



SSRO

Single Source
Regulations Office

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Allowable Costs guidance
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1. Introduction

- 1.1 The Defence Reform Act 2014 (the Act) requires that qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs) are priced on the basis of Allowable Costs. A contract is a QDC if it meets the definition laid down in section 14(2) of the Act. A QSC is a contract between a primary contractor and another contractor or between a sub-contractor and another contractor where it meets the definition laid down in section 28 of the Act, and has been assessed and notified as a QSC pursuant to the procedure under section 29 of the Act.
- 1.2 The Act also states that, in carrying out its functions, the SSRO must aim to ensure that:
 - good value for money is obtained in government expenditure on QDCs and QSCs; and
 - persons (other than the Secretary of State) who are parties to QDCs and QSCs are paid a fair and reasonable price under those contracts.
- 1.3 Section 20 of the Act specifies when costs are Allowable and sets out related provisions as follows:¹
 - a. Section 20(1) of the Act stipulates that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs.
 - b. Section 20(2) of the Act states that both parties need to be satisfied that costs are Appropriate, Attributable to the contract and Reasonable in the circumstances (AAR).
 - c. Section 20(3) of the Act states that the Secretary of State and the contractor must have regard to the SSRO's guidance in determining whether a cost satisfies the AAR test.
 - d. Section 20(4) of the Act states that a contractor (prime contractor or sub-contractor) may at any time be required to show that a particular cost is Allowable.
- 1.4 This guidance applies to the MOD and all contractors who have been awarded QDCs or QSCs. Terminology used but not expressly defined in this guidance is articulated in the Act or the Single Source Contract Regulations 2014 (the Regulations). Specific accountancy terms have not been defined in this guidance as definitions of these terms exist in relevant accounting standards.²
- 1.5 The following sections set out the SSRO's statutory guidance issued pursuant to section 20 of the Act.

¹ Section 20(5) and 20(6) of the Act deal with determinations in relation to Allowable Costs matters. Referrals are covered in Section 2 on Application.

² For example, International Accounting Standards Board or Financial Reporting Council

2. Application of the guidance

- 2.1 It is a legal requirement to have regard to this guidance in determining whether costs are Allowable under a QDC or QSC. This guidance applies to QDCs or QSCs entered into or amended on or after 1 April 2018 and replaces the version of the guidance published on 1 July 2016. Where a change in guidance occurs during contract negotiations, the contractor must report an agreed deviation from the statutory guidance if the previous guidance has informed the majority of the negotiation.
- 2.2 Section 20(4) of the Act places the onus upon the primary contractor of a QDC to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance as being Allowable. The burden of proof rests with the contractor and it is essential that the MOD has the ability to verify, challenge and agree the material costings that are submitted as being Allowable.
- 2.3 If the primary contractor has entered into sub-contracts to a QDC (including any QSC), then the prices of those sub-contracts will be costs in the QDC. The Secretary of State and the primary contractor will need to be satisfied that the prices are Allowable Costs (section 20(2)). The Secretary of State may require the primary contractor to demonstrate this is the case (section 20(4)). The legislation does not prescribe how this may be demonstrated, or what would be sufficient evidence that a sub-contract price satisfies the AAR test. It may be that the price of a sub-contract may be demonstrated to be Allowable without the need to demonstrate that all the component costs are Allowable.
- 2.4 In the case of a sub-contract that is also a QSC, the contract price must conform to the price formula and the costs must be Allowable. In terms of whether a cost in a QSC is Allowable, the application of section 20(2) and (4) is modified by section 30(1) of the Act. The Secretary of State and the sub-contractor must be satisfied that the costs are Allowable. The obligation to demonstrate to the Secretary of State that a cost included in the price of a QSC is Allowable sits with the sub-contractor. The price of any sub-contract to the QSC will need to be an Allowable Cost in the QSC and the guidance given at paragraph 2.3 will apply equally.

Further clarification

- 2.5 Any general enquiries related to this guidance should be addressed to the SSRO helpdesk³. The SSRO responds as quickly as possible to such requests, provided they are matters of general guidance and not contract-specific.
- 2.6 If the parties to a QDC or QSC, in advance of entering into the contract, would like a view as to whether costs under the contract may be Allowable Costs, then a referral may be made to the SSRO for an opinion. The SSRO has published guidance⁴ as to how it will deal with such referrals for an opinion.

