



SSRO

Single Source
Regulations Office

Single Source Cost Standards

Statutory Guidance on Allowable Costs

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Introduction

1. Introduction

1.1 This document is issued by the Single Source Regulations Office (SSRO) and sets out the guidance for use by contractors and the Ministry of Defence (MOD) when determining whether costs are Allowable under qualifying defence contracts and qualifying sub-contracts. Terminology used but not expressly defined in this guidance is as defined in the Defence Reform Act 2014 (the “Act”) or the Single Source Contract Regulations 2014 (the “Regulations”).

1.2 It is a legal requirement to have regard to this guidance document in determining whether costs are Allowable under a qualifying defence contract and qualifying sub-contract. This guidance must be followed unless there are good reasons not to.

1.3 The guidance is principles, rather than rules, based. The core principles are shown in italics throughout this document.

2. Background

2.1 Single source procurement is used for a variety of reasons including:

- when there is only a single contractor able to deliver the requirement;
- when there are strong reasons for maintaining national capability;

- because of the specialised or unique characteristics of the required services; or
- for issues of national security.

2.2 Annually, single source procurement makes up a significant proportion of MOD defence procurement and therefore it is important that the framework, which supports this procurement, is robust and fit for purpose. The guiding principle is that non-competitive contracts must emulate competitive conditions and be subject to sufficient challenge to ensure that single source contract awards deliver value for money to the UK tax payer and, at the same time, a fair and reasonable price is paid to the contractor.

2.3 An independent review undertaken by Lord Currie in 2011 resulted in the Better Defence Acquisition White Paper (2013), which recommended strengthening the MOD’s arrangements for single source procurement. This formed the foundations for Part 2 of the Act, which provides the legislative basis for the Single Source Procurement Framework.

2.4 The Framework has two main components:

- the Act, Regulations and statutory guidance; and
- the creation of an arms-length independent body known as the SSRO which manages and monitors the framework.

- 2.5 The Act identifies the following objectives of the framework:
- (a) to address shortcomings which arise from single-source procurement;
 - (b) to focus on areas where standardisation is of value;
 - (c) to be proportionate;
 - (d) to ensure a fair and reasonable price is paid under the contract in question; and
 - (e) to support value for money.

3. About this Guidance

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

The SSRO must issue guidance about determining whether costs are Allowable Costs under qualifying defence contracts.

4. Previous Guidance

- 4.1 The MOD, and defence industry contractors, have used the same non-legally binding, single source pricing framework since 1968, 'The Government Profit Formula and its Associated Arrangements', commonly referred to as the 'Yellow Book'. Despite many shifts in the industrial landscape and procurement approaches since 1968, the 'Yellow Book' remained largely unchanged.
- 4.2 This guidance replaces the existing Government Accounting Conventions, that were included as part of the Yellow Book, for

