
<b>CP</b>	Cost of production.
<b>CP:CE ratio</b>	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.
<b>CP:CE ratio unit</b>	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.
<b>CSAs</b>	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
<b>Currie Review</b>	An independent report by Lord Currie of Marylebone into the Single Source Pricing Regulations used by MOD, dated October 2011, together with ongoing consultations between MOD and industry where the context requires.
<b>DEFCONs</b>	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's Acquisition Operating Framework website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
<b>EBIT</b>	Earnings before Interest and Tax.
<b>FCSA</b>	The Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible assets.
<b>Financial Reporting Standard ('FRS') 17</b>	The accounting standard on retirement benefits issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.

<b>Firm Price</b>	A price, agreed for the articles or services, or both, which is not subject to variation.
<b>Fixed Price</b>	A price, agreed for the articles or services, or both, that is subject to variation in accordance with the variation of price provision of the contract.
<b>General Review</b>	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The most recent such review was the 2013 General Review, published by The Stationery Office (ISBN 978-0-11-773112-7) in 2013.
<b>Government Accounting Conventions ('GACs')</b>	The accounting conventions used for the determination of costs and capital employed attributable to non-competitive Government contracts.
<b>Government Profit Formula and its Associated Arrangements ('GPFAA')</b>	The Profit Formula Agreement, which supersedes the 1968 Memorandum of Agreement, the 1968 Profit Formula Agreement and all subsequent amendments thereto, is now made up of three sections: Section 1 Principles, Section 2 Arrangements agreed following the 2013 Review, and Section 3 Review Board Guidance.
<b>Government Profit Formula ('GPF')</b>	The formula for determining an allowance for profit to be included in the price (or the target price) of all non-competitive Government contracts and non-competitive amendments to competitive contracts.
<b>International Accounting Standards ('IASs')</b>	International Accounting Standards issued by the International Accounting Standards Committee, the body that preceded (1973-2001) the International Accounting Standards Board.
<b>International Financial Reporting Standards ('IFRSs')</b>	International Financial Reporting Standards issued by the International Accounting Standards Board.
<b>Intra-group inter-unit trading ('IGIU')</b>	Trading between different CP:CE units within the same group of companies.
<b>Joint Review Board Advisory Committee ('JRBAC')</b>	A body comprising representatives of the CBI and those trade associations and companies that have particular interest in non-competitive Government contracts.
<b>LIBID</b>	London Interbank Bid Rate.
<b>LIBOR</b>	London Interbank Offered Rate.

<b>Ministry of Defence ('MOD')</b>	The Ministry of Defence is the predominant user of the Government 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 Review Board on behalf of Government on all matters concerning the Government Profit Formula. However, if both contracting parties agree, the GPFAA 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 GPFAA.
<b>Modified historic cost ('MHC')</b>	MHC is not defined in accounting standards or company law. For the purposes of the GACs it is taken to refer to 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 recognised accounting standards.
<b>Non-competitive Government contracts</b>	Those Government contracts, or sub-contracts in aid of Government contracts, let other than by means of competitive tendering and including in the price (or target price) an allowance for profit calculated by reference to the GPF rate applicable at the time of pricing.
<b>Non-risk Baseline Profit Allowance ('NBPA')</b>	The profit allowance on cost applicable to cost-plus (i.e. non-risk) contracts, being the SBPA less 25 per cent.
<b>Non-risk contract</b>	A contract placed on a cost reimbursement basis (whether with a fixed fee or a percentage profit) which insulates a contractor against loss.
<b>Post-costing</b>	A review by MOD of the costs incurred on a contract, for comparison with the estimated (or target) costs agreed at the time of pricing.
<b>Private Venture Research and Development ('PV R &amp; D')</b>	Research and development expenditure which is not directly chargeable to the Government or any other customer under the terms of a specific contract.
<b>Questionnaire on the Method of Allocation of Costs ('QMAC')</b>	A document that MOD requires its contractors to complete when engaged in non-competitive contracting which discloses to MOD the contractor's cost accounting practices.
<b>Reference Group</b>	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 Government Profit Formula.

<b>Risk contract</b>	A contract with a pricing arrangement which does not insulate the contractor against loss.
<b>Risk/Reward matrix</b>	The table with notes that sets out the adjustments to be made to the SBPA (or ASBPA for risk contracts and contract amendments with an estimated or target cost of £50 million or more) to reflect the differing levels of risk for different types of work. The current Risk/Reward matrix is set out in the GPFAA – Section 2 Annex B.
<b>Single Source Contract Regulations ('SSCRs')</b>	Secondary legislation in the form of a Statutory Instrument, enabled by the Defence Reform Act 2013 (assuming the Defence Reform Bill 2013 is enacted). The Act and SSCRs will replace the GPFAA, for single source contracts within the scope of the legislation. The SSCRs were formerly known as Single Source Pricing Regulations ('SSPRs').
<b>Single Source Cost Standards ('SSCSs')</b>	Cost standards intended to be formulated and governed by the SSRO. These cost standards will replace the GACs.
<b>Single Source Regulations Office ('SSRO')</b>	The independent non-departmental public body recommended in the Currie Review, to be established under the Defence Reform Act 2013, with wider powers and remit than the Review Board, intended to replace the Review Board when formally established and resourced.
<b>Standard Baseline Profit Allowance ('SPBA')</b>	The profit allowance on cost applicable to all GPF contracts and amendments after adjustments to the BPR as appropriate.
<b>Standard Conditions of Government Contracts for Stores Purchases (SCs)</b>	The series of conditions applicable to Government contracts published as Form GC/STORES/1 and now replaced by similar DEFCONs in contracting with MOD.
<b>Target Cost Incentive Fee ('TCIF') Contracting</b>	A pricing basis whereby a target cost and a target fee are agreed at the outset, along with a formula which sets out how the Government and the contractor will share cost over-runs and cost savings.
<b>The 1968 Memorandum of Agreement</b>	The agreement between the Government and the CBI establishing the Review Board.
<b>Total Contract Profit Allowance ('TCPA')</b>	The total profit allowance applicable to a specific contract or contract amendment, expressed as a percentage of cost, comprising the sum of the CBPA, the FCSA and the WCSA.
<b>UK GAAP</b>	UK Generally Accepted Accounting Practice.
<b>WCSA</b>	The Working Capital Servicing Allowance provided to contractors for their investment in working capital.



## SECTION I

### INTRODUCTION

101. The basis for pricing non-competitive Government contracts is set out in The Government Profit Formula and its Associated Arrangements ('GPFAA') as agreed between the Ministry of Defence ('MOD'), on behalf of Government, and the Joint Review Board Advisory Committee ('JRBAC') representing the CBI, on behalf of industry. This agreement encapsulates a 1968 Agreement between Government and industry and numerous revisions since that date. The GPFAA is published in full in the Review Board's General Reviews, the latest of which is the 2013 General Review<sup>1</sup>. Subsequent proposed changes are discussed in this report, reflecting consideration of the issues in paragraph 105 below.

102. The aim of the Government Profit Formula ('GPF') is to give contractors engaged on non-competitive Government contracts 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 to both capital employed and cost of production – this is known as the comparability principle.

103. The Review Board for Government Contracts ('the Review Board') was established as an independent body in 1969 following the 1968 Agreement between Government and industry. The role of the Review Board includes carrying out General and Annual Reviews to consider aspects of the GPFAA.

104. Wide ranging General Reviews of the profit formula arrangements have been undertaken, normally triennially, since that date. These Reviews, the scope of which may include matters raised independently or agreed jointly by MOD and JRBAC, involve considerable participation by Government and by industry, and any relevant stakeholder is also able to contribute. In particular, the 2003 General Review resulted in a significant modernisation in the way in which the GPF operates following various studies initiated by HM Treasury.

105. Annual Reviews of the profit formula, like this 2014 Annual Review, are normally limited to examination of changes to the Reference Group rate of return and to other statistical data and their application to the GPF. The methodology used at an Annual Review is determined from the previous General Review. At the request of MOD and the JRBAC, this Annual Review also contains consideration of the issues of:

- Allowability of insurance premiums.
- Treatment of R&D tax credits following accounting changes introduced following the Finance Act 2013.
- The impact of asymmetrical revenue variation clauses within single source contracts, when pricing under the GPF.
- The Review Board's terms of reference for any cost disputes where it is required to provide a decision.

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<sup>1</sup> The report on the 2013 General Review of the Profit Formula for Non-competitive Government Contracts was published by The Stationery Office (ISBN 978-0-11-773112-7) in 2013.

These issues are considered in section V of this report.

106. At the conclusion of each General Review or Annual Review the Review Board makes a report to MOD giving its recommendations for the GPF and any other matters included in the scope of its work. These reports are simultaneously made available to the JRBAC and form the basis for discussions between MOD and the JRBAC on the recommendations included in the report.

107. This report, on the 2014 Annual Review of the Profit Formula for Non-competitive Government Contracts, contains the Review Board's recommended profit formula for the year from 1 April 2014.

### **Future Developments**

108. On 26 January 2011 the Minister for Defence Equipment, Support and Technology announced that Lord Currie of Marylebone was to chair an independent review of regulations used by MOD when pricing work to be procured under single source conditions without reference to competition (the 'Currie Review').

109. On 10 October 2011 Lord Currie released his report<sup>2</sup>, which included nine key recommendations and fourteen ancillary recommendations. During the course of the Currie Review, the Review Board met with and provided information to Lord Currie to assist him with his considerations.

110. The most significant recommendations made by Lord Currie were that there should be greater transparency between MOD and contractors, supported by enhanced reporting, and that the Review Board should be replaced by a new statutory body (referred to as the Single Source Regulation Office or SSRO) with wider responsibilities aimed at encouraging efficiency and value for money in MOD single source procurement.

111. It should also be noted that the Currie Review saw little merit in changing the approach to calculating the baseline profit allowance based on the principle of comparability. Lord Currie considered the approach developed by the Review Board was sound and, when considering efficiency, he was mindful that profit is generally less than ten per cent of the total costs of a contract.

112. There followed a public consultation period, following which MOD prepared a Summary of Public Consultation Responses document<sup>3</sup>, released in March 2012 and this was taken forward in a White Paper on Better Defence Acquisition<sup>4</sup> which was released in June 2013.

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<sup>2</sup> Lord Currie's report is available at the following web address:  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/35913/review\\_single\\_source\\_pricing\\_regs.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35913/review_single_source_pricing_regs.pdf)

<sup>3</sup> The Summary of Public Consultation Responses following the Currie Review is available at the following web address:  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/35914/Currie\\_Response2012.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35914/Currie_Response2012.pdf)

<sup>4</sup> The White Paper on Better Defence Acquisition is available at the following web address:  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/206032/20130610\\_WP\\_Better\\_Def\\_Acquisition\\_screen\\_final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206032/20130610_WP_Better_Def_Acquisition_screen_final.pdf)

113. At the time of finalisation of this report, the Defence Reform Bill, which will enable changes proposed by Lord Currie, is progressing through Parliament and is expected to be enacted in 2014. It is currently expected that the SSRO will replace the Review Board before the Board would have been due to submit its Report on its 2015 Annual Review.