³ helpdesk@ssro.gov.uk

⁴ Guidance on the SSRO's referrals (opinions and determinations) procedures under the Defence Reform Act 2014 and Single Source Contract Regulations 2014.

- 2.7 Following contract award, the parties to a QDC or QSC may apply to the SSRO to determine the extent to which costs are Allowable Costs. If such a referral is made, the SSRO will make a determination as to the extent to which costs are Allowable Costs (section 20(5) and 20(6)). The final determination has legal consequences for the parties. The SSRO has published guidance as to how it will deal with such referrals for a determination.

3. The AAR principles

- 3.1 Costs are Allowable to the extent they are Appropriate, Attributable to the contract and Reasonable in the circumstances. These criteria apply to all costs (estimated and actual) of a QDC or QSC. This guidance sets out the principles to be followed. The subsequent paragraphs set out a non-exhaustive list that parties should consider when assessing whether a cost might meet the Appropriate, Attributable and Reasonable criteria and are therefore Allowable.

Appropriate

- 3.2 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 the QDC or QSC in question. Appropriate costs are those which should be able to withstand public scrutiny and which can be supported by sufficient justification.

- 3.3 In order to assess whether a cost is Appropriate, consideration should be given to the following:

- a. whether a cost might be expected to be incurred in the delivery of the QDC or QSC;
- b. whether the cost is suitable for the purpose of the QDC or QSC;
- c. whether the inclusion of the cost would withstand public scrutiny; and
- d. whether the inclusion of the cost is fair and equitable.

Attributable

- 3.4 Guidance on Attributable costs:

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

All costs should be incurred by the contractor and applied to the QDC or QSC on a basis that is consistent with the contracting company's overarching cost accounting practices. The costs should be costs not recovered in any way from another contract, whether past, existing or proposed.

- 3.5 In order to assess whether a cost is Attributable, consideration should be given to the following:

- a. whether the treatment is consistent with generally accepted accounting principles;
- b. whether the cost is borne by the contractor;
- c. whether the cost has a causal relationship with the contract, in the sense of being required for its delivery;
- d. whether the cost is identifiable;
- e. whether the cost is incurred in fulfilling the requirements of the QDC or QSC; and
- f. whether it can be evidenced that the cost has not already been recovered.

Reasonable

3.6 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 the QDC or QSC in question, whether under competitive tendering conditions or as a single source contract.

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, any particular specification and performance requirements, any uncertainty involved, the economic environment, the statutory provisions in place at the time of contracting, 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’.

3.7 In order to assess whether a cost is Reasonable, consideration should be given to the following:

- a. whether it is congruent with meeting the contract requirements;
- b. whether the cost would withstand public scrutiny;
- c. whether cost estimates are based on empirical evidence, where this is possible;
- d. whether the cost is consistent with any available sector/market benchmarks;
- e. whether the quantum of the cost is consistent with good business practice; and
- f. whether the costs deliver value for money for the UK taxpayer.

4. Cost accounting and financial reporting

Cost accounting

- 4.1 Contractors with QDCs and QSCs may agree with the Secretary of State a methodology for the allocation and apportionment of costs to be used in the contract.
- 4.2 In order to be Allowable, the contractor must be able to demonstrate that costs have been allocated in a way that is Reasonable and which avoids over-recovery. Where the contractor's costing system for the Secretary of State's work is different from that used for other work, additional care will be needed in this regard.
- 4.3 The contractor should be able to identify and record all costs associated with delivering a contract. The contractor should separately identify and record costs that are Allowable and charged to the MOD and those which are incurred but are not Allowable. The SSRO does not otherwise provide guidance about the choice of accounting systems that a contractor uses to record accounting entries.

Direct and indirect costs

- 4.4 Allowable Costs in QDCs and QSCs may be either direct costs or indirect costs. The SSRO is not prescriptive about whether costs are categorised as direct costs or indirect costs but the MOD will want to be satisfied with the treatment of costs and the method of allocation and apportionment to the contract.
- 4.5 Direct costs will be those that are directly Attributable to the contract. Indirect costs which enable the performance of the QDC or QSC may be Allowable if both the cost and the method of allocation and apportionment satisfy the AAR principles. The method used should be consistent with any method previously agreed between both parties unless a change is necessary for the QDC or QSC in question.
- 4.6 Some costs may be determined through the use of recovery rates which are applied to an appropriate recovery base. The agreement of estimated and actual rates will be determined between the contractor and the MOD.