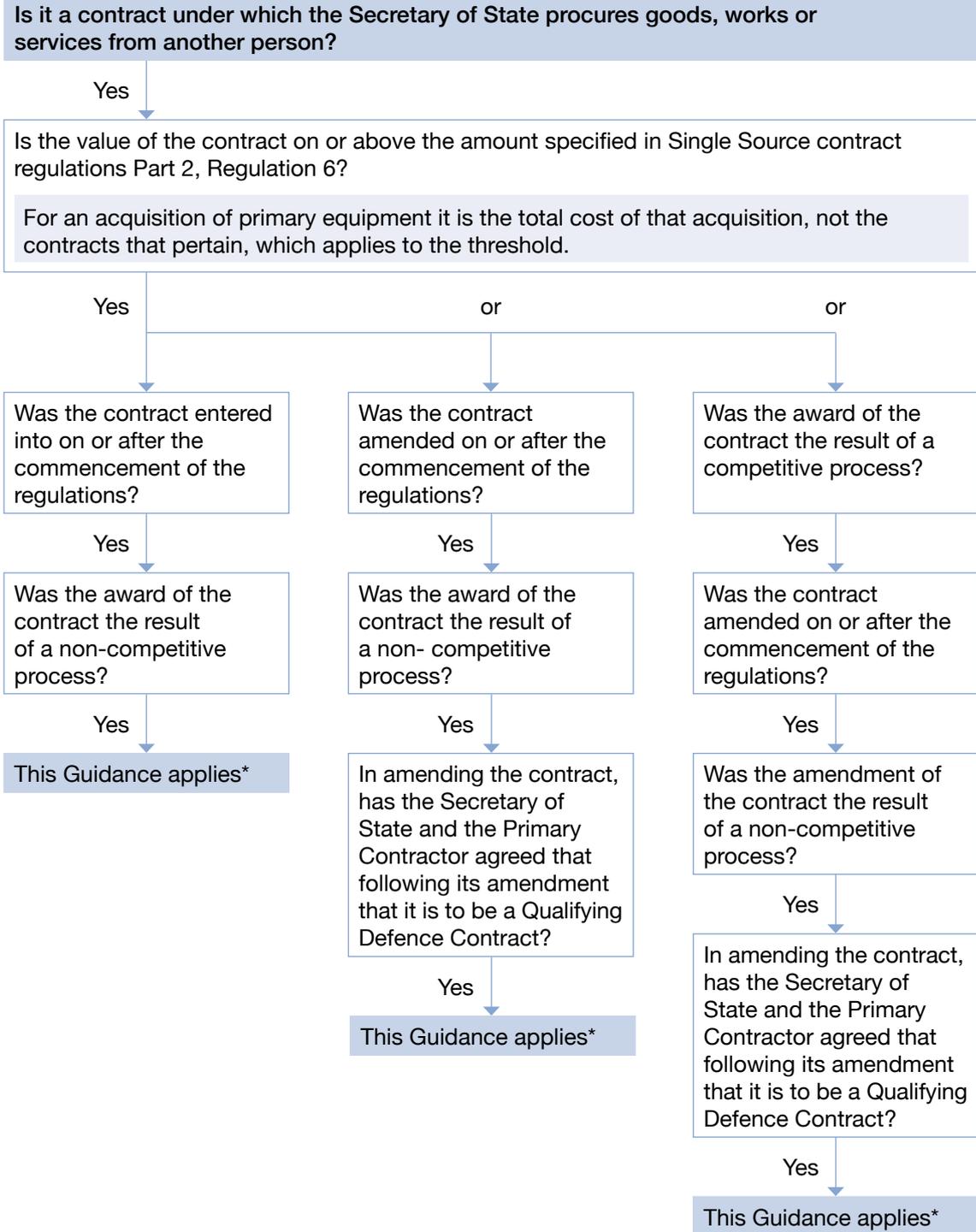
all contracts that are made after the Regulations come into force. For those contracts currently in force the Government Accounting Conventions remain in place unless such a contract becomes a qualifying defence contract as contemplated by paragraph 5.2 below.

5. Application of this Guidance

- 5.1 This is statutory guidance from the SSRO issued under Section 20 of the Act. It applies to all qualifying defence contracts and qualifying sub-contracts (subject to the restrictions set out in the Act and Regulations).
- 5.2 A contract is a Qualifying Defence Contract if:
- (1) it is a contract under which the Secretary of State procures goods, works or services from another person ("a primary contractor or sub-contractor to a primary contractor"); and
 - (2) the value of the qualifying defence contract is of or above the amount specified in Regulation 6 or Regulation 58 for qualifying sub-contracts; and
 - (3) (a) the contract is entered into on or after the Regulations came into force; and
 - (b) the award of the contract is not the result of a competitive process; or
 - (c) the contract is amended on or after the Regulations came into force; and
 - (d) the original contract was not the result of a competitive process; and
 - (e) in amending the contract, the Secretary of State and the primary contractor or sub-contractor agree that it is to be a qualifying defence contract or qualifying sub-contract;
- or
- (f) the award of the contract is the result of a competitive process; and
 - (g) the contract is amended on or after the Regulations came into force; and