114. The Review Board has been asked by MOD to continue to provide its existing services for an interim period, including if necessary the performance of a 2015 Annual Review, pending the proposed introduction of the SSRO. The Review Board should also be prepared to consider any references made to it under existing contract conditions or in accordance with the terms of reference for other disputes, as agreed by MOD and the JRBAC in this report on the 2014 Annual Review (see Appendix E).

## SECTION II

### SUMMARY

#### Profit Formula Recommendations

201. To achieve comparability with the return earned by British industry, the profit formula from 1 April 2014 should be structured as follows:

		2013 <i>General</i> <i>Review</i> %	2014 <i>Annual</i> <i>Review</i> %
BPR	Baseline Profit Rate (para 321)	10.16	10.70
FCSA	Fixed Capital Servicing Allowance (para 311)	6.39	6.20
WCSA	Working Capital Servicing Allowance (positive)(para 316)	2.43	2.07
WCSA	Working Capital Servicing Allowance (negative)(para 317)	1.42	1.25

202. The Reference Group baseline profit expressed as a percentage of the Reference Group cost of production (the Baseline Profit Rate (BPR)) shall be taken to represent the average of the returns that companies in the Reference Group earn on their uncapitalised intangible assets and for the risks they assume. The BPR is adjusted to generate:

- Standard Baseline Profit Allowance ('SBPA') (paragraph 324): for a contractor that does not conduct any IGIU trading, the 2014 Annual Review SBPA should be the same as the BPR, which is 10.70 per cent. Contractors that are part of a group of companies that undertake IGIU trading will compute and agree with MOD a reduced SBPA to be applied to contract costs so as to eliminate the impact of their IGIU trading.
- Adjusted Standard Baseline Profit Allowance ('ASBPA') (paragraph 325): a contractor's ASBPA, in respect of firm or fixed price contracts or amendments with costs in excess of £50m, should be 0.30 of a percentage point lower than its SBPA. Therefore, for the 2014 Annual Review, a contractor that does not undertake IGIU trading should have an ASPBA of 10.40 per cent.
- Contracts placed on a cost reimbursement basis should attract the SPBA less 25 per cent (paragraph 325). Therefore, for the 2014 Annual Review, a contractor that does not undertake IGIU trading should have a Non-risk Baseline Profit Allowance ('NBPA') of 8.03 per cent.

203. A flowchart showing how the Reference Group Baseline Profit Rate is the basis of deriving the Standard Baseline Profit Allowance and the Contract Baseline Profit Allowance for a non-competitive contract is included in Appendix A. Illustrations of the application of the recommended formula are shown at Appendix B.

#### Implementation of the Review Board's Recommendations

204. As agreed between MOD and the JRBAC the implementation date should be 1 April 2014.

## Recent Profits on Non-Competitive Contracts

205. The comparison of target and outturn results on profit formula contracts is received from two sources: annual returns received directly from contractors and the results of the post-costing exercise undertaken by MOD.

206. The Review Board's estimate, based on the 2012 annual returns, shows that the overall expected return on cost of production ('ROCP') on GPF contracts was 8.55 per cent (9.08 per cent in 2011), and that an actual ROCP of 12.65 per cent (10.83 per cent in 2011) was achieved. Therefore contractors, as a body, appear to have exceeded the expected ROCP by 4.10 percentage points (1.75 percentage points in 2011). However, this is an average figure and it masks a wide variety of results from individual contractor units (paragraphs 402-406).

207. The Review Board has also reviewed the results of the post-costing undertaken by MOD, which provides further information, in addition to that provided by annual returns, of how closely contract performance matches GPF target performance. The Review Board notes that the number of contracts being post-costed is still low and is concerned that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment under DEFCON 648A. The Review Board has consistently advocated post-costing as an essential tool for assessing the effectiveness of cost estimating procedures (paragraphs 407-413).

208. A significant part of the regime under the proposed new SSCRs relates to enhanced reporting by contractors to give greater transparency of costs throughout the contracting process. The Review Board believes that there may be continuing merit in MOD exercising its rights in connection with post-costing in appropriate circumstances.

## Other Aspects of Non-Competitive Pricing

209. At the request of MOD and the JRBAC, this Annual Review also contains consideration of the issues of:

- Allowability of insurance premiums: The MOD and the JRBAC have agreed revised wording for the GACs to clarify the insurance premium costs that can be charged to GPF contracts. The Review Board agrees with the proposals.
- Treatment of R&D expenditure credits following accounting changes introduced following the Finance Act 2013: The MOD and the JRBAC asked the Review Board to recommend how R&D tax credits should be treated for GPF contracts. The Review Board recommends that a contract should be priced using the prevailing GPF rate of profit on cost, net of any "above the line" ('ATL') R&D expenditure credits, of carrying out MOD-funded R&D that is priced using the GPF. The Review Board also recommends that:
  - No adjustment should be made to the method of calculation of the Reference Group baseline profit for this issue;
  - It would not be appropriate to make changes in respect of GPF contracts which have already been priced; and

- Recognising that the present R&D expenditure credit arrangements have applied for a number of years, it would be appropriate to negotiate transitional arrangements.
- The impact of asymmetrical revenue variation clauses within single source contracts, when pricing under the GPF: The MOD and the JRBAC asked the Review Board to assist MOD and the JRBAC to reach agreement on the differing views they might have on the impact of asymmetrical revenue variation clauses within single source contracts. The Review Board recommends that there should be no change to the existing GPFAA arrangements in relation to this matter in the interim period before the proposed SSCRs are introduced.
- The Review Board's terms of reference for any cost disputes where it is required to provide a decision: The MOD, the JRBAC and the Review Board have agreed the Review Board's terms of reference for cost disputes. The Review Board recommends that the terms of reference are accepted formally.

210. All of these issues are considered in section V of this report. The first issue results in recommended changes to the GACs. It is understood that MOD and the JRBAC intend to initiate a dialogue on the second issue during early 2014 with the aim of agreeing a process which will ensure consistent application across the supply base. The fourth issue results in a recommended addition to the GPFAA.

## SECTION III

### THE REFERENCE GROUP AND THE TARGET RATE OF RETURN

#### Introduction

301. In order to apply the comparability principle which is the aim of the GPF, the Review 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 Review 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

302. The constituents of the Reference Group have been considered in detail at each General Review. In general the Review Board has considered it appropriate to include in the Reference Group all sectors of British industry, subject to those sectors specifically excluded as explained in paragraph 304 below, that operate in a competitive environment and represent the alternative uses that a contractor would have for its capital if that capital were not deployed on non-competitive contracts. This leads to a broadly based Reference Group which has the benefit of reducing volatility, making it less susceptible to any special circumstances that might affect an individual sector from time to time.

303. For the purposes of the Reference Group the Review Board defines British industry as being represented by all companies involved in any type of economic activity producing goods or services that are listed on the London Stock Exchange main market or on AIM, and with headquarters in the United Kingdom. For the purposes of the Reference Group, the Review Board defines a company's headquarters as the location where its strategic decision-making is undertaken. The Review Board relies on data obtained from the Worldscope database, in particular its 'nation' categorisation, to identify UK listed companies that are headquartered overseas. Worldscope's criteria for determining a company's 'nation' are influenced by several factors, only one of which is the location of its headquarters. This can result in some companies being categorised by Worldscope as being located in the UK despite their headquarters being located overseas or vice versa. Where the Review Board is aware of such instances it exercises its judgement to include or exclude such companies from the Reference Group.

304. The Reference Group includes all sectors of British industry except where inclusion of a sector compromises the comparability principle. For example, the comparability principle would be compromised where a fair return, which is based on return on cost of production and return on capital employed, is distorted by sectors where the majority of companies' revenues and profits are not directly linked to their cost of production or capital employed. The Review Board considers that the following should be excluded:

- Primary industry sectors – Revenues and profits in these industries are largely dependent on the natural resources being exploited and on the valuation of those resources rather than the cost of bringing the goods or services to sale. Significant sectors currently falling into this category are: agriculture, mining and oil & gas.
- Sectors dominated by companies where a significant proportion of their activity is based on investment and lending, i.e. either the purchase of speculative assets, including financial instruments, or lending, with the expectation of favourable

future returns. Significant sectors currently falling into this category are: banking, insurance and investment.

- Sectors dominated by companies that are subject to price regulation on their operations which could have a significant influence on their profitability. In certain companies pricing may be regulated, for instance, by capping prices by reference to RPI or CPI or by reference to return on capital. This pricing structure is not comparable to companies undertaking non-competitive Government contracts. Significant sectors currently falling into this category are: water and multi-utilities.

305. The Review Board derives its data from the 'Worldscope' database which is compiled by Thomson Reuters. The Review Board scrutinises the data it receives and sometimes interprets data differently from Worldscope and seeks clarifications. Where appropriate, it will make adjustments.

306. The Reference Group for this Review comprises 631 companies with a total capital employed of £222 billion and sales of £810 billion as compared with 639 companies with capital employed of £215 billion and sales of £805 billion at the 2013 General Review.

### **The GPF Methodology**

307. The return on non-competitive Government contracts is made up of three elements:
- a. An allowance for the servicing of Fixed Assets used for non-competitive Government contracts (referred to as a 'Fixed Capital Servicing Allowance' or 'FCSA');
  - b. An allowance for the servicing of Working Capital used for non-competitive Government contracts (referred to as a 'Working Capital Servicing Allowance' or 'WCSA'); and
  - c. After making allowances for servicing recognised capital through the FCSA and WCSA (together the 'Capital Servicing Allowances' or 'CSAs'), the Reference Group has a residual profit figure (referred to as 'Baseline Profit'). The Baseline Profit figure is expressed as a percentage of cost of production (to arrive at the Baseline Profit Rate ('BPR')) which, after adjusting for any differences in the reporting of cost of production as between the Reference Group, the Contractor Group and the individual CP:CE ratio unit, determines the Standard Baseline Profit Allowance ('SBPA') on the cost of production of individual non-competitive Government contracts.

308. The underlying methodology is therefore that the Reference Group return should be reduced by the FCSA and the WCSA in order to derive a Baseline Profit figure from the Reference Group.

#### *The FCSA*

309. The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in book fixed assets, as adjusted for the GACs. On the basis that the average asset is assumed 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.

310. At the 2003 General Review it was accepted that it would be reasonable to use the yield on BBB3 (or BBB-) rated corporate bonds as a benchmark rate as BBB- is the lowest investment grade security. Because of the lack of liquidity in the Sterling BBB- corporate debt market resulting in limited reference data, the Review Board bases its FCSA calculation on the 7-year moving average of the 15-year Sterling BBB corporate bond rate and makes an adjustment based on the actual spread between Euro BBB and Euro BBB-. This proxy, for the spread between BBB and BBB-, is appropriate because the Euro debt market is considerably more liquid than the Sterling debt market. Therefore, the FCSA calculation is based on:

- The 7-year moving average of the 15-year Sterling BBB corporate bond rate; adjusted for
- The spread between 10-year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling-denominated BBB and BBB- corporate bond rates.

311. Based on the methodology described above and using the rates prevailing up to 30 November 2013, this gives a FCSA of 6.20%.

#### *The WCSA*

312. 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.

313. This methodology for deriving the WCSA is to use a 36-month moving average of:

- The 1-year Sterling BBB corporate bond rate; adjusted for
- The spread between 1-year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling-denominated BBB and BBB- corporate bond rates.