Sunk costs

- 4.7 If costs have already been incurred, referred to as 'sunk' costs, when an amended contract becomes a QDC or QSC, the SSRO expects that the parties would make appropriate arrangements such that it should be unnecessary for any question to be raised with the SSRO in relation to the sunk costs.⁵
- 4.8 Such arrangements may include stating in the amended contract that:
 - a. the contracting parties agree that the sunk costs are Allowable Costs; and
 - b. the parties will not seek to reclaim costs or to claim additional costs in respect of the period prior to the amended contract becoming a QDC or QSC.

⁵ Sunk costs will still need to be notified in accordance with the reporting requirements.

Financial reporting

- 4.9 The SSRO does not provide guidance in relation to the preparation of financial statements for statutory reporting purposes. Contracting companies may adopt a variety of accounting policies and make judgements in the preparation of financial statements for statutory reporting purposes (for example, International Financial Reporting Standards and UK Generally Accepted Accounting Practice). Application of these policies to QDCs will not necessarily result in costs charged satisfying the AAR principles and contractors must have regard to this guidance.

DefCARS

- 4.10 Users of this guidance should be aware that the SSRO has developed the Defence Contract Analysis and Reporting System (DefCARS) to enable contractors to submit contract and supplier reports. These reports include information on Allowable Costs including estimates, approved rates, forecast and actual costs. The SSRO has developed statutory guidance⁶ to assist contractors to meet their reporting obligations under the Act and the Regulations.

⁶ DefCARS – reporting guidance and system user guidance for defence contractors (SSRO website)

5 Guidance on specific cost types

- 5.1 All costs must satisfy the AAR test in order to be Allowable. Costs will either be completely Allowable, Allowable in part or not Allowable. This section provides guidance in relation to how the AAR test should be applied in relation to the specified categories. In some cases, the SSRO indicates the type of evidence that should be considered but the contracting parties may agree that additional evidence is necessary. The structure of this section is set out below:

Part	Sub-section	Cost type
Part A – Labour costs	A.1	Employee benefits
	A.2	Pension costs
	A.3	Redundancy costs
	A.4	Inflation of labour costs or rates
Part B – Material costs	B.1	Inflation of material costs or rates
Part C – Sales, marketing, bid, entertainment and third party costs	C.1	Marketing and sales costs
	C.2	Bid costs
	C.3	Entertainment costs
	C.4	Third party costs
Part D – Research and development costs	D.1	Research and development costs
Part E – Costs associated with loss, poor performance or other events	E.1	Losses, obsolescence and bad debt
	E.2	Reworks, wastage and faulty workmanship
	E.3	Damages and compensation
	E.4	Refunds, penalties and notional transactions
	E.5	Insurance
Part F – Exceptional and abnormal costs	F.1	Exceptional and abnormal costs
	F.2	Costs associated with closure, rationalisation or restructuring
	F.3	Idle facilities and capacity
Part G – Non-cash and financing costs	G.1	Non-cash costs
	G.2	Financing costs
Part H – Risk related costs	H.1	Risk related costs

Part A – Labour costs

A.1 Employee benefits

A.1.1 Where employee benefits payments are made for items such as profit sharing schemes, shares or benefits in kind, which are an element of employees' normal remuneration, then these may be included in Allowable Costs. The cost of shares issued to employees at favourable prices, is to be arrived at in the manner prescribed by the relevant Generally Accepted Accounting Principles.

A.1.2 Payments of staff bonuses must be in line with company policies. In order for these costs to be considered Reasonable, contractors must be able to provide supporting evidence. Exceptional bonuses payable following the sale of a company or part thereof and not part of normal remuneration are unlikely to be considered as Allowable Costs.

A.1.3 Distributions of profit are generally not Allowable.

A.2 Pension costs

A.2.1 Current pension costs, whether a defined benefit scheme or a defined contribution scheme, as provided in the income statement as an operating cost may be Allowable subject to the application of this guidance.

