

**Review Board  
for  
Government Contracts**

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**REPORT ON  
THE 2011 ANNUAL VIEW OF  
THE PROFIT FORMULA FOR  
NON-COMPETITIVE  
GOVERNMENT CONTRACTS  
FEBRUARY 2011**

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The Rt Hon Liam Fox, MP  
Secretary of State for Defence  
Ministry of Defence  
Main Building  
Whitehall  
London  
SW1A 2HB

February 2011

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2011 Annual Review of the profit formula for non-competitive Government contracts.

Copies have been sent to the President of the CBI and to the Director General Defence Commercial.

Yours sincerely

John Price  
Chairman

# REVIEW BOARD FOR GOVERNMENT CONTRACTS

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## **NOTE:**

The recommendations in this report are accepted by the Ministry of Defence and the Joint Review Board Advisory Committee in an agreed statement which is presented as an addendum to this report on page 34.

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## EXPLANATION OF TERMS AND ABBREVIATIONS USED IN THIS AND IN PREVIOUS REPORTS

<b>Acquisition Operating Framework ('AOF')</b>	A web based tool that sets out MOD's acquisition policy and practice and which can be located in the 'Defence for... Business' section of the MOD website.
<b>Adjusted Standard Baseline Profit Allowance ('ASBPA')</b>	The profit allowance on cost applicable to firm, fixed price and target cost contracts and contract amendments with an estimated or target cost of £50 million or more subject to any further adjustment in accordance with the risk/reward matrix.
<b>AIM companies</b>	Companies listed on the Alternative Investment Market in the United Kingdom.
<b>Annual return</b>	The return to the Review Board prepared by a contractor showing the profit achieved each year on its non-competitive Government contracts. The 2009 annual returns have been completed for company year ends ending in the period 1 April 2009 to 31 March 2010.
<b>Annual Review</b>	The review by the Review Board of the principal components of the profit formula, undertaken annually between General Reviews. The most recent General Review was dated 2010. The most recent Annual Review was the 2009 Annual Review which was published by The Stationery Office (ISBN 978-0-11-773088-5) in 2009.
<b>Baseline Profit Rate ('BPR')</b>	The profit of the Reference Group after deducting allowances for the servicing of capital employed, expressed as a percentage of the Reference Group's cost of production.
<b>BBB3 Corporate Bond</b>	The credit quality of debt obligations issued by corporations is evaluated by organisations such as Thomson Financial BankWatch, Moody's, S&P and Fitch Investors Service. Bloomberg uses these evaluations to produce a composite rating. BBB3 is the lowest investment grade rating i.e. immediately above non investment grade.
<b>CBI</b>	Confederation of British Industry.
<b>CE</b>	Capital employed.
<b>Comparability principle</b>	The aim of the Government Profit Formula, which is to give contractors engaged in non-competitive Government contract work a return equal on average to the overall return earned by British industry having regard to both capital employed and the cost of production.
<b>Contract Baseline Profit Allowance ('CBPA')</b>	The profit allowance on cost applicable to a specific contract after making all appropriate adjustments in accordance with the risk/reward matrix.

<b>Contractor Group</b>	A generic term for the group of contractors who are engaged in non-competitive Government work using the Government Profit Formula. The composition of the group may vary from year to year.
<b>CP</b>	Cost of production.
<b>CP:CE ratio</b>	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio is used to attribute to individual contracts a proportion of the contractor's capital employed.
<b>CP:CE ratio unit</b>	The business unit or other sub-division of a contractor's business for which a CP:CE ratio is calculated for the purposes of pricing non-competitive Government contracts.
<b>CSAs</b>	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
<b>DEFCONs</b>	The series of defence contract conditions applicable to MOD contracts. These are contained in the Commercial Managers' Toolkit which can be accessed on the MOD's Acquisition Operating Framework website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
<b>EBIT</b>	Earnings Before Interest and Tax.
<b>FCSA</b>	Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible assets.
<b>Financial Reporting Standard ('FRS') 17</b>	The accounting standard issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.
<b>Firm Price</b>	A price, agreed for articles or services, or both, which is not subject to variation.
<b>Fixed Price</b>	A price, agreed for articles or services, or both, that is subject to variation in accordance with the variation of price provision of the contract.
<b>General Review</b>	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The report on the 2010 General Review was published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.
<b>Government Accounting Conventions ('GACs')</b>	The accounting conventions used for the determination of costs and capital employed attributable to non-competitive Government contracts.

<b>Government Profit Formula and its Associated Arrangements ('GPFAA')</b>	The Government Profit Formula ('GPF') incorporating the 1968 Memorandum of Agreement between the Government and the CBI and subsequent revisions and changes since that time, as agreed between the representatives of Government and the CBI. The extant GPFAA is published as an Appendix in each General Review report; and an updated version is placed on the MOD website after each Annual or General Review, to incorporate the outcome of that latest Review.
<b>Government Profit Formula</b>	The formula for the pricing of non-competitive Government contracts.
<b>International Accounting Standards ('IASs')</b>	International Accounting Standards issued by the International Accounting Standards Committee, the body that preceded (1973-2001) the International Accounting Standards Board.
<b>International Financial Reporting Standards ('IFRSs')</b>	International Financial Reporting Standards issued by the International Accounting Standards Board.
<b>Intra-group inter-unit trading ('IGIU')</b>	Trading between different CP:CE ratio units within the same group of companies.
<b>Joint Review Board Advisory Committee ('JRAC')</b>	A body comprising representatives of the CBI and those trade associations and companies that have particular interest in non-competitive Government contracts.
<b>LIBOR</b>	London Inter Bank Offered Rate.
<b>Ministry of Defence ('MOD')</b>	The Ministry of Defence is the predominant user of the Government Profit Formula for non-competitive Government contracts and since the 1987 General Review has had the responsibility, formerly vested in HM Treasury, for communicating with the Board on behalf of Government on all matters concerning the profit formula. However, if both contracting parties agree, the GPFAA are available for application to non-competitive contracts placed by other Government departments or public sector bodies, by incorporation of the appropriate contract conditions. References in this report to MOD include, where appropriate, reference to other bodies making use of the GPFAA.
<b>Modified historic cost ('MHC')</b>	MHC is not defined in accounting standards or company law. For the purposes of the GACs it is taken to refer to the depreciated fixed asset value shown in a company's statutory accounts. These assets might be shown at cost or might be revalued in accordance with recognised accounting standards.
<b>MPTC</b>	Maximum Price Target Cost contracts. See Target Cost Incentive Fee.
<b>No Acceptable Price No Contract ('NAPNOC') contract</b>	Contracts placed according to arrangements introduced by MOD in July 1992 where MOD's aim is that such contracts should be priced before they are placed.