- (h) the amendment is not the result of a competitive process; and
- (i) in amending the contract, the Secretary of State and the primary or sub-contractor agree that it is to be a qualifying defence contract or qualifying sub-contract.
- 5.3 The guidance applies to qualifying defence contracts, and qualifying sub-contracts, above the thresholds specified in the Regulations. The total net contract value payable to contractors (excluding VAT) is used to establish whether the threshold values have been met. All revenues pertaining to a contract have to be taken into account, including:
- (a) whether received from the MOD or from third parties;
- (b) the total cost of an acquisition as it applies to a Prime Contractor; and
- any sub-contracts; or
 - secondary contracts to the Prime Contractor.
- 5.4 This means:
- for acquisition of primary equipment¹ it is the total cost of that acquisition to the MOD, not the value of the individual contracts that pertain to that acquisition, which applies to the threshold;
 - for non-primary equipment procurements, including materiel and works and services, the value of the procurement is defined as the total anticipated contract value.
- 5.5 The Regulations provide that a number of contracts do not qualify and therefore this guidance does not apply. Exempt contracts are those:
- (1) to which the government of any country other than the United Kingdom is party; or
 - (2) made within the framework of an international cooperative defence programme; or
 - (3) made wholly for the purposes of one or more of the following:
 - (a) the acquisition of land (including existing buildings or other structures, and land covered with water), and any estate, interest, easement, servitude or right in or over such land;
 - (b) the management or maintenance of any land or buildings or other structures; or
 - (c) intelligence activities.
- 5.6 This is separate from an exclusion where the Secretary of State specifically excludes an otherwise qualifying defence contract from the application of the Regulations and therefore this guidance.
- 5.7 Diagram 1 illustrates the systematic approach to establish whether this guidance is applicable.
- 5.8 This applies to both a primary contractor and sub-contractor to a primary contractor.
- 5.9 Any points of clarification must, on reference by the Secretary of State or contractors, be addressed by the SSRO who will issue supplementary and specific guidance, if required.

¹ Primary equipment is defined as an equipment that cannot normally be isolated. Non-primary equipment is a part of a primary equipment that can be isolated



* The Act gives the Secretary of State the power to exempt a contract even if it meets all the requirements of being a Qualifying Defence Contract. It is expected that these exemptions will only be granted in exceptional circumstances.

Allowable Costs

6. Importance of Allowable costs

- 6.1 The Act requires that qualifying defence contracts and qualifying sub-contracts are priced on the basis of “*Allowable Costs*”. Allowable Costs are an important element of MOD and defence industry contract pricing mechanisms as they are the key driver of the contract price.
- 6.2 The guidance for *Allowable Costs* is important because it enables the negotiation of fair contract prices between the MOD and the contractor. To support this the Act states that *Allowable Costs* must be: “*Appropriate, Attributable to the contract, and Reasonable in the circumstances*” (Section 20(2)(a)- (c)).
- 6.3 This guidance provides principles and procedures to determine whether or not costs are likely to be *Allowable Costs*. It does not provide guidance with regard to the methodology employed to calculate those costs.
- 6.4 The Act gives the SSRO the authority on referral to determine the extent to which a particular cost is an *Allowable Cost* under a qualifying defence contract and a qualifying sub-contract where an application is received for a determination.

7. Principles of Allowable Costs

- 7.1 To be *Allowable*, a cost **must** meet all three criteria of the principles

of *Appropriate, Attributable and Reasonable*. The principles of the criteria are:

- that costs are *Allowable* when supported by adequate and sufficient evidence;
- actual costs should be assigned to contracts only once;
- estimated costs should only be assigned once and not reflected again once they become actual; and
- actual costs are to be fully recorded and reflected in the books of account as being properly incurred

- 7.2 Therefore it is essential to the establishment of *Allowable Costs*, both at pricing and contract delivery stages, that *Allowable Costs* are auditable from resources employed through activities undertaken under the qualifying defence contract or qualifying sub-contract.