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

315. The Review Board has been advised that the 1-month LIBID (London Interbank Bid Rate) is likely to represent the highest level of interest that a company might expect to earn on short-term cash deposits. Where a contractor has net negative working capital its WCSA is based on a 36-month moving average of 1-month LIBID. Whilst there is no official published LIBID rate, for the purposes of the WCSA, the Review Board has calculated 1 month LIBID as 1-year LIBOR less 1/8 of a percentage point (0.125%).

316. Based on the methodology described above and using the rates prevailing up to 30 November 2013, the WCSA for positive working capital balances is 2.07%.

317. Based on the methodology described above and using the rates prevailing up to 30 November 2013, the WCSA for negative working capital balances is 1.25%.

## The Baseline Profit

318. The total profit earned by the Reference Group less the capital servicing allowances for financing fixed assets and working capital, can be expected to represent, inter alia, the average return companies will receive for the risks they have assumed and to be a return on their uncapitalised intangible assets. This can be expressed as a percentage of the Reference Group cost of production. This percentage, referred to as the Baseline Profit Rate, can then be used to determine the Standard Baseline Profit Allowance paid on the cost of production of non-competitive Government contracts. The calculation of the last five years' Baseline Profit Rates is set out below:

	2008/9	2009/10	2010/11	2011/12	2012/13
	Reference	Reference	Reference	Reference	Reference
	Group	Group	Group	Group	Group
	£m	£m	£m	£m	£m
(A) Cost of Production	687,083	705,897	718,833	711,002	716,653
(B) Capital Employed	224,567	232,951	221,846	215,478	222,309
(C) CP:CE ratio (A÷B)	3.06	3.03	3.24	3.30	3.22
(D) FC ratio (see Note 1)	101%	109%	112%	111%	109%
(E) WC (positive) (see Notes 1, 2)	n/a	n/a	n/a	14%	15%
(F) WC (negative) (see Notes 1, 2)	-1%	-9%	-12%	-25%	-24%
(G) Actual Profit (EBIT)	71,812	81,523	88,709	93,739	93,647
(H) FCSA % (see Note 1)	6.68%	6.71%	6.63%	6.48%	6.33%
(I) WCSA % (positive) (see Notes 1, 2)	6.66%	5.30%	3.80%	2.77%	2.33%
(J) WCSA % (negative) (see Notes 1, 2)	6.66%	5.30%	3.80%	1.41%	1.38%
(K) FCSA (B×(D÷100)×H)	15,162	17,035	16,473	15,499	15,339
(L) WCSA(pos+) (B×(E÷100)×I)	n/a	n/a	n/a	836	777
(M) WCSA(neg-) (B×(F÷100)×J)	(149)	(1,112)	(1,012)	(760)	(736)
(N) Total CSA (K+L+M)	15,014	15,923	15,462	15,575	15,379
(O) Baseline Profit (G-N)	56,798	65,600	73,247	78,164	78,268
(P) BP as % of CP (O÷A)	8.27%	9.29%	10.19%	10.99%	10.92%
<b>3 year rolling average</b>	<b>9.29%</b>	<b>9.04%</b>	<b>9.25%</b>	<b>10.16%</b>	<b>10.70%</b>

**Note 1.** The FCSA and WCSA percentage figures are derived using the data applicable as at 31 March of the year concerned.

**Note 2.** As part of the 2013 GR, it was agreed that separate rates should be applied to the Reference Group's positive and negative working capital balances in order to determine the value of the Capital Servicing Allowances. This has been calculated as from the 2011/12 Reference Group. Previously, a single WCSA% was applied to both positive and negative working capital balances, effectively applying a single rate to the net working capital. Therefore the working capital balances up to 2010/11 in the above table reflect the net position.

**Note 3.** Figures in the table are subject to rounding differences.

319. The Baseline Profit Rate is calculated from the average Baseline Profit of the Reference Group for the latest three years to reduce the volatility of the target rate caused by year-to-year fluctuations in the Reference Group's profitability. It can be seen from the table that the three-year simple average calculation has increased by 0.54 of a percentage point from the 2013 General Review. The main reason for this increase is that the 2009/10 Baseline Profit percentage figure has been replaced in the three-year rolling average calculation by the higher figure for 2012/13.

320. The Review Board has concluded that the Baseline Profit Rate derived on the basis of strict comparability with the overall return of British industry should be 10.70 per cent.

321. Accordingly the Review Board recommends that the Reference Group Baseline Profit Rate of 10.70 per cent should be used in the Government 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.

### **The Standard Baseline Profit Allowance**

322. The Reference Group Baseline Profit Rate on cost of production of 10.70 per cent, on the modified historic cost basis, needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractor Group.

323. The Review Board's assessment is that the calculation of cost of production in the Contractor Group will be different from that of the Reference Group, because the Contractor Group's figures for cost of production include intra-group trading whereas similar trading within the Reference Group will be eliminated through consolidation adjustments in group accounts. Therefore, intra-group trading within the Contractor Group needs to be assessed and eliminated in order to maintain comparability. This is undertaken through negotiations between MOD and individual members of the Contractor Group undertaking intra-group inter-unit ('IGIU') trading in order to calculate appropriately lower SBPA rates. This adjustment, together with any other adjustment that might be required in a particular year, results in the SBPA.

324. This year the Review Board does not consider that any such other adjustment is required. Therefore, for individual members of the Contractor Group with no IGIU trading, the recommended SBPA is the same as the recommended BPR for the 2014 Annual Review.

### **Risk/Reward**

325. The MOD and the JRBAC recognise that the risk profiles of different types of work will vary and the Review Board considers that the principle of pricing to reflect contract risk is sound. The parties took steps in the 2003 General Review to embed this principle into the GPF through the agreement of interim arrangements consisting of:

- A reduction of 30 basis points on the SBPA resulting in the Adjusted Standard Baseline Profit Allowance ('ASBPA') for firm or fixed price risk contracts over £50 million. Therefore, for CP:CE ratio units that are part of a group that does not undertake IGIU trading the recommended SBPA of 10.70 per cent reduces to an ASBPA of 10.40 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced ASBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading;
- A variable Risk/Reward matrix for contracts with estimated costs over £5 million. Depending on the type of work, possible 10 per cent increases or decreases in the SBPA or ASBPA may be applied to firm or fixed price contracts and contract amendments whose cost is £5 million or over; and
- A reduction of 25 per cent of the SBPA for non-risk contracts. For CP:CE ratio units that are part of a group that does not undertake IGIU trading the recommended SBPA of 10.70 per cent reduces to a Non-risk Baseline Profit Allowance (NBPA) of 8.03 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced NBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading.

326. At reviews since 2003 the Review Board has urged MOD and the JRBAC to review the interim arrangements dealing with the subject of risk and reward in GPF contracts, but little progress has been made. The Review Board understands that the assessment of the balance of risk and reward is now being considered for inclusion in the SSCRs.

327. The Review Board recommends that the existing arrangements in connection with the risk/reward matrix, as set out in Annex B to Section 2 of the GPFAA (reproduced also in Appendix C to this Report), should continue until such time as MOD and suppliers contract under new SSCRs.

### **The Contract Baseline Profit Allowance and the Total Contract Profit Allowance**

328. The SBPA (for contracts over £5 million but under £50 million) or ASBPA (for contracts over £50 million) relating to firm, fixed price or target cost contracts after adjustment in accordance with the risk/reward matrix for a particular contract becomes the Contract Baseline Profit Allowance ('CBPA').

329. As described in paragraph 307, the GPF methodology is made up of three elements. The profit allowance applicable to specific contracts and contract amendments therefore comprises the sum of the CBPA, the FCSA and the WCSA. This total allowance applicable to a non-competitive contract using the GPF methodology is known as the Total Contract Profit Allowance ('TCPA'). A flowchart setting out this methodology is at Appendix A of this Report and illustrations of the application of the recommended profit formula are at Appendix B.

### **The Comparability Principle**

330. In the GPFAA (Section 1 paragraph 1.36) the Review Board is asked 'to bring to notice in its reports anything that it regards as relevant to the operation of the GPF. This would include, should the occasion arise, respects in which the Review 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'. The Review Board has concluded that there is no such matter that it wishes to bring to the notice of MOD and the JRBAC in its Report on the 2014 Annual Review.

## SECTION IV

### RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

#### Introduction

401. The Review Board receives information on profits recently achieved on non-competitive Government contracts from two sources. Historically the primary source has been annual returns prepared for the Review Board by contractors, on a confidential basis, showing the overall results achieved on their non-competitive work in each financial year. The Review Board also receives reports summarising the results of MOD's post-costing investigations into the profits achieved on individual contracts.

#### Annual Returns

402. Thirty-seven CP:CE ratio units (contractor units), which belong to seventeen members of the Contractor Group, have submitted their 2012 annual returns for consideration at this Review. The returns analyse GPF contract work performed in the year with total sales of £5.1bn. The comparable figures for 2011 are 40 returns with total GPF sales of £5.7bn.

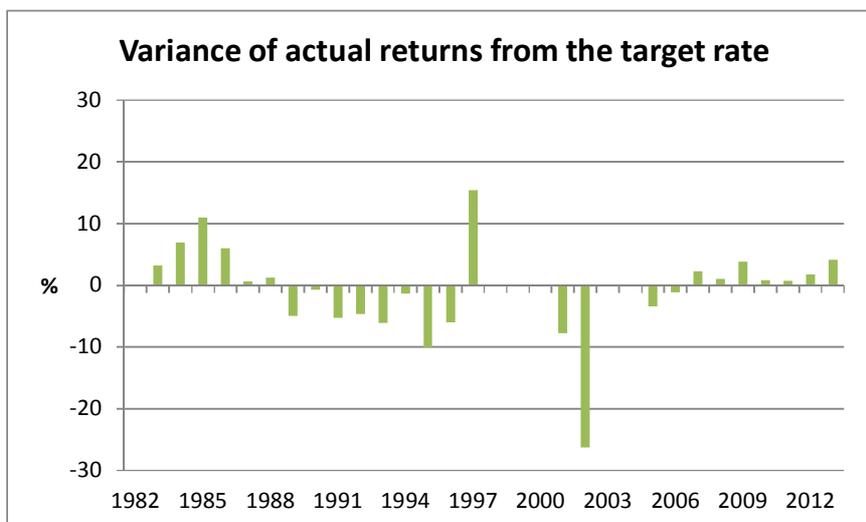
403. Analysis provided by MOD's Defence Economics unit shows that non-competitive Government contracts placed by MOD in 2012/13 totalled £3.40bn. A considerable volume of non-competitive amendments to contracts will also have been placed in the year. Defence Economics' statistics show that £3.13bn of contract amendments were placed, but it notes that there are data quality issues with this figure. This suggests total non-competitive Government contracts and amendments placed by MOD of some £6.5bn. Notwithstanding the data quality issues, and that there will be timing differences between the annual returns and the contracts placed data, it may be concluded that annual returns provide a material level of coverage of the population of GPF contracts.

404. The Review Board's estimate, based on the 2012 annual returns, shows that the overall expected ROCP on GPF contracts was 8.55 per cent (9.08 per cent in 2011), and that an actual ROCP of 12.65 per cent (10.83 per cent in 2011) was achieved. Therefore contractors, as a body, appear to have exceeded the expected ROCP by 4.10 percentage points (1.75 percentage points in 2011). The Review Board's estimate is based on a weighted average calculation of contracts with a variety of profit rates and which would have started in a number of different years.

