SSRO

Single Source
Regulations Office

Assuring value, building confidence

Single source cost standards

Statutory guidance on *Allowable Costs*

July 2016

Supersedes 2015 guidance

Contents

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 articulated in the Defence Reform Act 2014 (the Act) or the Single Source Contract Regulations 2014 (the Regulations).

1.2 This document replaces the version of guidance published on 26 January 2015.

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 the MOD's 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 taxpayer 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 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 oversees and monitors the framework.

2.5 The SSRO is established by Section 13 of the Act. The Act states that, in carrying out its functions, 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, and qualifying sub-contracts are paid a fair and reasonable price under those contracts.

2.6 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.

3. Previous regime

3.1 Prior to the Act and the Regulations coming into force, single source contracts were subject to a non-legislative form of regulation (The Government Profit Formula and its Associated Arrangements), commonly referred to as the 'Yellow Book'. Pursuant to the Yellow Book arrangements, profit was determined according to the Government Profit Formula, which was periodically reviewed by the Review Board for Government Contracts. Costs guidance was given in the form of the Government Accounting Conventions.

3.2 Single source defence contracts entered into before 18 December 2014 do not come within the Single Source Procurement Framework unless the contract is amended on or after 18 December 2014 and the parties agree that it is to be a qualifying defence contract or qualifying sub-contract. Single source contracts under the previous regime which are not brought within the Framework by amendment will continue to be governed by such guidance as was provided under the Yellow Book arrangements.

3.3 If it is agreed that a contract entered into under the Yellow Book arrangements should become a qualifying contract upon amendment (an Amended Contract), then from the date of the amendment the Amended Contract will be subject to statutory guidance issued by the SSRO. The parties will be required to have regard to the SSRO's guidance when determining whether costs under the Amended Contract are *Allowable Costs* (Section 20(3) of the Act).

4. Application of this guidance

4.1 This document provides statutory guidance from the SSRO issued under Section 20(1) of the Act. It applies to qualifying defence contracts or qualifying sub-contracts entered into on or after the publication date. It replaces the previous version issued on 26 January 2015.

4.2 A contract is a qualifying defence contract if it meets the definition laid down in Section 14(2) of the Act.

4.3 A qualifying sub-contract is a contract between a primary contractor and another contractor or between a sub-contractor and another contractor where it meets the definition laid down in Section 28 of the Act, and has been assessed and notified as a qualifying sub-contract pursuant to the procedure under Section 29 of the Act.

4.4 Part of the criteria for qualifying defence contracts is that their price is above the thresholds specified in the Regulations. The price of a qualifying defence contract is determined by establishing *Allowable Costs* which are then adjusted for the profit rate, and should exclude VAT. This total contract price should also include:

a. any contract options

b. any revenues pertaining to a contract whether received from the MOD or from third parties;

c. the total price of any subcontracts or secondary contracts payable by the primary contractor.

4.5 For clarity the following contracts and sub-contracts are described in the Regulations as being contracts of an international nature which may not be qualifying contracts:

- a contract to which the government of any country other than the United Kingdom is a party; and
- a contract made within the framework of an international cooperative defence programme, between sovereign nations.

4.6 The Secretary of State may also specifically exclude an otherwise qualifying defence contract from the application of the Regulations and this Guidance.

5. Other sources of clarifications

5.1 Any points may be clarified with the SSRO as they arise. The SSRO responds as quickly as possible to such requests, provided they are matters of general guidance and not contract-specific. The SSRO publishes SSRO Answers monthly, which provides clarification in response to a range of general questions and is a useful reference point.

5.2 If the parties to a qualifying defence contract or qualifying sub-contract, in advance of entering into the contract would like a more definitive view as to whether costs under the contract are (or would be) *Allowable Costs*, then a referral may be made to the SSRO for an opinion. The SSRO has published guidance as to how it will deal with such referrals for an opinion[1].

5.3 Post-contract award the parties to a qualifying defence contract or qualifying sub-contract may apply to the SSRO to determine the extent to which costs are *Allowable Costs*. If such a referral is made, the SSRO will determine definitively whether the costs are *Allowable Costs* and may adjust the contract price in consequence of the determination. The SSRO has published guidance as to how it will deal with such referrals for a determination[2].

The following sections set out the SSRO's statutory guidance issued pursuant to Section 20 of the Defence Reform Act 2014.

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 the MOD single source procurement process as they are the key driver of the contract price.

6.2 The guidance for *Allowable Costs* enables the negotiation of fair contract prices between the MOD and the contractor. To support this the Act requires 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 to be applied to determine whether costs are *Allowable*. It is not intended to provide guidance with regard to the methodologies employed to calculate these costs.

6.4 This guidance applies to both estimated costs and actual costs. Those costs that are incurred in advance of a contract becoming a qualifying defence contract or qualifying sub-contract may also be subject to the regime and this guidance.

6.5 It is a legal requirement to have regard to this guidance in determining whether costs are *Allowable* under a qualifying defence contract or a qualifying sub-contract. The parties to qualifying defence contract or qualifying sub-contract must have regard to the SSRO's statutory guidance in force at the time of entering into the contract.