- 7.3 It is expected that any costing system and costing methodology used by contractors will allow the identification of costs as they are allocated. Presentation of costs in this manner supports a degree of standardisation of cost information which in turn supports testing of costs to ensure that they meet the criteria for *Allowable Costs*.

- 7.4 This guidance applies to estimated costs (for example for the firm, fixed, target, and volume-driven pricing methods under Regulation

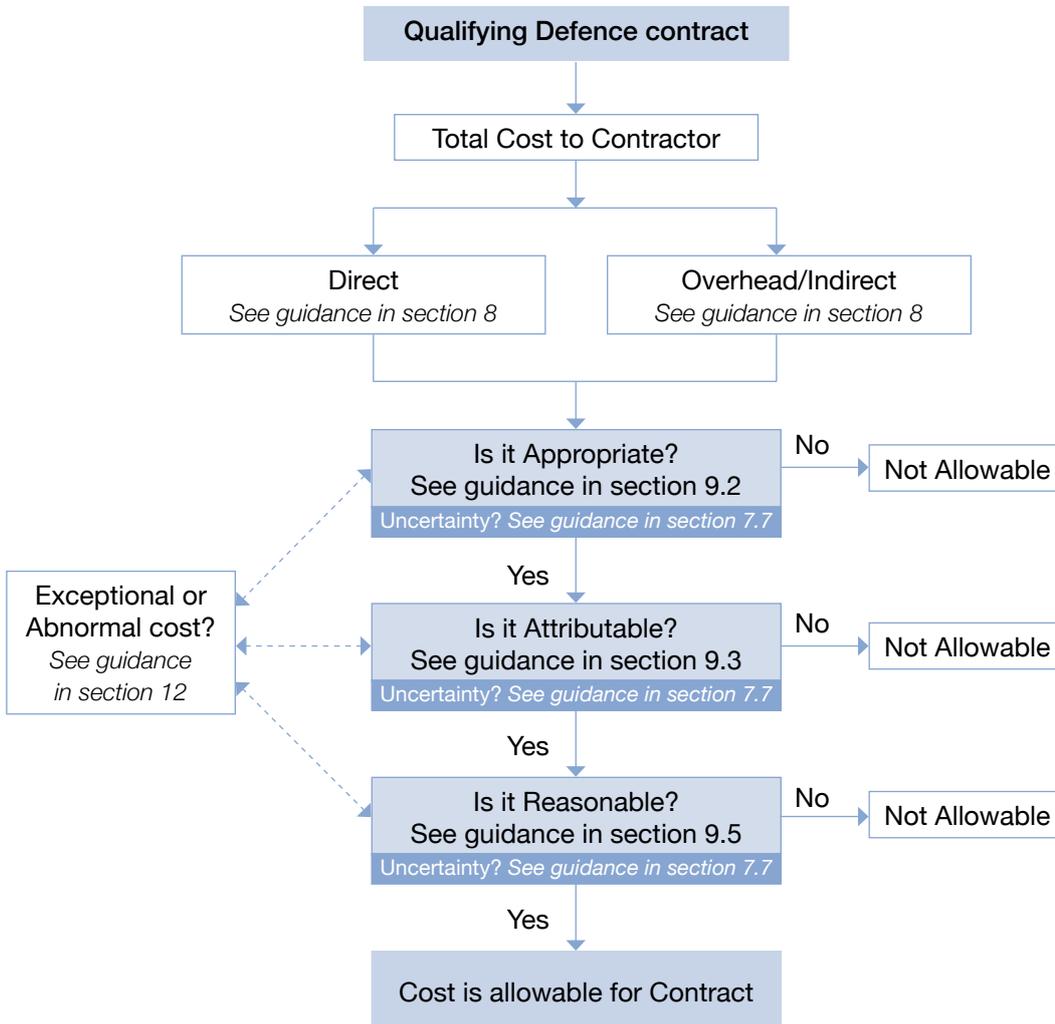
10 of the Regulations) and to actual costs (as in the cost plus and estimate-based fee pricing methods). It is recognised that some costs are incurred in advance of a contract.