405. The overall variance of 4.10 percentage points is somewhat higher than has been observed for a number of years. The Review Board has reviewed this figure and its principal findings were:

- There was a wide distribution in the performance of individual contractor units. The best performing contractor unit outperformed the Review Board's estimate of its target return by 44 percentage points whilst the return of the worst performing contractor unit was 31 percentage points below the Review Board's estimate of its target.
- Contractor units provided a wide variety of explanations including improved efficiency, renegotiation of contracts and profit recognition towards the end of a contract.

406. The following table shows the variance between the target returns and actual returns of GPF contracts in recent years:



Note: The above chart shows two periods when annual returns were not collected. First, the Review Board was asked to cease collecting annual returns during the period following the 1999 General Review, when Government was considering alternative methodologies for pricing non-competitive contracts, so that no returns were collected for the period 1997-1999. Secondly, part way through the 2005 annual review process MOD and the JRBAC asked the Review Board to withdraw the requirement for annual returns as they believed they would be of limited value owing to the new profit formula arrangements introduced in the 2003 General Review.

### Post-Costing

407. Post-costing is a review by the Government of the costs incurred on a contract, for comparison with the estimated (or target) costs agreed at the time of pricing.

408. Post-costing rights are to be exercised for the following purposes only:

- in pricing follow-on contracts, as an essential element in equality of information;
- to enable departments to check the accuracy of their estimating procedures;
- to provide the information for a selective scrutiny of the outcome of particular contracts so that a reference may be made by either side to the Review Board; and
- to provide verification of outturn costs for fixed or firm prices where contract terms require a sharing of the outcome of a cost over-run or under-run by means of an adjustment to the contract price. A reference may be made by either side to the Review Board where a party considers that the sharing outcome is inequitable.

409. The Review Board's direct use for post-costing results is to gain an understanding, in addition to that achieved through annual returns, of how closely contract performance matches profit formula target performance.

410. Post-costing results received from MOD are shown below:

All contracts post-costed by MOD				
	2009	2010	2011	2012
Total of contracts post-costed				
(a) Number	8	8	13	16
(b) Value	£1,057m	£1,404m	£748m	£739m

Analysis of costs of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2009	2010	2011	2012
A – Contracts where +/- 5 per cent accuracy was achieved:				
(a) Percentage by Number	63%	43%	38%	56%
(b) Percentage by Value	17%	72%	19%	40%
B – Contracts where +/- 10 per cent accuracy was achieved:				
(a) Percentage by Number	75%	57%	69%	94%
(b) Percentage by Value	84%	77%	42%	91%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):				
(a) Number	5	3	7	11
(b) Value	£827m	£909m	£215m	£525m
D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):				
(a) Number	2	2	4	1
(b) Value	£144m	£193m	£404m	£64m
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:				
(a) Number	2	1	2	2
(b) Amount of refund	£3m	£9m	£15.4m	£2.9m
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):				
(a) Number	1	1	2	4
(b) Value	£13m	£148m	£75m	£88m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):				
(a) Number	Nil	1	Nil	Nil
(b) Value	Nil	£21m	Nil	Nil

411. As can be seen, outturn costs were below target costs by more than 10 per cent on one contract with total estimated costs of £64m. Following post-costing exercises repayments totalling £2.9m were negotiated on this and on a related contract.

412. The Review Board notes that the number of contracts being post-costed is still low and is concerned that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment under DEFCON 648A. The Review Board has consistently advocated post-costing as an essential tool for assessing the effectiveness of cost estimating procedures.

413. A significant part of the regime under the proposed new SSCRs relates to enhanced reporting by contractors to give greater transparency of costs throughout the contracting process. The Review Board believes that there may be continuing merit in MOD exercising its rights in connection with post-costing in appropriate circumstances.

## SECTION V

### OTHER ASPECTS OF NON-COMPETITIVE GOVERNMENT PRICING

#### Introduction

501. Annual Reviews are usually restricted to a review of the principal components of the GPF so that the profit rate can be updated. This Annual Review has been required to consider some wider aspects of non-competitive pricing which are included in this section of the report:

- Allowability of insurance premiums.
- Treatment of R&D tax credits following accounting changes introduced following the Finance Act 2013.
- The impact of asymmetrical revenue variation clauses within single source contracts, when pricing under the GPF.
- The Review Board's terms of reference for any cost disputes where it is required to provide a decision.

#### Treatment of insurance premiums

502. The MOD raised a concern that, under the wording of the existing GACs, contractors might assume they could recover the costs of any insurance other than loss of profit insurance. The MOD and the JRBAC have agreed changes to the GACs to make it clearer which insurance costs can be charged to GPF contracts. The agreed changes, with deletions struck through and new wording underlined, are as follows:

#### 3 Computation of Capital Servicing Allowances

3.3 Cost of production, annualised where appropriate, should be computed for the same operating unit for which capital employed is computed. Inter alia, it should:

3.3.2 Exclude:

~~3.3.2.8 Loss of profit insurance premiums (profit element only).~~

3.3.2.8 Any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim.

3.3.2.9 The cost of premiums and payments for insurance which cover:

3.3.2.9.1 That element of consequential loss insurance that relates to loss of profit.

3.3.2.9.2 The contractor's own defects in materials or workmanship incident to the normal course of construction i.e. the costs to repair defects in materials or workmanship, and for breach of contract.

#### 4 Overhead costs attributable to government work

4.2 Items which are normally totally excluded:

~~4.2.6 Insurance of goods in transit and any other related to civil work risks unless required for Government work.~~

~~4.2.9 Loss of profits insurance (profit element only).~~

4.2.9 The cost or premiums and payment for insurance which cover:

4.2.9.1 That element of consequential loss insurance that relates to loss of profit.

4.2.9.2 The contractor's own defects in materials or workmanship incident to the normal course of construction i.e. the costs to repair defects in materials or workmanship, and for breach of contract.

4.3 Items which are normally treated as direct:

4.3.4 Product liability insurance, when related to a specific product.

503. The Review Board agrees with the proposed revisions.

### **Treatment of R&D expenditure credits**

#### *Introduction*

504. The terms of reference for the 2014 Annual Review include a requirement to review the treatment of R&D expenditure credits in the GACs to enable MOD to make recommendations in preparation for the transition to the baseline Single Source Cost Standards (SSCSs) on the formation of the Single Source Regulations Office.

505. Companies that incur eligible R&D expenditure are entitled to enhanced R&D expenditure credits (in excess of the amount actually spent), which reduce their tax liability and are intended to encourage UK companies to undertake R&D activity, in accordance with the Corporation Tax Act 2009. Following the Finance Act 2013, with effect from April 2013, HM Treasury changed the accounting treatment of R&D expenditure credits for R&D expenditure for large companies so they can be accounted for ATL at the operating profit level rather than “below the line”, as previously. This treatment will be optional until April 2016, at which point the ATL treatment becomes compulsory for large companies.

506. GPF contracts are assessed at the operating profit level so the change to the accounting treatment of R&D expenditure credits, to ATL, has an impact on the GPF. The change will affect both the profitability of the Reference Group, and by reference to the change in cost base to which profit is applied, the pricing of individual GPF contracts. The Review Board has noted that Government believes that the treatment of R&D expenditure credits in the pricing of GPF contracts is a matter of procurement policy. The Review Board has considered submissions provided to it by MOD and the JRBAC in connection with the changes proposed by HM Treasury and their possible impact on the GPF.

#### *The JRBAC's position*

507. The JRBAC has proposed that R&D expenditure credits should be treated as an unallowable credit irrespective of adoption of ATL or the retention of the super deduction treatment of R&D for tax purposes, and that the Review Board (and its successor the SSRO) make an adjustment to each year's Reference Group profits to remove the impact of the ATL R&D credit.

508. The JRBAC has also proposed that R&D expenditure credits should be excluded from cost of production when pricing a contract, which results in the calculation essentially remaining as it is at present, preserving the current overall target profit generated on GPF contracts. This proposal would result in contractors continuing to receive benefit through:

- A GPF rate of profit on any MOD non-competitive contracts; and
- R&D expenditure credits.

### *The MOD's position*

509. The MOD does not believe the impact of R&D expenditure credits is likely to be material enough to make an adjustment necessary to the Reference Group, but looks to the Review Board to make that judgement and recommend accordingly.

510. The MOD has proposed that ATL R&D expenditure credits relating to work funded by the MOD using the GPF, that are either directly or indirectly attributable to a GPF contract, should be included in the cost of production calculation when pricing a GPF contract. For those contractors affected by these changes and carrying out R&D funded by MOD using the GPF this would result in a lower net of tax profit compared to current practice. The MOD considers that it would be unacceptable to pay a return to contractors using the GPF and for the contractor to then earn a further return through R&D expenditure credits.

### *The Review Board's recommendations*

511. For the purposes of adjusting the Reference Group baseline profit the Review Board has considered the Research and Development Tax Credits Statistics released in August 2013 by HMRC. The detail in the statistics is not sufficient to be able to extract the precise amount in respect of companies that are included in the Reference Group. However, the statistics, which record historical data, suggest that the impact on the profitability of the Reference Group will be small. Both parties accept this. It is also currently unclear whether the Review Board will have access to sufficiently detailed information on R&D expenditure credits in order to be able to make adjustments to the Reference Group. Therefore the Review Board recommends that no adjustment should be made to the method of calculation of the Reference Group baseline profit.

512. The Review Board recommends the impact of the R&D expenditure credits on the Reference Group is monitored in the future to assess whether it would be appropriate to make amendments to the Reference Group in future periods.

513. Based on the submissions provided by MOD and the JRBAC, the Review Board considers it fair and reasonable that a contract should be priced using the prevailing GPF rate of profit on the cost, net of any ATL R&D expenditure credits, of carrying out MOD-funded R&D that is priced using the GPF.

514. The Review Board recognises that these changes may give rise to implementation issues which will need to be fully explored. It is understood that MOD and the JRBAC intend to initiate a dialogue during early 2014 with the aim of agreeing a process which will ensure consistent implementation across the supply base. The Review Board is willing to work with the parties to address these issues. The Review Board does make two particular recommendations:

- The Review Board considers that it would not be appropriate to make changes in respect of GPF contracts which have already been priced; and
- The Review Board recognises that the present R&D expenditure credit arrangements have applied for a number of years so it would be appropriate to negotiate transitional arrangements.

## **The impact of asymmetrical revenue variation clauses within single source contracts, when pricing under the GPF**

### *Introduction*

515. As part of its terms of reference the Review Board was requested by MOD and the JRBAC to assist MOD and the JRBAC to reach agreement on the differing views they might have in defining the base to which the profit allowance is applied, particularly in the light of the current arrangements and the principles reflected in Paragraph 1.20 of Section 1, Part B of the GPFAA.

516. The Review Board has received submissions from both MOD and the JRBAC setting out their views. The MOD's initial position is that it considers the issue to be too complex to be resolved within the timescale of the 2014 Annual Review and that it should be reviewed by the SSRO when it is created.