A.2.2 These costs should be reconcilable by scheme to the disclosure notes in the statutory accounts for the contractor in accordance with the relevant Generally Accepted Accounting Principles. The following guidance applies to assessing whether pension costs are Allowable Costs:

A.2.3 Defined Contribution scheme: all employer contributions paid or accrued in the year.

A.2.4 Defined Benefit scheme: the relevant annual Allowable expense will be limited to the current or 'normal' service cost charged to the income statement, and not related to the funding of any deficit cost or past expenses, therefore:

- a. the current service cost is Allowable, this represents the increase in the pension scheme liability for an extra year of service for the contractor's employees; and
- b. the annual administrative expenses and running costs are Allowable as these are reported as an operating cost relating to the scheme (including Pension Protection Fund levies); however
- c. all other expenses recognised in the income statement which relate to past service costs, settlement gains and losses, net interest on the pension liability and all re-measurements recognised through the statement of other comprehensive income are not Allowable.

A.3 Redundancy costs

A.3.1 Redundancy payments made in the normal course of business, and which are in accordance with the rates laid down by statute, may be included in Allowable Costs. If payments are made in excess of such rates then these may also be included as agreed between the contractor and employees, but only if approved by the Secretary of State.

A.4 Inflation of labour costs or rates

A.4.1 Inflation of labour costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable Cost.

Part B – Material costs

B.1 Inflation of material cost or rates

B.1.1 Inflation of material costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable Cost.

Part C – Marketing, sales, bid, entertainment and third party costs

C.1 Marketing and sales costs

C.1.1 Marketing and sales costs may include such items as salary costs and related staff expenses (travel and subsistence), marketing and sales campaigns, relationship/account management activities, sponsorships and other related commercial activities.

C.1.2 The MOD may decide to award single source contracts without the need for marketing and sales activity. Section C.2 refers to guidance on bid costs which may be incurred by a contractor when bidding for a single source contract. Marketing and sales costs may either in total or in part be considered Allowable in a single source contract if they meet the AAR principles and deliver demonstrable benefit to the UK Government.

C.1.3 Financial benefit to the MOD should be demonstrated by showing that the inclusion of marketing and sales costs results in a lower rate or unit costs charged to the QDC or QSC than if marketing and sales costs were excluded. The reduction in costs should be at least equivalent to the marketing and sales costs claimed. A sound evidence base should be provided to show how proven successful orders have resulted (retrospective test) or are expected to result through forecast sales (prospective test) in increased throughput of activity which then leads to the cost reduction in the QDC or QSC.

C.1.4 A contractor should ensure that any costs claimed are not or will not be recovered through other means. For example, where there is UK Government financial support for marketing and sales campaigns already in place these costs should not be claimed. Where possible, a contractor should provide a breakdown of their costs to enable them to be properly understood and to help determine whether they are Allowable. For example:

- a. segmenting their market by geography or product/service; or
- b. identifying where campaigns have UK Government financial support.

C.2 Bid costs

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

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

C.2.3 The contractor's marketing and sales costs should not be included as bid costs and should be treated separately under section C.1 of this guidance.

C.3 Entertainment costs

C.3.1 Entertainment costs are not Allowable Costs.

C.4 Third party costs

C.4.1 Donations of a political and charitable nature are not Allowable as these form no part of the costs associated with QDCs or QSCs.

C.4.2 Discounts allowed on sales to third parties are not Allowable as these do not financially benefit the QDC or QSC in question.

Part D – Research and development costs

D.1 Research and development

D.1.1 Contractors will account for private venture research and development expenditure in accordance with the relevant Generally Accepted Accounting Principles. 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.

D.1.2 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following guidelines to assess it as Allowable will normally apply:

- a. Any costs relating to projects where the research and development activity has already been funded via other routes should not be an Allowable Cost. In a case of a joint venture between the Secretary of State and other customers, a proportion of costs relevant to the Secretary of State's take up could be Allowable provided these costs have not been recovered elsewhere.
- b. Research and development costs should not be allowed where there has been no discernible benefit provided to the QDC or QSC as a whole or where sufficient evidence is not available to support the research and development costs.
- c. 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.
- d. 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 or service group.

D.1.3 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.

D.1.4 Due to the timeframes that research and development programmes can span, there may be circumstances where the parties may agree to carry forward a decision on whether costs are Allowable to a future date.