<b>Non-competitive Government contracts</b>	Those Government contracts, or sub-contracts in aid of Government contracts, let other than by means of competitive tendering and priced either prior to or following contract award with reference to the Government Profit Formula.
<b>Non-risk Baseline Profit Allowance ('NBPA')</b>	The profit allowance on cost applicable to cost-plus (i.e. non-risk) contracts, being the SBPA less 25 per cent.
<b>Non-risk contract</b>	A contract placed on a cost reimbursement basis (whether with a fixed fee or a percentage profit) which insulates a contractor against loss.
<b>Post-costing</b>	A review by MOD of the actual costs incurred on a contract, for comparison with the costs as estimated at the time when the price for the contract was agreed.
<b>Profit formula</b>	The formula for the pricing of non-competitive Government contracts.
<b>Private Venture Research and Development ('PV R &amp; D')</b>	Research and development expenditure which is not directly chargeable to the Government or any other customer under the terms of a specific contract.
<b>Questionnaire on the Method of Allocation of Costs ('QMAC')</b>	A document that MOD requires its contractors to complete when engaged in non-competitive contracting which discloses to MOD the contractor's cost accounting practices.
<b>Reference Group</b>	The group of UK companies representative of British industry whose average rate of return is used by the Review Board to determine the target rate of return in the Government Profit Formula.
<b>Risk contract</b>	A contract with a pricing arrangement which does not insulate the contractor against loss.
<b>Risk/Reward matrix</b>	A table with notes that sets out the adjustments to be made to the SBPA (or ASBPA for risk contracts and contract amendments with an estimated or target cost of £50 million or more) to reflect the differing levels of risk for different types of work.
<b>SAYE</b>	Save As You Earn.
<b>SMEs</b>	Small and Medium-sized Enterprises.
<b>Standard Baseline Profit Allowance ('SPBA')</b>	The profit allowance on cost applicable to all GPF contracts after adjustments to the BPR for differences between the Reference Group CP, the Contractor Group CP and the individual contractor CP as appropriate.
<b>Standard Conditions of Government Contracts for Stores Purchases (SCs)</b>	The series of conditions applicable to Government contracts published as Form GC/STORES/1 and now replaced by similar DEFCONs in contracting with MOD.

<b>Statement of Standard Accounting Practice ('SSAP') 24</b>	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the financial statements of enterprises. For UK listed companies this has now been superseded by IAS 19, and FRS 17 for other UK companies that have not elected to adopt IFRS.
<b>Target Cost Incentive Fee ('TCIF') Contracting</b>	A pricing basis whereby a target cost and target fee are agreed at the outset, along with a formula which sets out how the Government and the contractor will share cost over-runs and cost savings. Where such an arrangement is subject to an overall maximum price, it is usually referred to as a Maximum Price Target Cost ('MPTC') contract.
<b>The 1968 Memorandum of Agreement</b>	The agreement between the Government and the CBI establishing the Review Board.
<b>The Profit Formula Agreement</b>	The agreement between the Government and the CBI reached in 1968 which sets out the basis of pricing non-competitive Government contracts.
<b>Total Contract Profit Allowance ('TCPA')</b>	The total profit allowance applicable to a specific contract or contract amendment, expressed as a percentage of cost, comprising the sum of the CBPA, the FCSA and the WCSA.
<b>Trigger points</b>	A contract or sub-contract, incorporating the appropriate conditions, is eligible for reference to the Board where outturn costs vary from estimated costs by more than a specified percentage. The limits thus defined are referred to as the trigger points and are currently set by reference to a 10 per cent variation from estimated costs (see also paragraph 17 of the 1968 Memorandum of Agreement).
<b>UITF 17</b>	Urgent Issues Task Force Abstract 17 Employee Share Schemes. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment for various issues.
<b>UK GAAP</b>	UK Generally Accepted Accounting Practice.
<b>WCSA</b>	Working Capital Servicing Allowance provided to contractors for their investment in working capital.



## SECTION I

### INTRODUCTION

101. The basis for pricing non-competitive Government contracts is set out in The Government Profit Formula and its Associated Arrangements ('GPFAA') as agreed between the Ministry of Defence ('MOD'), on behalf of Government, and the Joint Review Board Advisory Committee ('JRBAC') representing the CBI, on behalf of industry. This agreement encapsulates a 1968 Agreement between Government and industry and numerous revisions since that date. The GPFAA is published in the Review Board's General Reviews, the latest of which is the 2010 General Review<sup>1</sup>. Subsequent proposed changes are discussed in this report, reflecting consideration of the issues in paragraph 105 below.

102. The aim of the Government Profit Formula ('GPF') is to give contractors engaged on non-competitive Government contracts a fair return; that is to say, a return equal on average to the overall return earned by British industry in recent years, by reference to both capital employed and cost of production – this is known as the comparability principle.

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

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

105. Annual Reviews of the profit formula, like this 2011 Annual Review, are normally limited to examination of changes to the Reference Group rate of return and to other statistical data and their application to the GPF. The methodology used at an Annual Review is determined from the previous General Review. With the agreement of MOD and the JRBAC, this Annual Review also contains consideration of the issues of:

- the effect of adoption of International Financial Reporting Standards by some CP:CE ratio units;
- refinement of the methodology for eliminating Intra-Group Inter-Unit ('IGIU') trading;
- the payment by Government of profit on contractor site rationalisation and/or plant closure costs; and the treatment of profits to contractors arising from the sale or disposal of assets during a site rationalisation and/or plant closure; and
- the justification of labour and overhead costs by contractors.

These issues are considered in section V of this report.

106. At the conclusion of each General Review or Annual Review the Board makes a report to MOD giving its recommendations. These reports are simultaneously made available to the JRBAC and form the basis for discussions between MOD and the JRBAC.

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1 The report on the 2010 General Review of the Profit Formula for non-competitive Government contracts was published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.



107. This report, on the 2011 Annual Review of the Profit Formula for non-competitive Government contracts, contains the Board's recommended profit formula for the year from 1 April 2011.

## **Future Developments**

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

109. The Government considers that in the current fiscal climate it is more important than ever that industry is incentivised to reduce costs through the use of modern, fit for purpose commercial arrangements (including for small and medium sized enterprises), in addition making UK industry more competitive on the world market.

110. Lord Currie will be consulting widely with stakeholders and will present his initial report to the Minister by July 2011, after which there will be further consultation with stakeholders to agree an implementation plan. In parallel, MOD has requested that the Board continue its work to maintain the existing processes until the outcome of the review is known and the way forward agreed.

111. The Minister's announcement states that the review implies no criticism of the Review Board for Government Contracts, which is considered a valued part of the existing framework and whose remit has been to maintain the profit formula and examine only those issues set before it by Government and industry.