517. In light of this, the Review Board considered whether this topic should continue to be included in the terms of reference for the current Review. The Review Board's view was that it should consider all matters included in its terms of reference, unless they were withdrawn by the mutual agreement of the parties to the terms of reference. In the course of discussions with the parties, it was agreed that the issue for consideration should be limited to an examination of the impact of asymmetrical revenue variation clauses within single source contracts, when pricing under the GPF. The expression "asymmetrical revenue variation clauses" is not one used by or defined in the GPFAA and its meaning and extent are not certain. If, however, the Review Board were asked to examine such a clause either by way of reference or by way of Pre-contract dispute then it would consider the meaning and implications in the context of the contract under examination.

518. Whilst the Review Board considers that it can advise on the cost base for profit calculations on individual contracts in the context of a reference it feels that, in this instance, it can only advise on the principles which should be followed, which are already contained within the GPFAA.

519. The underlying objective of the GPFAA is that fair and reasonable prices in respect of the placing and pricing of non-competitive Government contracts shall be agreed (GPFAA Section 1 paragraph 1.2) and therefore a cost should only be allowable if it is fair and reasonable when allocated to a particular contract. Whether or not a particular cost should be allocated to a contract is a matter for negotiation between MOD and the contractor, taking into account the guidance in the GACs.

### *The JRBAC's position*

520. The main concern raised by the JRBAC was in relation to the impact of asymmetric contract pricing arrangements such as TCIF contracts with a maximum price, or clauses with performance-related price adjustments. The JRBAC considered that the additional risk arising from these arrangements should be evaluated, so that expected returns remain at the priced profit rate. This, it was argued, would be consistent with the principles set out in Paragraph 1.20 (b) of Section 1 of the GPFAA.

### *The MOD's position*

521. The MOD accepted that there might be additional risk from these arrangements, but considered that any such risk should be recognised through a risk adjustment to the profit rate for the contract. Such an adjustment could be accounted for within the risk adjustment process envisaged for the Single Source Contract Regulations, but could not be applied easily to the Risk/Reward Matrix used in the existing arrangements.

### *The Review Board's recommendations*

522. It is the Review Board's view that adequate guidance and protections already exist to ensure that both parties to a GPF contract are treated fairly, in particular:

- The parties are free to determine the conditions to any contract they enter into and the Review Board believes, as it stated in its 2007 General Review (paragraph 219), that "it is not for the Board to set aside arrangements freely entered into by the parties, except in exceptional cases". For clarity, this is not intended to suggest that a contract that deviates from precise application of the GPF rate is not a GPF contract. A GPF contract includes in the price "an allowance for profit calculated *by reference* [emphasis added] to the GPF rate applicable at the time of pricing".
- Pre-contract disputes: Where there is a dispute between MOD and a contractor other than under the pricing DEFCONs<sup>5</sup> then in certain circumstances the matter may be referred to a third party, which may be the Review Board, for an expert opinion.

523. As part of its consideration of this issue the Review Board has reviewed the available evidence to see whether there is a suggestion that contractors might be being disadvantaged, either through asymmetric contracting arrangements or through some other factor. The Review Board's principal source of contract profitability data is the annual returns it receives from contractors, which are considered in detail elsewhere in this report. Whilst it is recognised that the data is aggregated and that returns for individual contracts and individual contractors will vary, the aggregated data shows that in recent years the contractors have been exceeding their target profit. The MoD's post costing results represent a smaller and more selective sample but also suggest that contractors have been exceeding their target profit. Therefore, neither of these sources of information provide any obvious support for the JRBAC's concerns.

524. In addition, the existing GPF arrangements include protections such as:

- Questionnaires on the Method of Allocation of Costs (QMACs): Contractors use the QMAC process to disclose their cost accounting practices, which should be the same for Government and for non- Government work.
- The GPF rate setting: MOD and the contractor agree the capital structure of the contracting unit and the appropriate rate to be used on GPF contracts.
- Equality of Information Pricing Statements: EoI pricing statements are signed by both parties at the outset of each contract to acknowledge that each party has made the other aware of material issues, including the expected costs, relevant to the pricing of the contract.

- GACs: “The aim of the GACs is to set out the basis upon which a Contractor includes direct costs in a contract price proposal and computes its capital employed, cost of production and overheads for a rate claim submission” (GPFAA Section 2 Annex D Paragraph 1.2). The GACs are at a high level and generally principle based, also allowing costs to be removed if they are deemed to be “unnecessary, extravagant or wasteful”.
- Contingencies: Contingencies are allowable (GPFAA Section 1 Paragraph 1.19 – 1.20), where justified by reference to previous experience, the length of a contract, its complexity, or the degree of technical innovation involved so that prices, on average, result in profits being earned in line with GPF allowances.
- Post-costing: Where a contract contains DEFCON 648 or 648A MOD is entitled to a summary of the costs incurred on that contract and may examine the contractor’s records relating to those costs.
- Post contract disputes: Where a contract contains DEFCON 650 (or 650A or 651 or 651A), and is eligible, it may be referred to the Review Board to review and give rulings on the pricing of that contract (GPFAA Section 1 Paragraphs 1.39 – 1.52).

525. In recent years the Review Board has encouraged the two parties to consider the treatment of risk and reward on non-competitive contracts; the Review Board now understands this topic is being addressed by MOD and its major contractors as part of the Currie Review, with the aim of incorporating a new risk/reward mechanism into new Single Source Contract Regulations (‘SSCRs’).

526. In conclusion, the Review Board considers that the existing arrangements provide contractors and MOD with adequate protection against unfair contracting arrangements and that issues can be referred to the Review Board for a decision where appropriate. The Review Board also considers that the principles set out in Paragraph 1.20 (b) are context specific in relation to contingencies and the level of provision made for them in contracts. Whilst consistent with the concept of fair and reasonable pricing, Paragraph 1.20 (b) is not specifically relevant to the arguments raised by MOD and the JRBAC. Therefore, the Review Board recommends that there should be no changes to the existing GPFAA arrangements in relation to this matter in the interim period before the proposed Single Source Contract Regulations are introduced.

527. The Review Board’s views on this matter are not intended to constrain the SSRO when it comes to consider this issue and, in particular, it is recognised that it may be appropriate to address the issue differently in the context of the proposed Single Source Contract Regulations.

### **Terms of reference of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs**

528. The GPFAA Section 1 paragraph 1.56 states that MOD and the JRBAC, in consultation with the Review Board, will develop the Review Board’s terms of reference in relation to disputes other than those referred through the provisions of the pricing DEFCONs<sup>6</sup>.

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<sup>5</sup> In this context the term ‘pricing DEFCONs’ refers to SC50 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

<sup>6</sup> In this context the term ‘pricing DEFCONs’ refers to SC50 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

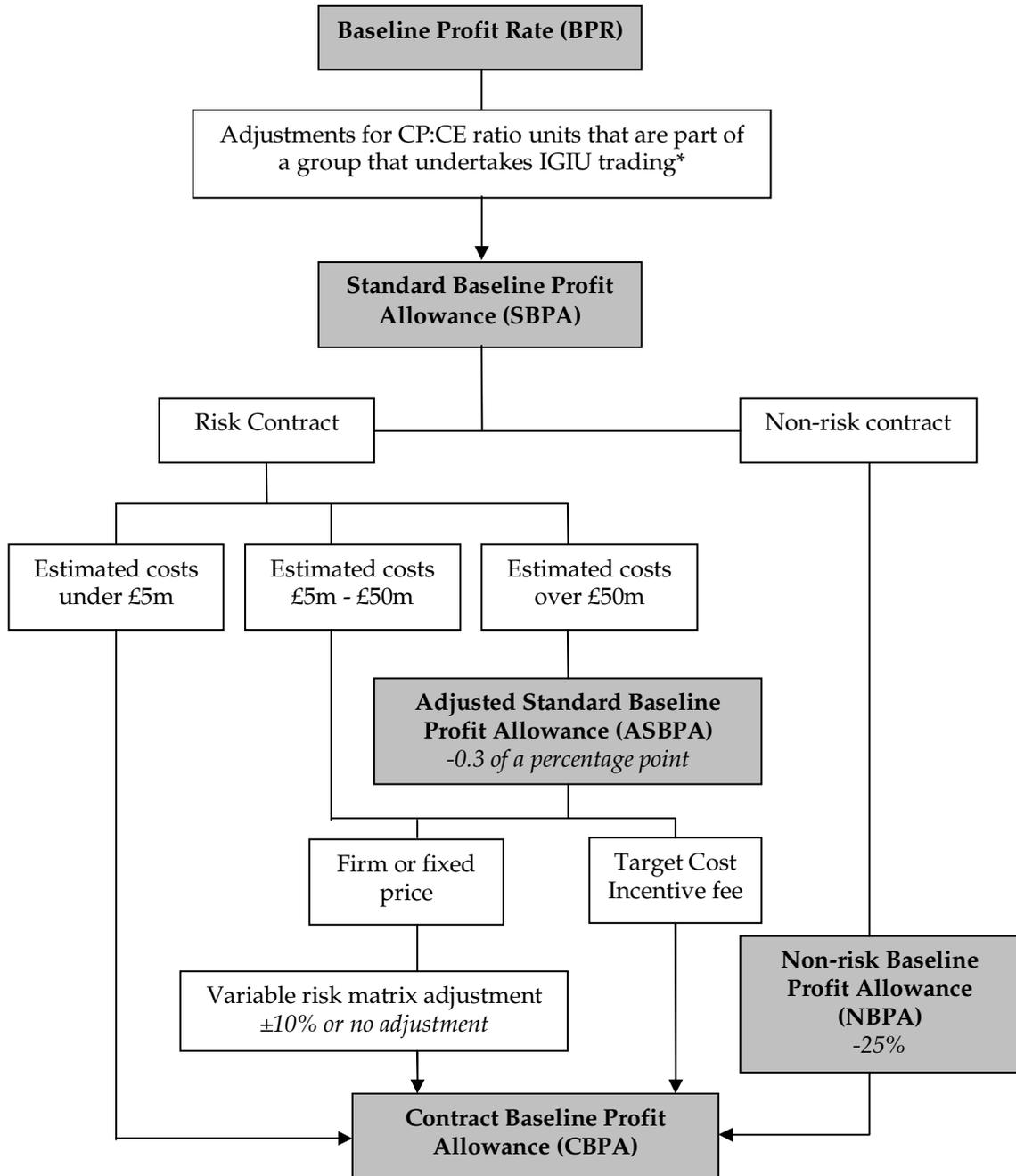
529. These terms of reference have been agreed by MOD, the JRBAC and the Review Board and are included at Appendix E. The Review Board recommends that they should be inserted into the GPFAA as Annex B to Section 1.

530. The Review Board, with the agreement of MOD and the JRBAC, has prepared notices of reference for these disputes which are available from the Review Board's secretariat.

APPENDIX A

BASELINE PROFIT FLOWCHART

Flowchart showing how the Reference Group Baseline Profit Rate is the basis of deriving the Total Contract Profit Allowance for a non-competitive Government contract



\* Exceptionally, there could also be an adjustment at this point for any divergence between strict comparability between reference group profitability and GPF profitability.