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

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/510492/Referrals_determinations_guidance_February_2016_v2.pdf

Allowable Costs Guidance

7. Principles of *Allowable Costs*

7.1 To be *Allowable*, a cost **must** meet all three criteria of *Appropriate*, *Attributable* and *Reasonable*. The following principles support the *Appropriate*, *Attributable* and *Reasonable* criteria and must be adhered to:

a. costs should be supported by adequate and sufficient evidence;

b. costs should be assigned to contracts only once; and

c. actual costs are to be fully recorded and reflected in the books of account.

7.2 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 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*.

7.3 When a qualifying sub-contract is awarded the burden of proof shifts from the prime contractor to the sub-contractor.

7.4 It is essential to the establishment of *Allowable Costs*, both at pricing and contract delivery stages, that they are evidenced and demonstrably linked to the delivery of the qualifying defence contract or qualifying sub-contract.

7.5 Any costing system and costing methodology employed by contractors should allow the identification of costs allocated to qualifying defence contracts or qualifying sub-contracts. This should enable the testing and evidencing of those costs to ensure that they meet the criteria for *Allowable Costs*.

7.6 All *Allowable Costs* are to be reported to the SSRO to reflect the maximum potential cost of a contract. This is the sum of the direct and overhead/indirect costs to deliver the contract. This includes the costs that are or will be incurred as well as the value of all options or variations that may apply.

7.7 The allocation of costs to the contract should be based on a contractor's normal accounting system and policies and in line with generally accepted accounting principles.

7.8 Regardless of the type of cost, Section 20(2) of the Act requires the parties to be satisfied that it is *Appropriate*, *Attributable* and *Reasonable* in the circumstances in order to be an *Allowable* Cost.

7.9 If costs have already been incurred, referred to here as 'sunk' costs when the amended contract becomes a qualifying defence contract or qualifying sub-contract, 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[3]. Such arrangements may include stating in the amended contract that:

- the parties agree that the sunk costs are *Allowable Costs*; and
- 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 qualifying contract or qualifying sub-contract.

7.10 Such arrangements may include stating in the amended contract that:

- the parties agree that the sunk costs are *Allowable Costs*; and
- 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 qualifying contract or qualifying sub-contract.

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

Direct costs

7.12 A direct cost is a cost that can be attributed to the production or delivery of specific goods, works or services required to fulfil the qualifying defence contract or qualifying sub-contract. Direct costs may consist of materials, labour or other costs. The parties must always be satisfied that the cost is *Appropriate*, *Attributable* and *Reasonable*.

Overhead/indirect costs

7.13 Overhead and indirect costs are defined as those costs which have necessarily been incurred for the performance of the qualifying defence contract or qualifying sub-contract as part of the conduct of the contractor's business in general, but cannot be measured as directly applicable to the performance of a single contract. These costs may be apportioned to individual contracts if both the costs and the proposed apportionment satisfy the test of being *Appropriate*, *Attributable* and *Reasonable*.

3 Sunk costs not subject to the regime will still need to be notified in accordance with the reporting requirements

8. Guidance on *Appropriate*, *Attributable*, and *Reasonable* criteria

8.1 Costs are *Allowable* to the extent they are *Appropriate*, *Attributable* to the contract and *Reasonable* in the circumstances. These criteria apply to all costs of a qualifying defence contract or qualifying sub-contract. 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

8.2 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 qualifying defence contract or qualifying sub-contract in question. *Appropriate* costs are those which should be able to withstand public scrutiny and which can be supported by sufficient justification.

8.3 In order to assess whether a cost is *Appropriate*, consideration should be given to the following;

- whether a cost might be expected to be incurred in the delivery of the qualifying defence contract;
- whether the cost is suitable for the purpose of the qualifying defence contract or qualifying sub-contract;
- whether the inclusion of the cost would withstand public scrutiny; and
- whether the inclusion of the cost is fair and equitable.

Attributable

8.4 Guidance on *Attributable* costs:

A cost is *Attributable* if it is incurred directly or indirectly for the fulfilment of the qualifying defence contract, or qualifying sub-contract 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 qualifying defence contract or qualifying sub-contract 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.

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

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

Reasonable

8.6 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 qualifying defence contract or qualifying sub-contract 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'.

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

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

9. Guidance on specific costs

9.1 This section details the treatment of specific costs for the purpose of assessing whether they are *Allowable*.

9.2 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*.

9.3 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.

9.4 The following section provides a non-exhaustive list of common cost items and guidance on the treatment of these costs with regard to the *Appropriate*, *Attributable* and *Reasonable* criteria. However, these will be assessed in the circumstances of individual contracts.

Depreciation, amortisation and impairment

9.5 Any expenditure of a capital nature, including the raising of that capital, is generally not *Allowable*. However, depreciation, amortisation or impairment may be an *Allowable* Cost.

9.6 Depreciation and amortisation charges are to be calculated at the contractor's own rates, provided they are consistent, equitable and relate to the non-current assets. Re-valuations 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.