112. The Board supports Lord Currie's review and looks forward to contributing to it.

## SECTION II

### SUMMARY

#### Profit Formula Recommendations

201. To achieve comparability with the return earned by British industry, the profit formula from 1 April 2011 should be structured as follows:

		2010 <i>General Review</i>	2011 <i>Annual Review</i>
		%	%
FCSA	Fixed Capital Servicing Allowance (paragraph 311)	6.71	6.65
WCSA	Working Capital Servicing Allowance (paragraph 313)	5.80	4.25
BPR	Baseline Profit Rate (paragraph 317)	9.29	9.04

202. As part of this 2011 Annual Review MOD and the JRBAC have agreed to a revised methodology for adjusting the BPR so it can be applied to individual contracts and this is described in more detail in section III of the report. The main adjustments to the BPR are:

- Standard Baseline Profit Allowance ('SBPA') (paragraph 322): for a contractor that does not conduct any IGIU trading, the 2011 Annual Review SBPA should be the same as the BPR, which is 9.04 per cent. Contractors that are part of a group of companies that undertake IGIU trading will compute and agree with MOD a reduced SBPA to be applied to contract costs so as to eliminate the impact of their IGIU trading.
- Adjusted Standard Baseline Profit Allowance ('ASBPA') (paragraph 325): a contractor's ASBPA, in respect of firm or fixed price contracts with costs in excess of £50m, should be 0.30 of a percentage point lower than its SBPA. Therefore, for the 2011 Annual Review, a contractor that does not undertake IGIU trading should have an ASPBA of 8.74 per cent.
- Contracts placed on a cost reimbursement basis should attract the SPBA less 25 per cent (paragraph 326). Therefore, for the 2011 Annual Review, a contractor that does not undertake IGIU trading should have a Non-risk Baseline Profit Allowance ('NBPA') of 6.78 per cent.

203. A flowchart showing the various stages of Baseline Profit is included at Appendix B.

#### Implementation of the Board's Recommendations

204. As agreed between MOD and the JRBAC the implementation date should be 1 April 2011.

#### Recent Profits on Non-Competitive Contracts

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

206. The Board has analysed the 2009 annual returns received from contractors and notes that contractors, as a body, appear to have exceeded their expected ROCP by 0.81 per cent for that year. However, this is an average figure and it masks a wide variety of results from individual contractors (paragraphs 402-406).

207. The Board has reviewed the results of the post-costing and, whilst the total value of contracts post-costed is higher than in recent years, the Board considers that the number of contracts post-costed by MOD remains disappointingly low. In 2009 there were 8 post-costed contracts and it seems unlikely that this is a large enough sample for the purpose of making a broad assessment of performance on non-competitive contracts. The Board has been provided with assurances that additional resources are being allocated to the post-costing programme, which the Board hopes will provide a larger sample against which to assess performance on GPF contracts (paragraphs 407-416).

### **Other Aspects of Non-Competitive Pricing**

208. The MOD and the JRBAC have proposed a number of revisions to the GACs to make clear that:

- exceptional rationalisation costs can be dealt with on a stand-alone basis and excluded from overheads, in which case there should not be an automatic application of the profit allowance;
- the MOD should not be restricted from sharing in profits earned by contractors on the sale of an asset where Government has made a significant investment in that asset; and
- the contractor's responsibility to justify and support levels of claimed labour and overhead costs is explicit.

209. Where there is a dispute between MOD and the contractor over claimed costs, a mechanism is intended to be introduced whereby MOD or the contractor may make a reference to a third party, which might be the Review Board. However it has been agreed that disputes will not be referred until the process of resolution and terms of reference for any dispute are agreed.

210. The Review Board supports these changes, which are embodied in the GACs set out in Appendix D of this report.

211. As indicated in paragraph 217 of the 2010 General Review, MOD and the JRBAC continued to review the consequences of the introduction of IFRS. As noted in paragraph 509 the parties have issued a joint statement on this topic which is included at Appendix E to this report and which, it is recommended, should be inserted as Annex E to Section 2 of the GPFAA.

212. A number of issues are being considered and progressed outside of the timetable for the 2011 Annual Review:

- The treatment of risk and reward on non-competitive contracts.
- Update of the QMAC.
- Aligning DEFCONs and the GPFAA.

The first of these topics is considered in further detail in section III and the others are considered in section V of this report.

## SECTION III

### THE TARGET RATE OF RETURN

#### Introduction

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

#### The Reference Group

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

303. The constituents of the Reference Group have been considered in detail at each General Review. The general principle adopted by the Board has been that all British listed companies are eligible to be included in the Reference Group except where:

- the Board considers that a sector comprises companies that are so fundamentally different, in their capital structure and areas of operation, from the companies undertaking non-competitive Government contracts that it would be inappropriate to include that sector in the Reference Group. Significant sectors currently falling into this category are: banking, insurance, investment trusts, property investment, mining, oil and gas; or
- the Board considers that a particular sector is dominated by companies that do not operate on a sufficiently competitive basis. Sectors currently falling into this category are the water sector and certain subsectors of the power sector.

304. The Reference Group for this Review comprises 718 companies with a total capital employed of £233 billion and sales of £787 billion as compared with 785 companies with capital employed of £225 billion and sales of £759 billion at the 2010 General Review. This change largely reflects the reduction in the number of companies quoted on the AIM market.

305. The Reference Group is derived from data obtained from the 'Worldscope' database which is compiled by Thomson Reuters.

306. The Board considers that the Reference Group is sufficiently large and broadly based to provide a sound basis for application of the principle of comparability.

## Determination of the Baseline Profit

307. The target rate of return in the profit formula is determined on a three-year rolling average basis to reduce the volatility of the target rate caused by year-to-year fluctuations in the level of the Reference Group's profitability. The simple average of the Reference Group Baseline Profit Rates for 2008, 2009 and 2010 is 9.04 per cent and the Board recommends that this should be adopted in the Profit Formula.

## The Profit Formula Methodology

308. At the 2003 General Review it was agreed that the return on non-competitive contracts should be made up of three elements:

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

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

### *The FCSA*

310. The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in fixed assets. The FCSA is:

- linked to the 7 year moving average of the 15 year BBB corporate bond rate; plus
- 0.5 of a percentage point to incorporate a premium for a BBB3 rating and a liquidity discount.

311. Based on the rates prevailing up to 30 November 2010, this gives a FCSA of 6.65 per cent.

### *The WCSA*

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

313. To reduce volatility the WCSA is based on a moving average of the one year LIBOR rate. The 36 month moving average of the one year LIBOR based on rates prevailing up to 30 November 2010 was 3.00 per cent, so the appropriate WCSA should be 4.25 per cent.