CBPA	+	FCSA	+	WCSA	=	Total Contract Profit Allowance (TCPA)
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## APPENDIX B

### THE RECOMMENDED PROFIT FORMULA - ILLUSTRATIONS

Prepared by the Review Board for Government Contracts – January 2014

This appendix provides some illustrations on the use of the recommended profit formula to determine the Total Contract Profit Allowance for individual contracts.

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

1. A CP:CE ratio of 3:1 and a contract attracting the Standard Baseline Profit Allowance;
2. A CP:CE ratio of 3.6:1 and a contract attracting the Standard Baseline Profit Allowance;
3. A CP:CE ratio of 6:1, net negative working capital and a contract attracting the Standard Baseline Profit Allowance;
4. A CP:CE ratio of 3:1 and a contract for a repeat production order attracting the Standard Baseline Profit Allowance less 10 per cent;
5. A CP:CE ratio of 3:1 and a contract requiring specialist skills and attracting the Standard Baseline Profit Allowance plus 10 per cent; and
6. A CP:CE ratio of 3:1 and a non-risk contract attracting the Standard Baseline Profit Allowance less 25 per cent.

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

## APPENDIX B: ANNEX I

### ILLUSTRATIONS OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
<b>CP:CE ratio calculation:</b>						
(A) Fixed capital	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
(B) Working capital	1,000,000	500,000	-500,000	1,000,000	1,000,000	1,000,000
(C) Total capital (A + B)	3,000,000	2,500,000	1,500,000	3,000,000	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	9,000,000
(E) CP:CE ratio (D/C)	3.0	3.6	6.0	3.0	3.0	3.0
<b>CSA calculation:</b>						
(F) FCSA	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%
(G) FC proportion (A/C)	66.67%	80.00%	133.33%	66.67%	66.67%	66.67%
(H) (F x G)	4.13%	4.96%	8.27%	4.13%	4.13%	4.13%
(I) WCSA (positive)	2.07%	2.07%	2.07%	2.07%	2.07%	2.07%
(J) WC proportion (B/C)	33.33%	20.00%	0.00%	33.33%	33.33%	33.33%
(K) (I x J)	0.69%	0.41%	0.00%	0.69%	0.69%	0.69%
(L) WCSA (negative)	1.25%	1.25%	1.25%	1.25%	1.42%	1.42%
(M) WC proportion (B/C)	0.00%	0.00%	-33.33%	0.00%	0.00%	0.00%
(N) (L x M)	0.00%	0.00%	-0.42%	0.00%	0.00%	0.00%
(O) CSA (H + K + N)	4.82%	5.37%	7.85%	4.82%	4.82%	4.82%
(P) CSA as percentage of CP (O/E)	1.61%	1.49%	1.31%	1.61%	1.61%	1.61%
<b>Individual contract price:</b>						
(Q) Contract CP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
(R) Standard Baseline Profit Allowance	10.70%	10.70%	10.70%	10.70%	10.70%	10.70%
(S) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(T) Contract Baseline Profit Allowance	10.70%	10.70%	10.70%	9.63%	11.80%	8.03%
(U) CSA (P)	1.61%	1.49%	1.31%	1.61%	1.61%	1.61%
(V) Total Contract Profit Allowance (T + U)	12.31%	12.19%	12.01%	11.24%	13.41%	9.64%
(W) Total formula payments (Q x V)	123,100	121,900	120,100	112,400	134,100	96,400
(X) Total contract price (Q + W)	1,123,100	1,121,900	1,120,100	1,112,400	1,134,100	1,096,400

**Note:** the above figures are subject to rounding errors.

#### Explanation:

The above illustrations assume contracts with a CP of £1 million in a variety of circumstances. Example 1 assumes that the Standard Baseline Profit Allowance of 10.70% 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 and with negative working capital. Examples 4, 5 and 6 illustrate how payments change for contracts where the Standard Baseline Profit Allowance requires an adjustment in accordance with the risk/reward matrix.

**APPENDIX B: ANNEX II**

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

	CSAs	Total
<b>Contractor's CP:CE ratio:</b>		
(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 (D/C)	3	
<b>CSA calculation:</b>		
(F) FCSA	6.20%	
(G) FC proportion (A)	80.00%	
(H) (F x G)	4.96%	
(I) WCSA	2.07%	
(J) WC proportion (B)	20.00%	
(K) (I x J)	0.41%	
(L) CSA (H + K)	5.37%	
(M) CSA as percentage of CP (L/E)	1.79%	
<b>Individual contract price:</b>		
(N) Contract CP	75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	10.70%	
(P) Reduction for contracts over £50m	0.30%	
(Q) Adjusted Standard Baseline Profit Allowance (O – P)	10.40%	
(R) Adjustment in accordance with the Risk/Reward matrix	nil	
(S) Contract Baseline Profit Allowance	10.40%	
(T) CSA (M)	1.79%	
(U) Total Contract Profit Allowance (S + T)	12.19%	
(V) Total formula payments (N x U)	9,142,500	9,142,500
(W) Total contract price (N + V)		84,142,500

**Explanation:**

The illustration assumes a contract with a CP of £75 million being undertaken by a contractor with a CP:CE ratio of 3:1. It also assumes that the Adjusted Standard Baseline Profit Allowance does not require any adjustment in accordance with the risk/reward matrix for this contract.

## APPENDIX C

### THE RISK/REWARD MATRIX

<b>FLEXIBLE PROFIT ADJUSTMENT (TO STANDARD BASELINE PROFIT ALLOWANCE)</b>			
<b>TYPE OF WORK</b>	<b>SBPA – 10%</b>	<b>SBPA</b>	<b>SBPA + 10%</b>
SUPPLY	<ul style="list-style-type: none"> <li>● Follow on and repeat orders for production/ supply involving existing specification</li> <li>● Repeatable quality</li> </ul>	<ul style="list-style-type: none"> <li>● Interrupted production</li> <li>● Typical/normal production orders</li> </ul>	<ul style="list-style-type: none"> <li>● First production batch for a new requirement with significant development/production overlap</li> <li>● One-off high technology procurement</li> </ul>
SUPPORT/SERVICE PROVISION	<ul style="list-style-type: none"> <li>● Clearly defined specification</li> <li>● Repeatable quality</li> <li>● Reactive support/repairs, maintenance or ongoing contracts</li> </ul>	<ul style="list-style-type: none"> <li>● Initial repair and support order</li> <li>● Customer specified repair and maintainability standards</li> <li>● Support requirements not fully defined</li> </ul>	<ul style="list-style-type: none"> <li>● Long term commitment to Service and Capability provision to a defined output standard</li> </ul>
DEVELOPMENT	<ul style="list-style-type: none"> <li>● After design certification, support activities involving routine document maintenance and simple analysis of existing designs</li> <li>● Post development work, minor development work and programmes involving minor modification of established technologies</li> </ul>	<ul style="list-style-type: none"> <li>● Development work</li> <li>● Contractor accepts full responsibility for performance and integration</li> <li>● Modification Programmes including proposals for, and analysis of, extensive changes to existing design in respect of established technologies</li> <li>● Fault management</li> </ul>	<ul style="list-style-type: none"> <li>● High Technology or Specialist skills or new concepts</li> </ul>

## 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 Baseline Profit Allowance less 25 per cent in all instances. The risk matrix set out above does not apply to cost-plus contracts.
4. In the case of firm or fixed price contracts and contract amendments with an estimated or target cost of £50 million or more, the Baseline Profit allowance should be 30 basis points less than the Standard Baseline Profit Allowance (known as the Adjusted Standard Baseline Profit Allowance or ASPBA) subject to any further 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 Baseline Profit Allowance for contracts or contract amendments with a target cost below £50 million; and
  - should be based on the Adjusted Standard Baseline Profit Allowance (ie the SBPA 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 subject to review and monitoring in order that the arrangements can be refined and developed.

## APPENDIX D

### Government Accounting Conventions updated for the recommendations contained in the report on the 2014 Annual Review

#### 1. Aim of the Government Accounting Conventions

- 1.1 The Government Accounting Conventions (GACs) are those accounting conventions agreed from time to time, between the Ministry of Defence ('MOD') acting on behalf of the Government and the CBI acting on behalf of industry, for pricing non-competitive Government contracts. These Conventions are applicable to both direct contract costs and indirect costs. These Government Accounting Conventions are available for use by all other Government departments.
- 1.2 The aim of the GACs is to set out the basis upon which a Contractor includes direct costs in a contract price proposal and computes its capital employed, cost of production and overheads for a rate claim submission to the Government department concerned, for the purpose of pricing non-competitive Government contracts. Wherever possible a contractor's normal accounting systems will be used. The Contractor is to disclose his cost accounting practices and apply them consistently.
- 1.3 At the request of the Government department considering the direct labour and overhead costs submitted in accordance with 1.2 above the contractor will give access to the department to information that it holds adequate to justify the direct labour rates and specific elements of the burden rates claimed.
- 1.4 The Government department concerned will examine the information described in paragraphs 1.2 to 1.3 above, with the aim of reaching agreement with the Contractor concerning those rates. Where costs are disallowed a written explanation will be provided to the Contractor by the Government department. In cases where the Government department concerned is not persuaded by the justification of costs provided and consequent disallowances mean that an agreement cannot be reached, then the dispute over claimed costs may be referred to a third party<sup>7</sup> for an expert opinion.
- 1.5 Costs and capital employed shall be computed in accordance with the GACs for determining the level of fixed capital employed, working capital employed, overhead costs and the cost of production applicable at the time of pricing.
- 1.6 Where costs arise which are exceptional or abnormal in size or incidence then the parties will negotiate on a case-by-case basis the extent to which such costs (wholly or in part) can be agreed to be settled outside of the overheads. In all cases where costs arise or are expected to arise which are exceptional or abnormal in size or incidence, then the parties should inform each other and commence confidential discussions at the earliest opportunity.

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<sup>7</sup> Which may be the Review Board for Government Contracts.

- 1.7 The attribution of costs between overhead costs and direct contract costs is a matter for agreement between Government and individual contractors based on the contractor's normal accounting system.

## **2. Disclosure of Cost Accounting Practices**

- 2.1 The contractor is to disclose his cost accounting practices to the Government department concerned and is to apply them consistently. In the MOD, this information is obtained through the use of a contractor disclosure statement known as a Questionnaire on the Method of Allocation of Costs (QMAC).
- 2.2 The contractor's costing system should be the same for his Government work as it is for his non-Government work. If it is proposed that the allocations on his Government work should differ from that on his non-Government work this should be clearly stated and full explanations provided.

## **3. Computation of Capital Servicing Allowances**

- 3.1 The aim is to establish the average capital employed in 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.
- 3.2 Capital Employed. In order to determine the contractor's capital employed it is necessary to allocate employment of capital shown in the balance sheet ('net assets') between those items which qualify for capital servicing allowances and those which do not, thereby enabling the apportionment of qualifying net assets between individual contracts pro-rata to cost of production. 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 3.1 above for the period under review (based on the company's accounts subject to any adjustment required in order to comply with International Accounting Standards<sup>8</sup>), adjusted for the following where relevant:
- 3.2.1 Exclude from assets
- 3.2.1.1 Goodwill.
- 3.2.1.2 Adverse (debit) balance in retained earnings.
- 3.2.1.3 Investments in shares and securities.
- 3.2.1.4 Shares held in and permanent loans to subsidiary companies being capital not employed in the business of the parent Company.
- 3.2.1.5 Cash demonstrably surplus to requirements (i.e. short term investments; deposits; and cash demonstrably in excess of the amount required for working cash resources

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<sup>8</sup> However UK GAAP may be appropriate in circumstances where the parties agree.

for day to day operations).