D.1.5 Abortive research and development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost.

D.1.6 Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should 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 should generally be Allowable.

Part E – Costs associated with loss, poor performance or other events

E.1 Losses, obsolescence and bad debt

E.1.1 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 still be Allowable. This will only apply when the contractor's costing system is able to isolate these stock losses as an indirect overhead. Contractors will be requested to provide evidence to support any claimed obsolescent stock write-offs and be able to demonstrate that these were not as a result of poor storage, handling or control.

E.1.2 Losses on other contracts are generally not Allowable, as by their nature these are not applicable to the QDC or QSC in question.

E.1.3 Bad debts, and any provision for those bad debts, are generally not Allowable unless they specifically relate to and arise on the QDC or QSC in question.

E.2 Reworks, wastage and faulty workmanship

E.2.1 The costs of reworks and wastage may be Allowable. This recognises that no production or manufacturing process is likely to be completely effective and that attempts to achieve zero rework or wastage may be uneconomical.

E.2.2 The assessment of what is a Reasonable level of rework or wastage will depend on the information available and the specific circumstances of the contract being delivered:

- a. Contractors should have adequate quality control and monitoring systems in place to be able to identify the level and, where material, the causes of reworks and wastage. There should be plans in place to reduce costs through learning curve and efficiency gains.
- b. Once both parties have considered the information available and the specific circumstances of the contract, including how they compare to other contracts, a judgement can be made about whether costs are Allowable.

E.2.3 The costs of faulty workmanship are not Allowable where the fault has occurred due to poor skills, training, systems or materials that the contractor has in place or has purchased. Costs associated with faulty workmanship may be Allowable where both parties are satisfied that faulty workmanship cannot be avoided because of the complexity or lack of maturity of the process being undertaken and the AAR test is met. These costs may be re-classified as reworks in some circumstances.

E.3 Damages and compensation

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

E.4 Refunds, penalties and notional transactions

E.4.1 Where reimbursements, credits, grants or refunds are received by contractors and cannot be identified to a particular contract then these should be apportioned to individual contracts to reduce Allowable Costs.

E.4.2 Notional transactions are generally not Allowable.

E.4.3 Civil penalties and fines, are not Allowable as 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 generally do not meet the Appropriate, Attributable and Reasonable criteria.

E.5 Insurance

E.5.1 The costs of insurance may be Allowable, but the nature of the insurance cover will be material to whether the costs satisfy the Appropriate, Attributable and Reasonable test. The costs of insurance covering buildings and equipment, employer's liability or vehicles and plants may be Allowable.

E.5.2 However, it would be neither Appropriate nor Reasonable for the taxpayer to pay for the contractor to be covered against its own poor performance in delivering the contract in question and, accordingly, the costs of such insurance should not be Allowable.

E.5.3 Accordingly, insurance against faulty workmanship (see section E.2 above), defective parts, breach of contract or loss of profit associated with poor performance should not be Allowable. If insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable. A part of the costs may be Allowable if the contractor demonstrates what the cost would be with any Inappropriate, Non-attributable or Unreasonable cover excluded.

Part F – Exceptional or abnormal costs

F.1 Exceptional or abnormal costs

- F.1.1 This guidance is applicable to all contract discussions between the Secretary of State and contractors regarding Allowable Costs in regard to QDCs and QSCs. 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 and this should be sought from the SSRO if agreement cannot be reached between the Secretary of State and the contractor.
- F.1.2 Where costs arise which are exceptional or abnormal in size or incidence then they will be reviewed on a case-by-case basis to determine the extent to which such costs (wholly or in part) are Allowable. These generally relate to exceptional or abnormal costs which would have a major impact on Allowable Costs and require specific additional analysis and evidence to arrive at an agreement on suitable treatment.
- F.1.3 In all cases of an exceptional nature which result in separate negotiations the SSRO should be informed.
- F.1.4 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.

F.2 Costs associated with closure, rationalisation or restructuring

- F.2.1 Exceptional costs will not be allowed where they relate to normal commercial business risk and any discussions around closure, rationalisation or restructuring must ensure that value for money remains the primary consideration. Contractors must demonstrate innovation and efficiency in the proposals they submit for reducing the costs associated with the closure, rationalisation or restructuring.
- F.2.2 Where a site is closed resulting in other sites operated by the contractor or within a joint venture benefit from gaining more work as a result of the site closure, the net cost of closure, rationalisation or restructuring must be tested and recovered against the benefits associated with the other sites or joint venture.
- F.2.3 Profits and losses must be calculated at the time that closure, rationalisation or restructuring takes place.