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

### *The Baseline Profit*

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

	2005/6 Reference Group £m	2006/7 Reference Group £m	2007/8 Reference Group £m	2008/9 Reference Group £m	2009/10 Reference Group £m
(A) Cost of Production	432,434	425,872	477,563	687,083	705,897
(B) Capital Employed	160,393	169,899	185,913	224,567	232,951
(C) CP:CE ratio (A÷B)	2.70	2.51	2.57	3.06	3.03
(D) FC:WC ratio	94:6	89:11	89:11	101:-1	109:-9
(E) Actual Profit (EBIT)	57,622	54,067	58,073	71,812	81,523
(F) FCSA % (see note 1 below)	6.78%	6.71%	6.70%	6.68%	6.71%
(G) WCSA % (see note 1 below)	5.82%	6.23%	6.55%	6.66%	5.30%
(H) FCSA (B×(D['FC']÷100)×F)	10,222	10,146	11,086	15,162	17,035
(I) WCSA (B×(D['WC']÷100)×G)	560	1,164	1,340	-149	-1,112
(J) Total CSA (H+I)	10,782	11,311	12,425	15,014	15,923
(K) Baseline Profit (E-J)	46,840	42,757	45,647	56,798	65,600
(L) BP as % of CP (K÷A)	10.83%	10.04%	9.56%	8.27%	9.29%
<b>3 year rolling average</b>			<b>10.14%</b>	<b>9.29%</b>	<b>9.04%</b>

**Note 1:** The FCSA and WCSA percentage figures are derived using the methodology set out earlier in this section. However, for the purposes of calculating the Baseline Profit, the figures used are those prevailing up to 31 March of each year concerned.

**Note 2:** Figures in the table are subject to rounding differences.

316. The Baseline Profit Rate is calculated from the average Baseline Profit of the Reference Group for the latest three years. It can be seen from the table that the three year simple average calculation has decreased by 0.25 of a percentage point since the 2010 General Review. The Board has concluded that for the 2011 Annual Review the Baseline Profit Rate derived on the basis of strict comparability with the returns of British industry should be 9.04 per cent.

317. Accordingly the Board recommends that the Reference Group Baseline Profit Rate of 9.04 per cent should be used in the profit formula arrangements. This figure needs to be adjusted before it can be applied to individual contracts, and this process is considered in the following section.

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

318. The Reference Group Baseline Profit Rate on cost of production of 9.04 per cent, on the modified historic cost basis, needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractor Group.

319. The Board's assessment is that the calculation of cost of production in the Contractor Group will be different from that of the Reference Group, because the Contractor Group's figures for cost of production include IGIU trading whereas similar trading within the Reference Group will be eliminated as consolidation adjustments in group accounts. Therefore intra-group trading within the Contractor Group needs to be assessed and eliminated in order to maintain comparability.

320. The methodology for deriving the GPF has remained unchanged since it was first introduced, following the Board's 2003 General Review. Within the significant changes to the GPF in the 2003 General Review it was agreed that the Contractor Group's IGIU trading should be eliminated through an adjustment to the BPR, applied to all contractors constituting the Contractor Group. The adjustment was calculated from the results of an annual exercise between MOD and the contractors to determine the level of IGIU trading across the whole Contractor Group. Although this 'blanket' adjustment had the merit of simplicity, it had the disadvantage that contractors with no IGIU trading received a lower SBPA than they would otherwise have received.

321. In a submission to this 2011 Annual Review MOD and the JRAC have agreed that there should be a refinement to the process and methodology for eliminating IGIU trading which reflects experience gained since the IGIU adjustment was first introduced. It has been agreed that for this and for subsequent reviews the IGIU adjustment should be calculated for each corporate group of companies rather than applying a 'blanket' IGIU adjustment to the Contractor Group. The Board agrees that this methodology is a sensible refinement of the previous methodology and recommends that it should be applied from 1 April 2011. This adjustment, together with any other adjustment that might be required in a particular year, results in the SBPA.

322. As a consequence of the change described above, and because the Board does not consider that any other adjustment is required, for contractors that are part of a group that do not undertake IGIU trading the recommended SBPA is the same as the recommended BPR for the 2011 Annual Review. However, individual CP:CE ratio units will agree lower SBPA rates with MOD if they are part of a group that undertakes IGIU trading. The Board requests that the JRAC continues to support the MOD in providing the Board with data on IGIU trading and on agreed profit rates so the Board can continue to monitor any differences between expected and outturn profits on GPF contracts.

### **The Risk/Reward Matrix**

323. The MOD and the JRAC recognise that the risk profiles of different types of work will vary and the principle that contracts should be priced at a target rate of return that relates to their risk profile is a sound principle. The parties took steps in the 2003 General Review to

further embed this principle into the GPF through the agreement of interim arrangements. These arrangements consisted of a variable Risk/Reward matrix and a reduction of 30 basis points on the SBPA for firm or fixed price contracts over £50 million.

324. At reviews since 2003 the Board has urged the parties to review the interim arrangements dealing with the subject of risk and reward in GPF contracts. In paragraph 411 of its report on the 2010 General Review the Board noted that the parties were in discussion on this topic and that discussions were expected to have reached a sufficiently advanced stage for inclusion in the 2011 Annual Review. Owing to conflicting priorities and time constraints, MOD has been required to concentrate its resources on other matters so that limited progress has been made on the topic in the past year. The Board believes that this remains an important topic to be addressed by the parties.

325. The Board recommends that the existing arrangements should continue until the review of risk and reward by MOD and the JRBAC has been completed. The recommended Adjusted Standard Baseline Profit Allowance ('ASBPA') for the 2011 Annual Review is therefore 30 basis points below its SBPA. For CP:CE ratio units that are part of a group that does not undertake IGIU trading the ASBPA will be 8.74 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced ASBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading.

326. The Risk/Reward matrix also addresses the issue of non-risk contracts and notes that non-risk contracts should attract the Standard Baseline Profit Allowance less 25 per cent. Therefore the Board recommends that if CP:CE ratio units that are part of a group that does not undertake IGIU trading its non-risk contracts should attract a Contract Baseline Profit Allowance of 6.78 per cent. For CP:CE ratio units that are part of a group with IGIU trading a reduced NBPA will be computed and agreed with MOD so as to eliminate the impact of IGIU trading. The Risk/Reward matrix, as it currently stands, is reproduced at Appendix C.

## **The Comparability Principle**

327. In Section 1.36 of the GPFSA the Board is asked 'to bring to notice in its reports anything that it regards as relevant to the operation of the GPF. This would include, should the occasion arise, respects in which the Board might wish to draw attention to any perceived ill-effect for either party, or for both, deriving from strict observance of the comparability principle and to make further recommendations which should be separately identified'. The Board has concluded that there is no such matter that it wishes to bring to notice in the Report on the 2011 Annual Review.

## SECTION IV

### RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

#### Introduction

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

#### Annual Returns

402. Thirty-seven contractors have submitted their 2009 annual returns for consideration at this Review. The returns analyse GPF contract work performed in the year with total sales of £6.6bn. The comparable figures for 2008 are 35 returns with total GPF sales of £6.2bn. MOD's statistics state that £8.0bn of non-competitive contracts were placed by MOD in 2009/10 (compared with £11.8bn in 2008/09, £7.6bn in 2007/08 and £8.7bn in 2006/07). This suggests that the annual returns represent a high level of coverage of the total non-competitive contracts and amendments placed by MOD in recent years.