7.5 Section 20(4) of the Act places the onus upon the primary contractor of a qualifying defence contract to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance or otherwise as being Allowable. The burden of proof rests with the contractor and it is essential that the MOD operates as an intelligent client and has the ability to verify, challenge and agree the costings that are submitted as being Allowable.

7.6 The diagram below illustrates the systematic approach to establish whether the costs associated with a qualifying defence contract are Allowable.

Opinion and Determination

7.7 Under Section 20(5) of the Act the SSRO, in the event of a disagreement as to whether a cost is Allowable, may determine the extent to which a particular cost is Allowable under a qualifying defence contract or qualifying sub-contract, where required so to do by either the Secretary of State, referral from the MOD or the primary contractor or a sub-contractor.



8. Costs

8.1 The total cost, including those costs properly adjusted for applicable variances of a contract, is the sum of the direct and overhead or indirect costs related to the contract, incurred or to be incurred. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is consistently applied may be used. The allocation must be based on a contractor's normal accounting system and policies.

8.2 Direct costs are those charged directly to contracts, as opposed to indirect costs which are apportioned over a number of contracts, products, or services.

8.3 Regardless of the type of cost, the *Appropriate, Attributable* and *Reasonable* principles will always apply in determining whether the cost is Allowable.

8.4 The following cost definitions are provided to inform the different characteristics of costs.

Direct Costs

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

Overhead / Indirect Costs

8.6 Overhead and indirect costs which cannot be directly attributed are defined as those costs which, though necessarily having been incurred during the performance of the qualifying defence contract and qualifying sub-contract for

the conduct of the contractor's business in general, cannot be identified and measured as directly applicable to the performance of that contract. The criteria of *Appropriate, Attributable* and *Reasonable* will always apply.

9. Guidance on Appropriate, Attributable, and Reasonable criteria

9.1 Costs are Allowable to the extent they are *Appropriate, Attributable* and *Reasonable*. These criteria apply to all costs of a qualifying defence contract or qualifying sub-contract. The guidance and checklists below set out the principles to be followed when determining whether a cost might meet the *Appropriate, Attributable* and *Reasonable* criteria. The boxes below provide a checklist of key questions that should be considered when assessing the treatment of costs and the likelihood they are *Allowable*.

Appropriate

9.2 Guidance on *Appropriate* costs:

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

Checklist to help assess whether a cost is *Appropriate*

- Is it a cost that would be expected to be incurred in the delivery of the qualifying defence contract?
- Is the cost suitable for the purpose of the qualifying defence contract or qualifying sub-contract?
- Would the inclusion of the cost withstand public scrutiny?
- Is inclusion of the cost fair and equitable?

Attributable

9.3 Guidance on *Attributable* costs:

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

- 9.4 All costs must have been (or will be) incurred by the contractor and applied to the qualifying defence contract or qualifying sub-contract on a basis that is consistent with the contracting company's overarching cost accounting practices, while having not been, or planned to be, recovered in any way from existing or future contracts.

Checklist to help assess whether a cost is *Attributable*

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

Reasonable

9.5 Guidance on *Reasonable* Costs:

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

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

Checklist to help assess whether a cost is *Reasonable*

- Is it congruent with meeting the contract performance requirements?
- Would the cost withstand public scrutiny?
- Are cost estimates based on empirical evidence, where this is possible?
- Is the cost consistent with sector/ market benchmarks?
- Is the quantum of the cost consistent with good business practice?
- Do the costs deliver value for money to the UK taxpayer?