- 3.2.1.6 Capital not employed efficiently such as capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use<sup>9</sup> 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.
- 3.2.1.7 Certificates of tax deposit.
- 3.2.2 Include within assets
  - 3.2.2.1 Trading balances with subsidiary, affiliate and other group companies.
- 3.2.3 Other adjustments (these may result in either an addition to or a deduction from balance sheet figures, according to the circumstances):
  - 3.2.3.1 The balance sheet figure for inventories is included in capital employed based on costs derived from values recorded in the statutory accounts 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 3.2.3.4. through 3.2.3.6.
  - 3.2.3.2 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.
  - 3.2.3.3 Development expenditure 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.
  - 3.2.3.4 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

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<sup>9</sup> Assets in course of construction are admissible as capital employed.

to the contract price.

- 3.2.3.5 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.
- 3.2.3.6 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.
- 3.2.3.7 Where costs are spread over several years under 4.4.1, any amount not written off at a balance sheet date will be included as an asset in capital employed.
- 3.2.3.8 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.

3.2.4 Creditors and other general adjustments:

- 3.2.4.1 Where non current assets have been acquired under finance leases, the amount included in the balance sheet as a creditor will be treated as a source of capital i.e. not deducted.
- 3.2.4.2 All loans (including bank overdrafts) are treated as a source of capital – i.e. not deducted.
- 3.2.4.3 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.
- 3.2.4.4 Mainstream corporation tax and deferred taxation are treated as a source of capital – i.e. not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.
- 3.2.4.5 Launch 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.

3.2.4.6 Declared and proposed dividends are treated as a source of capital – i.e. not deducted.

3.2.4.7 Provisions for future cost liabilities where excluded from allowable costs should be treated as a source of capital - i.e. not deducted.

3.3 Cost of production, annualised where appropriate, should be computed for the same operating unit for which capital employed is computed. Inter alia, it should:

3.3.1 Include:

3.3.1.1 Direct costs – direct wages, materials, bought out equipment, subcontractors' and other direct charges.

3.3.1.2 Indirect costs –with the exceptions set out in 3.3.2 below.

3.3.2 Exclude:

3.3.2.1 Capital expenditure.

3.3.2.2 The cost of raising and servicing loan capital.

3.3.2.3 Appropriation of profits, e.g. dividends, corporation tax.

3.3.2.4 Notional transactions.

3.3.2.5 Costs related to assets excluded from capital employed in accordance with 3.2.1 above.

3.3.2.6 Discounts allowed on sales, which are treated as abatements of selling prices.

3.3.2.7 Unnecessary, extravagant or wasteful outlays excluded from overheads under 4.2.8 below.

3.3.2.8 Any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim.

3.3.2.9 The cost of premiums and payments for insurance which cover:

3.3.2.9.1 That element of consequential loss insurance that relates to loss of profit.

3.3.2.9.2 The contractor's own defects in materials or workmanship incident to the normal course of construction i.e. the costs to repair defects in materials or workmanship, and for breach of contract.

- 3.3.2.10 Compensation payments of an abnormal nature to the extent that they are excluded under 4.4.1.1 below.
- 3.3.2.11 Lump sum additions to pension schemes to the extent that they are excluded from overheads under 4.4.1.2 below.
- 3.3.2.12 Subscriptions and donations of a political nature.
- 3.3.2.13 Credits, grants or refunds dealt with under 4.5.1 below should be deducted from cost of production.

#### **4. Overhead costs attributable to government work**

- 4.1 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 the contractor is entitled to ask for and receive a written justification of the reason for the proposed disallowance. 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 International Accounting Standards<sup>10</sup> and subject to the following adjustments:
  - 4.2 Items which are normally totally excluded:
    - 4.2.1 Any expenditure of a capital nature (depreciation is allowable).
    - 4.2.2 Any distributions of profit.
    - 4.2.3 The cost of raising and servicing capital, including short-term financing and finance leases.
    - 4.2.4 Bad debts and any provision therefore, unless they arise on Government sub-contracts.
    - 4.2.5 Discounts allowed on sales.
    - 4.2.6 Notional transactions.
    - 4.2.7 Unnecessary, extravagant or wasteful outlays. The contractor is entitled to a written justification on the exclusion of this type of expenditure.
    - 4.2.8 The cost or premiums and payments for insurance which cover:
      - 4.2.8.1 That element of consequential loss insurance that relates to profit.
      - 4.2.8.2 The contractor's own defects in materials or

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<sup>10</sup> However UK GAAP may be appropriate in circumstances where the parties agree.

workmanship incident to the normal course of construction i.e. the costs to repair defects in materials or workmanship, and for breach of contract.

- 4.2.9 Costs and income related to assets excluded from capital employed in accordance with 3.2.1 above.
- 4.2.10 Subscriptions and donations of a political nature.
- 4.3 Items which are normally treated as direct:
  - 4.3.1 Agents' commissions.
  - 4.3.2 Outward carriage of finished products.
  - 4.3.3 Insurance of credit risk, royalties and licence fees where these can be identified as direct costs.
  - 4.3.4 Product liability insurance, when related to a specific product.
- 4.4 Items which may be partially excluded or deferred:
  - 4.4.1 Where the allowable portion of some costs (as negotiated on a case by case basis) is exceptional or abnormal in size and incidence, it may be spread over a number of years. Costs spread forward in this way will be eligible for inclusion in capital employed under 3.2.3.7. Examples of these costs are:
    - 4.4.1.1 Compensation payments of an abnormal nature.
    - 4.4.1.2 Lump sum additions to pension schemes.
    - 4.4.1.3 Bid and Proposal costs.
  - 4.4.2 Research and Development (see 6 below).
  - 4.4.3 Marketing and selling expenses (including salaried salesmen's commissions). Marketing & Selling is a broad heading which refers to a range of costs and overheads that relate to the function. Expenses should be analysed by type of cost and by product group so as to ensure that the share of the total expenses borne by each product group fairly reflects the correct incidence of costs falling on the product groups which the expenditure was designed to benefit.
- 4.5 Items treated as reducing overhead costs:
  - 4.5.1 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.
- 4.6 Other items:
  - 4.6.1 Depreciation/amortisation. The amount to be included for depreciation/amortisation should be calculated at the contractor's own rates, provided they are consistent, reasonable, and relate to

the fixed asset values, subject to exclusions in 3.2. Amortisation of development expenditure carried forward should be treated as costs to be recovered under 6.2.1 below.

- 4.6.2 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.
- 4.6.3 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.
- 4.6.4 Bonuses paid in cash or in kind. Where payments under employees' profit sharing schemes are simply an element of employees' normal remuneration the payments should be included in attributable costs. 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 cost of shares issued to employees at favourable prices should be arrived at in the manner prescribed by IFRS.
- 4.6.5 Costs incurred to purchase permits under the EU Emissions Trading System ('EU ETS') will be included in attributable costs provided that the contractor can demonstrate that it is taking reasonable measures to minimise its emissions. Attributable costs will be reduced by the value of any credits gained through the sale of permits. The cost of fines or penalties imposed on a contractor for breaches of emissions regulations will be excluded from attributable costs.

## **5. Rationalisation and/or Plant Closures.**

- 5.1 Rationalisation and/or plant closure costs may arise which are exceptional in size or incidence and by agreement between the parties may be negotiated as a separate, stand-alone arrangement, as described at GAC 1.6 above. The parties will agree on a case-by-case basis when such situations arise, noting the following are likely to be indicators that a separate agreement should be considered:

Site closures

Substantial redundancy programmes

Substantial site reorganisation and remodelling

Where there is no future business at a site

- 5.2 In such cases where it is agreed that negotiations are to be on a stand-alone basis, any negotiation should consider as its starting point the GACs. Whilst the negotiation of any sum to be paid by the Government department concerned may initially have to be made on the basis of

projected estimated costs, the Government department will look to negotiate final settlement on the basis of the actual costs incurred.

- 5.3 Where reasonable net costs incurred on rationalisation and/or plant closures are to be included in attributable costs to be recovered through overheads, then such costs may include:

Redundancy payments;

Employee relocation expenses;

Job creation scheme costs;

Transfer costs for equipment;

Education/learner costs on transferred work;

Disruption costs – waiting and idle time;

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

- 5.4 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 the government department and the contractor.

- 5.5 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:

5.5.1 Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits exceed such costs the Government department should not be entitled to share in the excess unless the profits arise on disposal of assets to which the department has contributed significant investment.

5.5.2 The net profit from asset disposals set against rationalisation and/or closure costs should be calculated by reference to the gains realised by the company on disposal of that asset. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed. The amount of any loss realised on asset disposal is to be added to the rationalisation or closure costs.

5.5.3 Estimated profits/losses should be calculated at the time that rationalisation or plant closure takes place. 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 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.

## 6. Private venture research and development expenditure

### 6.1 Recording, classification and attribution of expenditure

6.1.1 Contractors will classify in their accounting records all expenditure on private venture research and development (R&D) in accordance with the definitions in UK SSAP 13.

6.1.2 Private venture research and development expenditure will 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.

6.1.3 The principles described in paragraphs 6.1.1 and 6.1.2 above will also apply to expenditure incurred by a contracting group at a research and development establishment including those cases where this is operated by a separate company.

### 6.2 Recovery of expenditure

6.2.1 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following rules for its recovery will, subject to the qualifications contained in paragraphs 6.2.2 to 6.3.2 below, normally apply:

6.2.1.1 In the case of a product or service under development, the nature of which is such that it should be possible to ascertain the utilisation of the product or service developed, the recovery will be by direct charge to the product or service concerned. The direct charge should be a fair apportionment of the contractor's unfunded private venture product development costs (whether or not these have been carried forward in the contractor's accounts) calculated on the basis of the forecast total sales of the product or service.

6.2.1.2 In the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs will be recovered by a charge to the current total output of the product group. Abortive private venture research and development expenditure admitted for recovery under paragraphs 6.3.1 and 6.3.2 below will be recovered on this basis.

6.2.2 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:

6.2.2.1 having regard to all the circumstances, that the

classification, allocation and apportionment of expenses adopted by the contractor is fair and reasonable; and

6.2.2.2 that any unreasonable, unnecessary, extravagant or wasteful expenditure is excluded.

6.2.3 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.

6.2.4 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.

### 6.3 Abortive expenditure

6.3.1 Abortive research and technology expenditure should be treated in the same way as any other research and be admitted for recovery on the principle described in paragraph 6.2.1.2 above.

6.3.2 Expenditure on product development which proves abortive or is otherwise irrecoverable (for example, because of inadequate sales of the product concerned) will be admitted for recovery in accordance with paragraph 6.2.1.2 above only to the extent that the development had potential benefit to the Department concerned and subject to the provisions of paragraphs 6.1.2, 6.1.3 above and 6.4.1 below.

### 6.4 Timing of recovery

6.4.1 As a result of the long time span or fluctuating level of some research and development programmes, it may be 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. In these 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.