403. The Board's analysis of the 2009 annual returns shows that the contractors' overall expected rate of return on cost of production ('ROCP') on GPF contracts was 7.94 per cent on their cost of production (7.01 per cent in 2008), and that they achieved an actual ROCP of 8.75 per cent (10.82 per cent in 2008). Therefore contractors, as a body, appear to have exceeded their expected ROCP by 0.81 of a percentage point (3.81 percentage points in 2008). This is a weighted average calculation of contracts with a variety of profit rates and which started in a number of different years.

404. The Board notes that the Contractor Group has outperformed the target profit in each of the past four years albeit analysis of the 2009 results shows there is a very wide variety in the results achieved by individual contracting units. The positive variance in 2009 masks the fact that 16 of the contracting units performed above the target and 21 performed below the target and is influenced by the size of individual contracts. However, some contractors appear to have performed better than the target in recent years and others appear to have performed worse. The Board would expect that MOD's post costing exercises would enable it to understand such variances and would inform its estimating procedures. The Board does note that some 92 per cent (by sales value) of the contracts included in the returns relate to Risk contracts where the price is fixed at the outset.

405. Further, the historic run of results suggests that performance against target does tend to be volatile. This can be seen from the figures for variance of actual returns from the target return for the past 15 years:

Year	Variance	Year	Variance	Year	Variance
2009	+0.81%	2004	-3.37%	1999	No returns
2008	+3.81%	2003	No returns	1998	No returns
2007	+1.05%	2002	No returns	1997	No returns
2006	+2.29%	2001	-26.3%	1996	+15.4%
2005	-1.1%	2000	-7.8%	1995	-6.0%

406. The Board will continue to monitor the performance of contractors in order to determine any developing trend and, if so, will seek to understand the causes for it.

### Post-Costing:

407. Post-costing is a review by MOD of the actual costs incurred on a contract, for comparison with the costs estimated at the time when the price of the contract was agreed. Post-costing is designed to assist MOD in contract pricing by providing a check on the accuracy of estimating procedures and to provide a guide to follow-on pricing.

408. Past post-costing results received from MOD are shown below:

All contracts post-costed by MOD				
	2005	2006	2008	2009
Total of contracts post-costed				
(a) Number	36	13	15	8
(b) Value	£989m	£694m	£807m	£1,057m
Of which the following were not fully analysed:				
(a) Number	Nil	Nil	Nil	Nil
(b) Value	Nil	Nil	Nil	Nil

Analysis of costs of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2005	2006	2008	2009
A – Contracts where +/- 5 per cent accuracy was achieved:				
(a) Percentage by Number	76%	67%	27%	63%
(b) Percentage by Value	72%	78%	30%	17%
B – Contracts where +/- 10 per cent accuracy was achieved:				
(a) Percentage by Number	88%	92%	47%	75%
(b) Percentage by Value	97%	84%	51%	84%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):				
(a) Number	17	10	4	5
(b) Value	£361m	£503m	£73m	£827m
D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):				
(a) Number	Nil	Nil	3	2
(b) Value	Nil	Nil	£121m	£144m

*continued overleaf*

Analysis of costs of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2005	2006	2008	2009
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:				
(a) Number	Nil	Nil	1	2
(b) Amount of refund	Nil	Nil	£0.5m	£3m
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):				
(a) Number	12	1	4	1
(b) Value	£387m	£11m	£526m	£13m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):				
(a) Number	4	1	4	Nil
(b) Value	£27m	£100m	£38m	Nil

**Note:** MOD did not report any post-costing results for 2007.

409. The number of contracts included in the post-costing exercise remains small. As can be seen, outturn costs were below target costs by more than 10 per cent on two contracts. These contracts had estimated costs of £144m and MOD negotiated refunds of £3m from the contractors. This set of post-costing results included what is believed to be the first payment resulting from the ‘automatic’ sharing arrangements for unconscionable profits and losses, which were introduced following the 2003 General Review through the use of DEFCON 648a. One of the other contracts included in the exercise was placed before 2003 and therefore did not include the sharing arrangements. However, as an indication of the potential significance of the new sharing arrangements it is worth noting that if DEFCON 648a had applied to this contract then MOD might have expected a significant repayment, in excess of £10m. These sharing arrangements are applied to additional profits or losses made by the contractor that exceed five per cent of the contract value. The Board notes that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment.

410. In explaining the reasons for contractor cost variances revealed by post-costing, MOD has made several references to contingencies in certain specific contracts, that have not in the event been required. The Board is aware that both parties recognise the need to treat contingency provisions carefully and within the overall context of risk allocation, and that existing guidance prohibits the inclusion of ‘general’ contingencies. Nevertheless, the Board considers that the parties might give further consideration to the management of contingencies when they are included in the cost estimates of contracts.

411. The Board’s direct use for post-costing results is to gain an understanding, in addition to that achieved through annual returns, of how closely contract performance matches profit formula target performance. In this respect there are two principal concerns which have the potential to reduce the value of data, being the status of the figures contained in the post-costing analysis and the number and value of the contracts included in the post-costing exercise. These are considered below:

#### *The status of the post-costing result*

412. During the course of this review there has been debate between the Review Board, MOD and the JRBAC concerning the derivation of the post-costing statistics, which are provided to the Public Accounts Committee as well as to the Board. The process adopted for post-costing is that MOD identifies a contract for post-costing and the contractor then produces a certificate containing its record of the actual outturn cost of that contract. MOD then refers to the estimates of cost used at the time of pricing (including pricing of amendments) and

compares the actual costs with the estimates included in the price. The process does not require the two parties to agree the extent of any variance between estimated and outturn costs so the cost variance reported to the Board by MOD will be MOD's view on the outturn.

413. The Board believes that it would be advantageous if both MOD and the contractor were to state their respective positions on each post-costed contract; MOD and the JRBAC have an aspiration of amending the post-costing process accordingly.

*The number and value of contracts post-costed*

414. The Board believes strongly that post-costing is a vital exercise for MOD and must provide it with valuable information to understand costs thus informing subsequent pricing. The Board has consistently encouraged MOD to increase the coverage of its post-costing exercise and has received a number of previous assurances that this was in train. It can be seen that the number of contracts post-costed remains very low. Of particular note is that the 2007 analysis has been omitted from the table as the Board was informed by MOD that there was only one low value contract where post-costing work was completed in that year. The Board has been informed that MOD has recently allocated more investigative resource to post-costing and that MOD expects these efforts will reinvigorate the post-costing programme and lead to an increase in the number and value of post-costed contracts in coming years for the benefit of all parties and external stakeholders such as the Review Board.

415. The low number of contracts currently included in the post-costing exercise also means that it is unlikely to be a representative sample for the purpose of making a broad assessment of performance on non-competitive contracts. The Board hopes that a broadening of the post-costing exercise will also make the sample more representative so that more meaningful conclusions can be drawn from the aggregated results.

416. The Board also requested general explanations of variances seen in the post-costing exercise. MOD has provided some explanation in the current year but the Board, MOD and the JRBAC all recognise that such explanations are limited where MOD and the individual contractor have not reconciled the extent of, or reasons for, any cost/profit variance revealed by the post-costing exercise.