10. Guidance on Costs generally Allowable

- 10.1 The costs described in this section must be tested against the *Appropriate*, *Attributable* and *Reasonable* criteria to determine whether they are partly *Allowable*, wholly *Allowable* or completely excluded from *Allowable* Costs.
- 10.2 Costs that are assessed as being *Allowable* under the *Appropriate*, *Attributable* and *Reasonable* criteria as further described in this document will be expected to be reconcilable to actual costs incurred.
- 10.3 Whilst normally any cost which is *Appropriate*, *Attributable* and *Reasonable* will be *Allowable*, the following cost items are provided as an illustration to assist users in their assessment. This list is not exhaustive nor is it definitive and is merely provided to guide users.

Depreciation and amortisation

- 10.4 Depreciation and amortisation charges are to be calculated at the contractor's own rates, provided they are consistent, equitable and relate to the fixed asset values. Changes to the valuation of assets

have to be agreed by the Secretary of State if they are to be allowable. There should be no recovery of depreciation charges where the costs have been recovered through other means.

General stock losses and obsolescence

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

Redundancy Payments

- 10.6 Redundancy payments made in the normal course of business, and which are in accordance with the rates laid down by statute, may be included in *Allowable* Costs. If payments are made in excess of such rates then these may also be included, if agreed between the contractor and employees and approved by the MOD, and notified to the SSRO as part of the reporting process.

Employee Benefits

- 10.7 Where employee benefits payments are made for items such as profit sharing schemes, shares or benefits in kind, which are an element of employees' normal remuneration, then these may be included in *Allowable* Costs. The cost of shares issued to employees at favourable prices, is to be arrived at in the manner prescribed by the relevant International Financial Reporting Standards. Payments of staff bonuses must be in line

with company policies. In order for these cost items to be considered *Reasonable*, contractors must be able to provide supporting evidence. Exceptional bonuses payable following the sale of a company or part thereof are not part of normal remuneration and are unlikely to be considered *Allowable Costs*.

Private Venture Research and Development

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

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

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

nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs should be recovered by a charge to the current total output of the product group.

- Expenditure that can be related to an agreement between the MOD and a contractor, which specifically limits the amount of the MOD's contribution (including those cases where the limit is expressed as a share of total expenditure) will not, unless specifically provided for in the agreement, normally be recoverable through *Allowable Costs*.
- The fact that a contractor may have adopted a particular accounting treatment for research and development expenditure in its financial accounts will not prejudice the recovery of such expenditure on MOD contracts.
- Any costs relating to projects where the research and development activity has already been funded will not be an *Allowable Cost*.
- Research and development costs will not be allowed where there has been no discernible benefit provided to the MOD or the public sector as a whole or where sufficient evidence is not available to support the research and development costs.

10.10 Abortive research and technology expenditure should be treated in the same way as any other research and development expenditure and be admitted for recovery. The charges must be a fair apportionment of the contractor's unfunded private venture product development, meet the *Appropriate, Attributable* and *Reasonable* criteria (whether or not these have been carried forward in the contractor's accounts) and be calculated on the basis of the

forecast total sales of the product or service.

include, but are not necessarily limited to the following items:

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

- changes to commutation arrangements; or
- discretionary increases where it is normal scheme practice.

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

- pension protection levy reimbursements to pension schemes in whole or part by Contractors employing scheme members should be included in *Allowable Costs*;
- any amounts not included in the income statement in arriving at profit before tax must not be included in *Allowable Costs*;
- any pension costs relating to scheme deficits are *not Allowable* because they are not considered a normal in-year service cost;
- other cost and credit entries to the Contractors income statement that are not considered to be normal, and which will not be included in *Allowable costs* include but are not limited to:

Pension Costs

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

- defined contribution plan contributions are to be included as an *Allowable Cost*;
- in the case of defined benefit plans the value to be included as *Allowable Costs* will be limited to the current or "normal" service cost charged to the income statement;
- costs or credits relating to defined benefit plans that may be considered to be "normal"

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

Marketing and Sales

10.14 Marketing and sales costs can only be considered *Allowable*, if they are demonstrably linked to a qualifying defence contract or qualifying sub-contract. Marketing and sales costs may include such items as salary costs and related staff expenses (travel and subsistence), sales and marketing campaigns and other related commercial activities.