9.7 The treatment of intangible assets, such as 'Goodwill', may be an *Allowable* Cost if the impairment action has been taken in accordance with generally accepted accounting principles and should be approved by the Secretary of State. Any increase in value of an intangible asset will not reduce *Allowable Costs* under the contract.

Risk

9.8 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.

9.9 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[4] is covered in the SSRO's Guidance on adjustments to the Baseline Profit Rate.

9.10 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.

Losses, obsolescence and bad debt

9.11 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 as *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.

9.12 Bad debts, and any provision for those bad debts, are generally not *Allowable* unless they specifically relate to and arise on the qualifying defence contract or qualifying sub-contract in question.

9.13 Losses on other contracts are generally not *Allowable*, as by their nature these are not applicable to the qualifying defence contract or qualifying sub-contract in question.

Redundancy payments

9.14 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.

Employee benefits

9.15 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.

9.16 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 and not part of normal remuneration are unlikely to be considered as *Allowable Costs*.

9.17 Distributions of profit, are generally not *Allowable*, as these costs are earnings as a result of sales exceeding production costs (they do not form part of production).

4 Guidance on adjustments to the Baseline Profit Rate, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/510514/Guidance_on_adjustments_to_the_Baseline_Profit_Rate_23_March_-_FINAL_WEB.pdf

Private venture research and development

9.18 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.

9.19 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 qualifying defence contract or qualifying sub-contract 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.

9.20 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.

9.21 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.

9.22 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.

9.23 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*.

Pension costs

9.24 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.

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

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

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

Marketing and sales

9.26 Marketing and sales costs should 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), marketing and sales campaigns, sponsorships and other related commercial activities, and in general should be retrospective in nature.

9.27 A demonstrable link should be made that evidences financial benefit to the qualifying contract or qualifying sub-contract in question as a result of the particular sales and marketing expenditure. This may include a reduction to the overheads apportioned to the qualifying defence contract or qualifying sub-contract from a relevant qualifying business unit.

Bid costs

9.28 Bid costs, which were incurred for the qualifying defence contract or qualifying sub-contract, if properly evidenced may be *Allowable*.

9.29 In addition, bid costs may include for instance staff costs to prepare and review of proposals, and may be more appropriate to be charged directly to the contract, rather than being apportioned as indirect costs.

Third party costs

9.30 Entertainment expenses of any sort are not *Allowable Costs*.

9.31 Donations of a political and charitable nature are not *Allowable* as these form no part of costs associated with qualifying defence contracts or qualifying sub-contracts.

9.32 Discounts allowed on sales to third parties are generally not *Allowable* as these do not financially benefit the qualifying defence contract or qualifying sub-contract in question.

Reworks and faulty workmanship

9.33 The cost of rework and wastage may be *Allowable* if it meets the principle of being *Appropriate*, *Attributable* and *Reasonable*. These costs have to be agreed between the contractor and the Secretary of State based on the expected level of rework and wastage given the nature of the contract in question.

9.34 Contractors must have appropriate quality management systems in place and be able to evidence the causes of rework and wastage.

9.35 Rework and wastage costs arising from the experimental manufacturing processes agreed as part of a contract with the Secretary of State may be *Allowable*.

9.36 Conversely, damages or compensation or loss of profit for poor performance, such as faulty workmanship or breach of contract, are not *Allowable Costs*.

Inflation, labour and material rates

9.37 Labour and costs of material inflation applied to a contract has to be relevant to the cost category or activity being benchmarked.

9.38 Labour and costs of material Inflation should be evidenced against an appropriate benchmark or indices in order to be an *Allowable Cost*.

Refunds, penalties and notional transactions

9.39 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*.

9.40 Notional transactions are generally not *Allowable*.

9.41 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 *Appropriate*, *Attributable* and *Reasonable* criteria.

Insurance

9.42 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 plant may be *Allowable*.

9.43 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*.

9.44 Accordingly, insurance against faulty workmanship, 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.

10. Exceptional or abnormal costs

10.1 This guidance is applicable to all contract discussions between the Secretary of State and contractors regarding *Allowable Costs* 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 and this should be sought from the SSRO if agreement cannot be reached between the Secretary of State and the Contractor.

10.2 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.

10.3 In all cases of an exceptional nature which result in separate negotiations the SSRO should be informed.

10.4 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.

Costs associated with the closure, rationalisation or restructuring

10.5 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.

10.6 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.

10.7 Profits and losses must be calculated at the time that closure, rationalisation or restructuring takes place.

Idle facilities and capacity

10.8 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 which were designed for that purpose.

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

10.10 The costs of idle facilities or capacity is 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.

10.11 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.

11. Cost allocation practices

11.1 Single Source contractors are required annually to declare to the MOD, through the Questionnaire on the Method of Allocation of Costs (QMAC), their cost 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.

11.2 A contractor will follow its own normal accounting systems, and in advance must declare material changes to the SSRO and the Secretary of State, together with a clear statement explaining the reasons behind the change.

11.3 The contractor's costing system must be the same for the Secretary of State's 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.

11.4 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.

11.5 The contractor is required to demonstrate to the Secretary of State and evidence any claim for a cost to be *Allowable*. Any unresolved disputes between the contractor and the Secretary of State can be referred to the SSRO.