## SECTION V

### OTHER ASPECTS OF NON-COMPETITIVE PRICING

#### Introduction

501. Annual Reviews are usually restricted to a review of the principal components of the GPF so that the profit rate can be updated. This Annual Review has been required to consider some wider aspects of non-competitive pricing which are included in this section of the report. In addition there has been a proposed change to the IGIU process, which is dealt with in section III of this report.

#### Rationalisation and/or plant closure costs

502. The MOD wished to establish the principle that there should not be an automatic application of a profit allowance on rationalisation costs and it agreed modified wording to the GACs with the JRBAC so such costs can be dealt with on a stand-alone basis. The MOD was also concerned that the existing wording of the GACs is unreasonably restrictive on MOD's rights to participate in a contractor's profit on the sale of assets. MOD agreed with the JRBAC that GAC 5.5.1 should be amended so that account should be taken of any significant investment contributed by the Government.

503. The consequent revisions to section 5 of the GACs, as proposed by MOD and the JRBAC, are included in Appendix D. The Board accepts these revisions and recommends that they are adopted.

#### Justification of labour and overhead costs

504. This topic addresses the process whereby a contractor's claimed capital employed, cost of production and overhead recovery rates are submitted to the Department for investigation with the aim of agreeing rates and ratios for the pricing of non-competitive Government contracts.

505. The MOD expressed concern that contractors needed to do more to justify and support the levels of claimed costs and sought to clarify a contractor's responsibility by inserting an explicit requirement to make information available to justify the reasonableness of rates claimed.

506. The JRBAC accepted the principle proposed by MOD but was concerned that an increased scrutiny of costs appears likely to result in an increase in the number of disputes between MOD and its contractors. The JRBAC sought to introduce a mechanism whereby MOD or the contractor might refer to a third party for the resolution of disputes that could not be resolved in a reasonable manner between them.

507. MOD and the JRBAC have agreed the consequent revisions to sections 1 and 4 of the GACs which are shown in Appendix D.

508. At the time this report was finalised it was agreed that the parties should be able to refer matters to a third party and it was considered that the Review Board might be that third party. However, the process and the terms of reference for a referral have not been finalised



and it is agreed that disputes of this nature should not be accepted by the Review Board, or any other body, until the process and terms of reference are agreed. The Review Board has offered to assist in developing the process and terms of reference.

### **Amendments to GACs as a consequence of International Financial Reporting Standards**

509. As indicated in paragraph 217 of the 2010 General Review, MOD and the JRBAC have continued to review the consequences of the adoption of IFRS by some CP:CE ratio units. The MOD and the JRBAC have issued a statement on the subject which is reproduced at Appendix E to this report and is to be included as Annex E to Section 2 of the GPFAA. The GACs do not need any further amendment as a result of the statement.

### **Topics outside the 2011 Annual Review timetable**

510. At the time of finalisation of this report there are a number of topics relating to the GPF that are being considered by working parties from MOD and the JRBAC. In addition to the issue of risk and reward, which is discussed in paragraphs 323-326 of this report, the following matters are being considered:

- Update of the QMAC: MOD and the JRBAC are working on an updated version of the QMAC. It is expected that the final version will be available by June 2011 and that it will be implemented from January 2012.
- Aligning DEFCONs and the GPFAA: this topic has been raised by the parties but detailed consideration has been deferred until a current contract reference has been completed by the Board.

511. The Board recommends that work on these topics should continue.

## APPENDIX A

### THE RECOMMENDED PROFIT FORMULA – ILLUSTRATIONS

#### Prepared by the Review Board for Government Contracts – January 2010

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

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

1. a CP:CE ratio of 3:1 and a contract attracting the Standard Baseline Profit Allowance
2. a CP:CE ratio of 6:1 and a contract attracting the Standard Baseline Profit Allowance
3. a CP:CE ratio of 1.5:1 and a contract attracting the Standard Baseline Profit Allowance
4. a CP:CE ratio of 3:1 and a contract for a repeat production order attracting the Standard Baseline Profit Allowance less 10 per cent
5. a CP:CE ratio of 3:1 and a contract requiring specialist skills and attracting the Standard Baseline Profit Allowance plus 10 per cent
6. a CP:CE ratio of 3:1 and a non-risk contract attracting the Standard Baseline Profit Allowance less 25 per cent

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

## APPENDIX A: ANNEX I

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

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
<b>CP:CE ratio calculation:</b>						
(A) Fixed capital (80%)	2,400,000	1,200,000	4,800,000	2,400,000	2,400,000	2,400,000
(B) Working capital (20%)	600,000	300,000	1,200,000	600,000	600,000	600,000
(C) Total capital (A + B)	3,000,000	1,500,000	6,000,000	3,000,000	3,000,000	3,000,000
(D) Total cost of production of CP:CE unit	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000
(E) CP:CE ratio is therefore (D/C)	3	6	1.5	3	3	3
<b>CSA calculation:</b>						
(F) FCSA	6.65%	6.65%	6.65%	6.65%	6.65%	6.65%
(G) FC proportion (A)	80.00%	80.00%	80.00%	80.00%	80.00%	80.00%
(H) (F x G)	5.32%	5.32%	5.32%	5.32%	5.32%	5.32%
(I) WCSA	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%
(J) WC proportion (B)	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%
(K) (I x J)	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%
(L) CSA (H + K)	6.17%	6.17%	6.17%	6.17%	6.17%	6.17%
(M) CSA as percentage of CP (L/E)	2.06%	1.03%	4.11%	2.06%	2.06%	2.06%
<b>Individual contract price:</b>						
(N) Contract CP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
(O) Standard Baseline Profit Allowance	9.04%	9.04%	9.04%	9.04%	9.04%	9.04%
(P) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(Q) Contract Baseline Profit Allowance	9.04%	9.04%	9.04%	8.14%	9.94%	6.78%
(R) CSA (M)	2.06%	1.03%	4.11%	2.06%	2.06%	2.06%
(S) Total Contract Profit Allowance (Q + R)	11.10%	10.07%	13.15%	10.20%	12.00%	8.84%
(T) Total formula payments (N x S)	111,000	100,700	131,500	102,000	120,000	88,400
(U) Total contract price (N + T)	1,111,000	1,100,700	1,131,500	1,102,000	1,120,000	1,088,400

**Explanation:** The above illustrations assume contracts with a CP of £1 million in a variety of circumstances. Example 1 assumes that the Standard Baseline Profit Allowance of 9.04% is applicable (i.e. that there is no IGIU trading) and the contractor's CP:CE ratio is 3:1. Examples 2 and 3 illustrate how payments will change for contractors with varying CP:CE ratios. Examples 4, 5 and 6 illustrate how payments change for contracts where the Standard Baseline Profit Allowance requires an adjustment in accordance with the risk/reward matrix.