Refunds

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

11. Guidance on Costs which are generally not Allowable

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

- Any expenditure of a capital nature will not be allowable as capital costs are recovered through depreciation (which is classified as *Allowable*) and the contract profit rate mechanism.
- Distributions of profit as these costs are earnings as a result of sales exceeding production costs i.e. they do not form part of production.
- Bad debts and any provision for those bad debts unless they specifically relate to and arise on qualifying sub-contracts.
- Civil penalties and fines. These are payments imposed to compensate for harm done through the wrongdoing of the party concerned, which in this case would be the contractor, and as such would never meet *Appropriate, Attributable* and *Reasonable* requirements criteria.
- The cost of raising and servicing capital, including short-term financing and finance leases. This is not applicable as a cost item because of the different sources of funds that are available to contractors which make it impossible to know what a fair return is, based on the mix of capital employed. There are also significant differences between debt and equity funding and the associated risk that makes it difficult to assess this as a relevant cost item. The cost of capital is dealt with via the contract profit rate mechanism.
- Costs and income related to assets excluded from capital employed in calculating the contract profit rate. If it has been assessed that assets are to be excluded from the formula then by their nature they have been deemed to not be associated with a qualifying defence contract or qualifying sub-contract.
- Discounts allowed on sales (external) will not form part of *Allowable Costs* as the financial benefit is received by Parties other than the MOD.
- Entertainment expenses of any sort can never be determined to meet *Appropriate, Attributable* and *Reasonable* criteria.
- Goodwill (an intangible asset), is excluded from any capital servicing allowances and so in turn any amortisation of goodwill is excluded from *Allowable Costs*.
- Losses on other contracts, by their nature, are not applicable to the qualifying defence contract in question.
- Notional transactions.
- Provision for cost contingencies and cost risk are not *Allowable* as contractors are expected to

manage actual costs and cost estimates as part of contract delivery. This is separate from, and does not apply to price risk in relation to a risk based contract where the contractor accepts risks on behalf of the MOD and where both parties accept this as being a necessary component of the contract. These and any other exceptional or abnormal costs will be assessed under Section 12 of this guidance.

- Subscriptions and donations of a political or charitable nature form no part of costs associated with qualifying defence contracts or qualifying sub-contracts.
- Sponsorships.
- Liquidated damages and other penalties for poor performance.
- Cost or premiums and payments for insurance which cover that element of consequential loss that relates to profit are excluded on similar grounds.
- Cost or premiums and payments for insurance, including product liability insurance, which covers the contractor's own defects in materials or workmanship incidental to the normal course of construction or manufacturing. This includes the insurance to repair defects in materials or workmanship, and for any breach of contract and therefore will not meet *Appropriate, Attributable* and *Reasonable* criteria.
- Costs for the remedy of faulty workmanship or the consequences that result. This does not include experimental manufacturing processes that have been agreed as part of a contract, nor wastage as a natural consequence of manufacturing.

11.2 This is neither definitive nor an exhaustive list and other costs may also be considered not

to be *Allowable*. Elements of the above costs may also be considered *Allowable* if they meet the *Appropriate, Attributable* and *Reasonable* criteria. In the event of uncertainty the SSRO can be called upon to provide an opinion.

12. Exceptional or Abnormal Costs

12.1 This guidance is applicable to all contract discussions between the MOD and contractors regarding *Allowable Cost* in regard to qualifying defence contracts and qualifying sub-contracts. Whilst the majority of discussions about whether costs are *Appropriate, Attributable* and *Reasonable* will be resolved without reference to further guidance there are a number of more complex issues that arise that may require additional guidance.