F.3 Idle facilities and capacity

- F.3.1 Idle facilities are defined as those facilities and capital assets which are completely unused and that are not required by the contractor to fulfil current QDC or QSC commitments but which were designed for that purpose.
- F.3.2 Idle capacity is that part of an overall facility or capital asset which is under-utilised for the delivery of a QDC or QSC.

F.3.3 The costs of idle facilities or capacity are not generally Allowable unless after application of the Appropriate, Attributable and Reasonable criteria it is confirmed that those unused facilities:

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

F.3.4 Any decision on whether such costs are Allowable must be subject to a separate agreement between the contractor and the Secretary of State, 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.

Part G - Non-cash and financing costs

G.1 Non-cash costs

G.1.1 This section is concerned with tangible and intangible assets that have been recorded in the contractor's balance sheet and in respect of which the contractor seeks to charge costs under a QDC or QSC. The following are examples of these assets:

- a. construction of a facility;
- b. property, plant and equipment which has been purchased;
- c. internally generated intangible assets, such as development of intellectual property; and
- d. goodwill that arises when a contractor buys another contractor.

Depreciation and amortisation

G.1.2 A non-cash cost is an item that is reported on the income statement for which there is no related cash payment during the period. The non-cash costs associated with tangible assets are known as depreciation and the non-cash costs associated with intangible assets are known as amortisation.

G.1.3 A contractor should apply its own accounting policies when valuing and recognising assets on its balance sheet. Contractors should adopt a consistent approach to the allocation or apportionment of non-cash costs such as depreciation and amortisation to QDCs or QSCs.

G.1.4 Depreciation and amortisation should not be Allowable in respect of an asset if the costs of the asset have already been recovered from the MOD. For example, if the MOD pays for a tangible asset at or before the start of the contract it should not pay additional costs in the form of depreciation in relation to that asset while the contract is being delivered.

G.1.5 If the MOD retains ownership of an asset and makes it available to the contractor in order for it to deliver the contract, depreciation and amortisation should not be Allowable Costs.

G.1.6 Business combinations, such as the acquisition of a company or business, may result in the creation of goodwill. Goodwill itself is not an Allowable Cost because it is an intangible asset which a contractor may record on its balance sheet due to the application of its accounting principles. A case-by-case review is required to determine the reason for the business combination to determine if the acquisition of the business is Attributable to the contract and whether any associated non-cash costs are Appropriate and Reasonable.

Re-valuation and Impairment

G.1.7 If a contractor's application of its own accounting policies results in a change in the valuation of an asset (for example, through a re-valuation or an impairment review), this may also result in a change in non-cash costs such as depreciation and amortisation, or a new non-cash cost (for example, an impairment expense or gain). Such circumstances will require a case-by-case review to understand why the value has changed, whether the MOD is due any balancing credit and ensure that any costs are Reasonable.

G.2 Financing costs

G.2.1 Any costs associated with the raising of capital will generally not be Allowable. The step 6 capital servicing adjustment is intended to compensate for servicing of capital and the SSRO would not expect these to form part of the Allowable Costs. The SSRO publishes separate guidance⁷ on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ in delivering QDCs or QSCs.

⁷ SSRO guidance on the baseline profit rate and its adjustment

Part H - Risk related costs

H.1 Risk related costs

- H.1.1 Risk that can be estimated and modelled may be an Allowable Cost within the contract price if agreed by the Secretary of State. Costs associated with compensating the contractor for such risk should be evidenced, be appropriately modelled, and only be recovered once.
- H.1.2 A risk over which the contractor has no or little control, may be covered under the provision of an adjustment to the baseline profit rate if the relevant evidence is provided. Further detail on the basis of a cost risk adjustment is covered in the SSRO's Guidance on the Baseline Profit Rate and its adjustment.
- H.1.3 Given that there is no consistent definition of the various terms relating to risk, the underlying principle to be applied is that costs associated with compensating the contractor for risk should be clearly evidenced and only be recovered once.