## APPENDIX A: ANNEX II

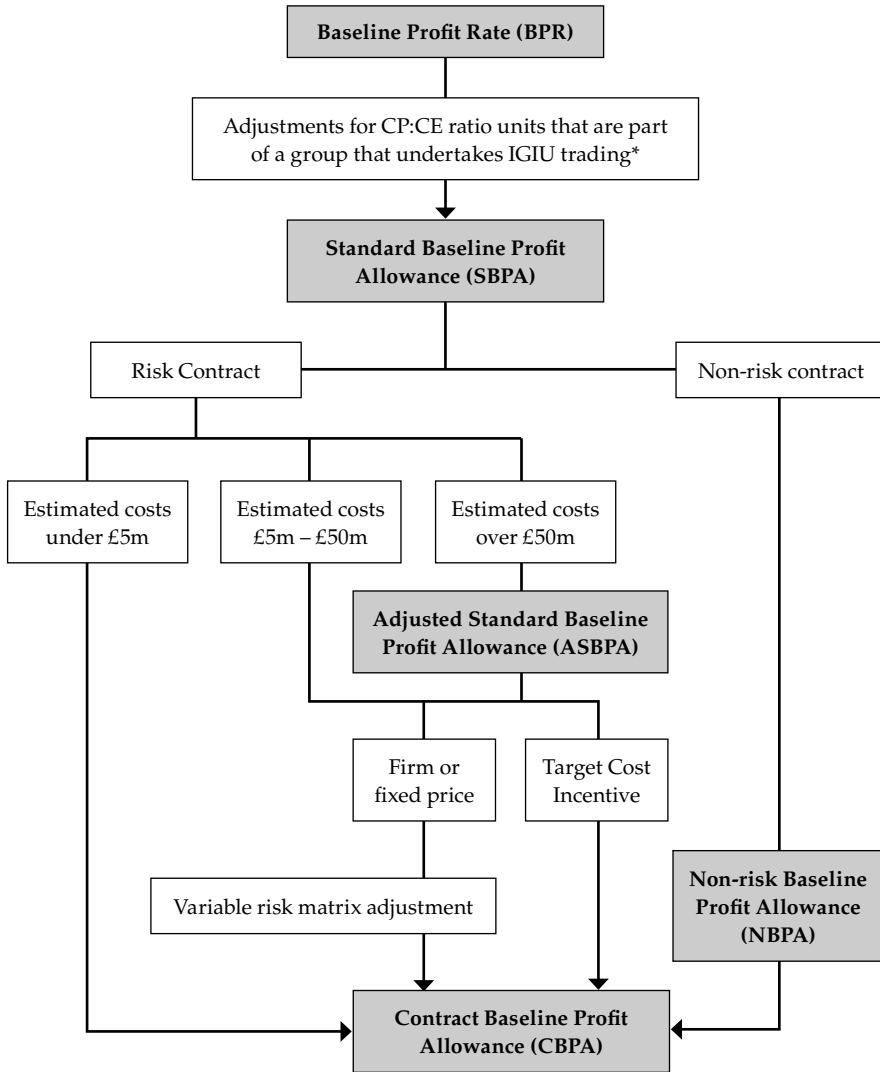
### ILLUSTRATION OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA UNDER THE SPECIAL ARRANGEMENTS FOR CONTRACTS IN EXCESS OF £50 MILLION

	CSAs	Total
<b>Contractor's CP:CE ratio:</b>		
(A) Fixed capital (80%)	24,000,000	
(B) Working capital (20%)	6,000,000	
(C) Total capital (A + B)	30,000,000	
(D) Total cost of production	90,000,000	
(E) CP:CE ratio is therefore (D/C)	3	
CSA calculation:		
(F) FCSA	6.65%	
(G) FC proportion (A)	80.00%	
(H) (F x G)	5.32%	
(I) WCSA	4.25%	
(J) WC proportion (B)	20.00%	
(K) (I x J)	0.85%	
(L) CSA (H + K)	6.17%	
(M) CSA as percentage of CP (L/E)	2.06%	
<b>Individual contract price:</b>		
(N) Contract CP	75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	9.04%	
(P) Reduction for contracts over £50m	0.30%	
(Q) Adjusted Standard Baseline Profit Allowance (O - P)	8.74%	
(R) Adjustment in accordance with the Risk/Reward matrix	nil	
(S) Contract Baseline Profit Allowance	8.74%	
(T) CSA (M)	2.06%	
(U) Total Contract Profit Allowance (S + T)	10.80%	
(V) Total formula payments (N x U)	8,100,000	8,100,000
(W) Total contract price (N + V)		£83,100,000

**Explanation:** The illustration assumes a contract with a CP of £75 million being undertaken by a contractor with a CP:CE ratio of 3:1. It also assumes the SBPA is 9.04% (i.e. that there is no IGIU trading) and that the Adjusted Standard Baseline Profit Allowance does not require any adjustment in accordance with the risk/reward matrix for this contract.

## APPENDIX B

### FLOWCHART SHOWING THE VARIOUS LEVELS OF BASELINE PROFIT AND THE RECOMMENDED TERMINOLOGY AND ABBREVIATIONS TO BE USED



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

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

### THE RISK/REWARD MATRIX

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

## Notes

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

## APPENDIX D

### Existing Government Accounting Conventions marked-up with recommended additions and deletions arising from the 2011 Annual Review

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

- 1.1 The Government Accounting Conventions ('GACs') are those accounting conventions agreed from time to time, between the Ministry of Defence ('MOD') acting on behalf of the Government and the CBI acting on behalf of industry, for pricing non-competitive Government contracts. These Conventions are applicable to both direct contract costs and indirect costs. These Government Accounting Conventions are available for use by all other Government departments.
- 1.2 The aim of the GACs is to set out the basis upon which a Contractor includes direct costs in a contract price proposal and computes its capital employed, cost of production and overheads for a rate claim submission to the Government department concerned, for the purpose of pricing non-competitive Government contracts. Wherever possible a contractor's normal accounting systems will be used. The Contractor is to disclose his cost accounting practices and apply them consistently.
- 1.3 At the request of the Government department considering the direct labour and overhead costs submitted in accordance with 1.2 above the contractor will give access to the department to information that it holds adequate to justify the direct labour rates and specific elements of the burden rates claimed.
- 1.4 The Government department concerned will examine the information described in paragraphs 1.2 to 1.3 above, with the aim of reaching agreement with the Contractor concerning those rates. Where costs are disallowed a written explanation will be provided to the Contractor by the Government department. In cases where the Government department concerned is not persuaded by the justification of costs provided and consequent disallowances mean that an agreement cannot be reached, then the dispute over claimed costs may be referred to a third party<sup>1</sup> for an expert opinion.
- 1.5 Costs and capital employed shall be computed in accordance with the GACs for determining the level of fixed capital employed, working capital employed, overhead costs and the cost of production applicable at the time of pricing.
- 1.6 Where costs arise which are exceptional or abnormal in size or incidence then the parties will negotiate on a case-by-case basis the extent to which such costs may be allowable, and the method of recovery (see 4.4.1 below)(wholly or in part) can be agreed to be settled outside of the overheads. In all cases where costs arise or are expected to arise which are exceptional or abnormal in size or incidence, then the parties should inform each other and commence confidential discussions at the earliest opportunity.