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

12.3 In all cases of an exceptional nature which result in separate negotiations the SSRO should be informed. The MOD should provide the information to the SSRO in accordance with reporting requirements under Part 5 of the Regulations including:

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

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

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

Costs associated with the closure or rationalisation of a plant

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

12.7 Where a contractor proposes to rationalise or close a facility on economic grounds and can demonstrate that the resultant costs are related to the delivery of single source contracts to the MOD then the following guidelines can be used to assess whether the costs are *Allowable*.

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

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

12.8 Where a site is closed resulting in other sites operated by the contractor or within a joint venture benefit from gaining more work as a result of the site closure, the net cost of rationalisation/closure must be tested and recovered against the benefits associated with the other sites or joint venture. The amount of the costs is subject to agreement on a case by case basis and the details of which will be passed onto the SSRO through the reporting requirements.

12.9 Profits and losses must be calculated at the time that rationalisation or plant closure takes place.

Idle Facilities

12.10 Idle facilities are defined as those facilities and capital assets which are completely unused and that are not required by the contractor to fulfil current qualifying defence contract or qualifying sub-contract commitments but were designed for that purpose.

12.11 Idle capacity is a part of an overall facility or capital asset which is under-utilised for the delivery of a qualifying defence contract or qualifying sub-contract.

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

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

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

12.14 Any determination that such costs are *Allowable* is to be subject to a separate agreement between the contractor and the MOD, to which the contractor is to provide the relevant evidence to support the payment. Any such agreement is to be separately reported to the SSRO with the necessary evidence to support the agreement.

Pensions

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

- the costs of defined contribution pension plans, being the actual pension contributions paid to bona fide pension scheme providers in respect of current employees; and
- in relation to defined benefit schemes, the current service cost as recorded in the income statement in accordance with the relevant accounting standards. These costs are an additional cost of employment related to the terms and conditions under which staff are employed.

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

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

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

Research and Development Tax Credits

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

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

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

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

Cost Allocation and Authority

13. Cost Accounting Practices

- 13.1 Single Source contractors are required annually to declare, through the questionnaire on the method of allocation of costs, their normal accounting and cost allocation approach. This declaration does not pre-determine whether costs are *Allowable*. The contractor must make information available on an open book basis.
- 13.2 A contractor will follow its own normal accounting systems, and must declare when it plans or decides otherwise to the SSRO and the MOD, together with a clear statement explaining why it is doing so.
- 13.3 The contractor's costing system must be the same for MOD work as it is for other work in which it is engaged thus ensuring that the allocation of costs can be relied upon as being both fair and transparent.
- 13.4 In making an assessment of *Allowable Costs*, the parties must arrive at a determination on whether a cost is, or is not, *Allowable* in line with this statutory guidance.
- 13.5 The contractor is required to demonstrate to the MOD and evidence any claim for a cost to be *Allowable*. Any unresolved disputes between the contractor and the MOD can be raised with the SSRO.

14. Authority and Responsibilities

- 14.1 The Act and Regulations:
- Require that primary contractors, and where applicable sub-contractors, keep relevant records and to report in accordance with the Act.
 - Require that primary contractors, and where applicable sub-contractors, are able to show that the requirements, set out as the principles for contract costs to be *Appropriate, Attributable* to that contract and *Reasonable* in the circumstances, have been met. The onus rests with the contractor to ensure that *Allowable Costs* are sufficiently evidenced.
 - Empower the SSRO to determine the extent to which a particular cost is *Allowable* under a qualifying defence contract or qualifying sub-contract on referral from the Secretary of State or contractor.
 - Empower the SSRO to determine whether the price payable under the qualifying defence contract or qualifying sub-contract is to be adjusted, and by what amount on referral from the Secretary of State or contractors.

Annex 1

Qualifying Sub-Contract