6.4.2 If also carried forward in the financial accounts of the contractor, such expenditure will rank as capital employed for Government Profit Formula 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.

## 7. Pensions<sup>11</sup>

- 7.1 The guidance issued by the Board in its 1990GR which was based on SSAP24, the prevailing accounting practice at that time in terms of pensions, is no longer appropriate now that SSAP24 has, for UK listed companies, been superseded by the introduction of IAS 19, and FRS 17 for other UK companies that have not elected to adopt IAS 19;
- 7.2 Defined contribution plan costs should continue to be allowed in full for pricing purposes;
- 7.3 The normal annual cost for defined benefit pension plans charged to the Income Statement (including the net financing charge relating to pensions) should be allowed in pricing contracts under the Government Profit Formula arrangements; and
- 7.4 Actuarial gains and losses arising on defined benefit pension plans should not be allowed as a cost of production in pricing contracts under the Government Profit Formula arrangements.

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### <sup>11</sup> FOOTNOTE:

Following the Review Board's 2007GR recommendation on pension costs, captured in GAC 7 above, the MOD and the JRBAC did further work to assist with its implementation, and published their agreement in an Addendum to the 2007GR. Appendix 1 to the Addendum recorded the agreement of a definition concerning defined benefit pension schemes, as follows:

**MOD/JRBAC agreed definition concerning defined benefit pension schemes (Review Board 2007GR report, paragraph 454c refers)**

#### Post-retirement benefits: defined benefit schemes

The amount to be allowed in attributable costs under the Government Profit Formula arrangements should be limited to the current service cost (deemed 'normal') as recorded in the Income Statement. Other elements in the income statement that may be considered to be 'normal' may include, but are not necessarily limited to, the following items:

- (i) Changes to commutation arrangements;
- (ii) Discretionary increases where it is normal scheme practice.

Amounts that may form part of a charge or credit to the Income Statement that are not to be considered 'normal' should be disallowed. These may include, but are not necessarily limited to, the following items:-

- (i) Financing Charge or Credit;
- (ii) Experience (or Actuarial) Gains and Losses;
- (iii) Amortizations;
- (iv) Pension curtailment and /or settlement gains; and
- (v) Any element of current service cost related to deficit funding.

Any amounts that appear in the SORIE should also be excluded.

During the 2013GR, the MOD and the JRBAC agreed the following concerning the Pension Protection Levy:

Pension Protection Levy reimbursed to pension schemes in whole or in part by companies employing scheme members will be allowed in attributable costs.

## APPENDIX E

### Terms of reference of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs

#### **Overall aims:**

1. The overall aim of the process is to provide fair and reasonable solutions in a quick and cost effective manner for cost related disputes between MoD and contractors which are not eligible for referral under the pricing DEFCONs<sup>1</sup>.

#### **Jurisdiction:**

2. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs<sup>1</sup>, the Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.
3. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs<sup>1</sup>, the Government and the CBI have also agreed that disputes relating to certain terms, such as the failure by the contractor to supply an adequate summary of costs incurred and disproportionate actions by MoD may be referred to the Review Board.
4. The bases for referral of a dispute under paragraphs 2 or 3 above to the Review Board, whether for a pre-contractual cost-based dispute or for an individual contract referral made other than through the provisions of the pricing DEFCONs<sup>1</sup>, are any of the following:
  - a. where there is a statutory provision that provides for a reference to be made by the Government, a supplier, or both;
  - b. where there is an agreement between the Government and a supplier that provides for a reference to be made by the Government, a supplier, or both; and
  - c. where there is a procurement contract between the Government and a supplier that includes a term, other than the pricing DEFCONs<sup>1</sup>, that provides for a reference to be made by the Government, a supplier, or both.
5. Disputes that, at the time of the reference, are eligible for referral under the pricing DEFCONs<sup>1</sup> must be referred using the procedures contained in the relevant Standard Condition or DEFCON contained in the contract, unless otherwise agreed by MoD, the contractor and the Review Board.
6. The Review Board will only have jurisdiction to give an expert determination if it can satisfy itself that it has jurisdiction under the terms of paragraphs 2 to 5 above.

#### **Terms of Reference:**

##### ***Process:***

7. 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 only if:

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<sup>1</sup> In this context the term 'pricing DEFCONs' refers to SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

- a. the notice is in writing, identifying the parties to the reference, the matter being referred, and the specific circumstances which have occasioned the reference; and
  - b. except where the reference is made jointly by both the Government department on the one hand and the contractor or subcontractor on the other hand, the party making the reference has simultaneously sent a copy of the notice to the other party to the reference.
8. Where the parties submit a joint notice of reference it is anticipated that the facts of the reference and supporting evidence will be submitted with the notice of reference and that the timetable is likely to be:
  - a. the Review Board will acknowledge receipt of the notice of reference; and then
  - b. within 15 working days the Review Board will satisfy itself that it has sufficient information to undertake the reference. If it requires further information it will contact the parties with a timetable for responses; and then
  - c. when the Review Board considers that it has sufficient information it may meet the parties to question them on the information provided. It will meet the parties if requested to do so by either of them; and then
  - d. the Review Board will deliver its decision to the parties within 15 working days of the meeting with the parties or, if no meeting is held, within 15 days of receiving sufficient information.
  - e. If the parties do not provide sufficient information on which the Review Board can come to a considered opinion within the timetable provided under paragraph b., the Review Board may promptly notify the parties, cancel the reference and return all papers to the parties.
9. Where just one of the parties has submitted a notice of reference it is anticipated that the timetable is likely to be:
  - a. within 15 working days the parties will submit to the Review Board:
    - a set of facts concerning the dispute, insofar as they can be agreed between the parties
    - matters disputed between the parties
    - supporting evidence
    - relief sought by each of the parties; and then
  - b. within 15 working days the Review Board will satisfy itself that it has sufficient information to undertake the reference. If it requires further information it will contact the parties with a timetable for responses; and then
  - c. when the Review Board considers that it has sufficient information it may meet the parties to question them on the information provided. It will meet the parties if requested to do so by either of them; and then
  - d. the Review Board will deliver its decision to the parties within 15 working days of the meeting with the parties or, if no meeting is held, within 15 days of receiving sufficient information.
  - e. If the parties do not provide sufficient information on which the Review Board can come to a considered opinion within the timetable provided under paragraph b., the Review Board may promptly notify the parties, cancel the reference and return all papers to the parties.
10. The Review Board has the right to alter the process or timing of the determination at any time by giving written notice to the parties.
11. Any information disclosed by a party to a reference and received by the Review Board in relation to a reference will be used by the Review Board solely for reaching its

determination on the reference. The Review Board will keep that information confidential, protect it from disclosure and will not disclose it to any other party except:

- a. to Review Board members, the Review Board's secretariat and any external adviser appointed to assist the Review Board with the reference in question under an obligation of confidence; or
- b. with the consent of the party to the reference who disclosed that information to the Review Board.

Confidential information does not include any information which falls within any of the following categories:

- i Information which was or has become published or publicly available for use through no fault of the Review Board, its secretariat or any adviser appointed to assist the Review Board with the reference in question; or
- ii Information which is in the possession of the Review Board, its secretariat or any adviser appointed to assist the Review Board with the reference in question without restriction on disclosure or use, or which is independently and lawfully discovered, after the date of receipt of the same information from a party to the reference, by the Review Board, its secretariat or any adviser appointed to assist the Review Board with the reference in question; or
- iii Information which is obtained without restriction on disclosure or use, after the date of receipt of the same information from a party to the reference, by the Review Board, its secretariat or any adviser appointed to assist the Review Board with the reference in question, from any third party which the Board reasonably believes to be lawfully in possession of that information and not in violation of any contractual or legal obligation to the parties to the reference or any other person with respect to that information; or
- iv Information which is lawfully required to be disclosed by any Court or arbitrator of competent jurisdiction, law, recognised stock exchange, government department or agency, regulatory authority or professional obligation to which the Review Board, its secretariat or any adviser appointed to assist the Review Board with the reference in question, are subject;

Except, in relation to information falling within sub-paragraphs (i) (ii) or (iii) but not (iv) of this paragraph, where the disclosure of such information would necessarily result in the disclosure of any other confidential information.

***Obligations on MoD and the contractor:***

12. Notice of a reference may be made to the Review Board by either party or jointly by both Government and the supplier. If a sole reference is made then the party making the reference must send a copy at the same time to the other party to the reference.
13. Once a party has formally notified the other in writing of its intention to put forward a reference, the parties to the reference must preserve all information relevant to the reference, whether supporting or adverse to their case, which is in their possession, custody or control.
14. The parties to the reference shall disclose all relevant information to enable the Review Board to reach its determination, at the outset of the reference, or as requested from time to time by the Review Board. The parties agree that any requests for additional information will be dealt with promptly.
15. The parties accept any reasonable process for the conduct of the reference, as given by written notice from the Review Board.

16. The parties accept that the Review Board will incur costs in undertaking the reference, including the costs of its Secretariat and of any independent expert required to enable the Review Board to interpret the information provided and to advise the Review Board in arriving at and giving an opinion, including its reasons.
17. The parties' costs in making a reference will lie where they fall. The parties will pay any costs and expenses allocated to them by the Review Board that it has incurred in undertaking the reference. Those costs will be allocated by the Review Board as follows:
  - a. Joint references: costs will be allocated equally between the parties;
  - b. References made by a single party: costs will be allocated as the Review Board sees fit.
18. Any reference within the jurisdiction of the Review Board will be conducted by the Review Board and the parties to the reference in conformity with the applicable principles set out in the Government Profit Formula and Associated Arrangements, Section 1, Annex A.
19. Determinations by the Review Board are final and conclusive and are binding on the parties, unless they relate to a pre-contractual situation in which case the determination shall be non-binding unless the parties agree otherwise.
20. Parties will undertake prompt settlement of any decision by the Review Board.

***Obligations on the Review Board:***

21. The Review Board is required to provide determinations that it considers to be fair and reasonable, taking account of previous decisions of the Review Board and by reference to:
  - a. the Government Profit Formula and Associated Arrangements,
  - b. International Accounting Conventions and International Financial Reporting Standards,
  - c. agreements between the parties, and
  - d. UK industry practice.If the proponent relies on elements c. or d. in making its case it must provide compelling evidence to the Review Board.
22. References may be examined and determined by the Chairman and two other members only, together with its secretariat, unless the parties agree otherwise.
23. Any reference within the jurisdiction of the Review Board will be conducted by the Review Board and the parties to the reference in conformity with the applicable principles set out in the Government Profit Formula and Associated Arrangements, Section 1, Annex A.
24. The Review Board may seek clarification of the facts and evidence submitted by the parties. The Review Board's determination should be reasonable and proportionate and should be based on:
  - a. written submissions made by the parties,
  - b. clarifications received from the parties, and
  - c. any advice obtained by the Review Board from an independent expert.
25. The Review Board is required to make a determination within 15 working days of receiving all submissions and clarifications required for the determination, so long as

sufficient information is provided by the parties to the reference. The Review Board will provide the reasoning behind its determination to the parties.

26. The determinations and reasoning given to the parties will not be published, except to the parties. The Review Board's Annual Report will identify the number of references made, the number of determinations given and any matters of principle arising that may have common application.
27. The Review Board is required to undertake the reference in an expeditious and efficient manner.