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1 Which may be the Review Board for Government Contracts.



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

## 2. Disclosure of Cost Accounting Practices

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

## 3. Computation of Capital Servicing Allowances

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

- 3.2 Capital Employed. In order to determine the contractor's capital employed it is necessary to allocate employment of capital shown in the balance sheet ('net assets') between those items which qualify for capital servicing allowances and those which do not, thereby enabling the apportionment of qualifying net assets between individual contracts pro-rata to cost of production. Provided no further adjustment has taken place in Group Accounts, a contractor's total capital employed is taken as the average of his total net assets as shown in the relevant balance sheets for the entity as described in 3.1 above for the period under review (based on the company's accounts subject to any adjustment required in order to comply with International Accounting Standards<sup>2</sup>), adjusted for the following where relevant:

- 3.2.1 Exclude from assets
- 3.2.1.1 Goodwill.
  - 3.2.1.2 Adverse (debit) balance in retained earnings.
  - 3.2.1.3 Investments in shares and securities.
  - 3.2.1.4 Shares held in and permanent loans to subsidiary companies being capital not employed in the business of the parent Company.
  - 3.2.1.5 Cash demonstrably surplus to requirements (i.e. short term investments; deposits; and cash demonstrably in excess of the amount required for working cash resources for day to day operations).

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2 However UK GAAP may be appropriate in circumstances where the parties agree.

- 3.2.1.6 Capital not employed efficiently such as capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use<sup>3</sup> where held for speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposal of surplus assets.
- 3.2.1.7 Certificates of tax deposit.
- 3.2.2 Include within assets
  - 3.2.2.1 Trading balances with subsidiary, affiliate and other group companies.
- 3.2.3 Other adjustments (these may result in either an addition to or a deduction from balance sheet figures, according to the circumstances):
  - 3.2.3.1 The balance sheet figure for inventories is included in capital employed based on costs derived from values recorded in the statutory accounts subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by auditor attestation. If a company has not already done so in its balance sheet, interim payments on account of work in progress are deducted therefrom in accordance with 3.2.3.4. through 3.2.3.6.
  - 3.2.3.2 Patents and trade marks may be included in capital employed on a consistent and reasonable basis to the extent that a company can demonstrate that they are 'live' and contribute to its earnings, although not shown in the company's balance sheet.
  - 3.2.3.3 Development expenditure may be included in capital employed up to the value shown in the balance sheet 'net' of provisions provided orders have been received, or are likely to be received, for the product under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.
  - 3.2.3.4 Advance payments received from customers prior to the company's performance of the sales contract are treated as capital employed, i.e. not deducted from assets, subject to an appropriate transfer being made from advance payments to progress payments, in accordance with the billing arrangements of the contract wherever possible, or failing that, pro-rata to the value of work-in-progress in the same proportion as the total advance payments bear to the contract price.
  - 3.2.3.5 Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed.
  - 3.2.3.6 Prepayments by the Government on non-competitive contracts, calculated after adjusting the contractor's work in progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted except where otherwise agreed.

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3 Assets in course of construction are admissible as capital employed

- 3.2.3.7 Where costs are spread over several years under 4.4.1, any amount not written off at a balance sheet date will be included as an asset in capital employed.
- 3.2.3.8 The net balance sheet figure for debtors is included in capital employed, although balance sheet figures of debtors will be adjusted for increases or decreases becoming known after the balance sheet date, due to any revision of prices. Such adjustments may relate to non-Government contracts as well as to Government contracts of all kinds.
- 3.2.4 Creditors and other general adjustments:
  - 3.2.4.1 Where non current assets have been acquired under finance leases, the amount included in the balance sheet as a creditor will be treated as a source of capital i.e. not deducted.
  - 3.2.4.2 All loans (including bank overdrafts) are treated as a source of capital – i.e. not deducted.
  - 3.2.4.3 Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed moneys such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.
  - 3.2.4.4 Mainstream corporation tax and deferred taxation are treated as a source of capital – i.e. not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.
  - 3.2.4.5 Launch aid is usually treated as a creditor in computing capital employed, and as such is deducted from launching costs as the equivalent of cash on account of work done.
  - 3.2.4.6 Declared and proposed dividends are treated as a source of capital – i.e. not deducted.
  - 3.2.4.7 Provisions for future cost liabilities where excluded from allowable costs should be treated as a source of capital – i.e. not deducted.
- 3.3 Cost of production, annualised where appropriate, should be computed for the same operating unit for which capital employed is computed. Inter alia, it should:
  - 3.3.1 Include:
    - 3.3.1.1 Direct costs – direct wages, materials, bought out equipment, subcontractors’ and other direct charges.
    - 3.3.1.2 Indirect costs –with the exceptions set out in 3.3.2 below.
  - 3.3.2 Exclude:
    - 3.3.2.1 Capital expenditure.
    - 3.3.2.2 The cost of raising and servicing loan capital.

- 3.3.2.3 Appropriation of profits, e.g. dividends, corporation tax.
- 3.3.2.4 Notional transactions.
- 3.3.2.5 Costs related to assets excluded from capital employed in accordance with 3.2.1 above.
- 3.3.2.6 Discounts allowed on sales, which are treated as abatements of selling prices.
- 3.3.2.7 Unnecessary, extravagant or wasteful outlays excluded from overheads under 4.2.8 below.
- 3.3.2.8 Loss of profit insurance premiums (profit element only).
- 3.3.2.9 Compensation payments of an abnormal nature to the extent that they are excluded under 4.4.1.1. below.
- 3.3.2.10 Lump sum additions to pension schemes to the extent that they are excluded from overheads under 4.4.1.2. below.
- 3.3.2.11 Subscriptions and donations of a political nature.
- 3.3.2.12 Credits, grants or refunds dealt with under 4.5.1 below should be deducted from cost of production.

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

4.1 It is not possible to produce an exhaustive list covering all the adjustments which may from time to time be required in computing overheads on non-competitive Government contracts. Nor is it possible to lay down absolutely fixed rules, given the varying circumstances prevailing within the different organisations. Whenever partial disallowance of any specific items of expense is proposed the contractor is entitled to ask for and receive a ~~full~~-written ~~explanation-justification~~ of the reason for the proposed disallowance. In assessing contractors' claims for overhead costs on non-competitive Government work current practice is to adopt the costs charged in the contractors' accounts subject to any adjustment required in order to comply with International Accounting Standards<sup>4</sup> and subject to the following adjustments:

4.2 Items which are normally totally excluded:

- 4.2.1 Any expenditure of a capital nature (depreciation is allowable).
- 4.2.2 Any distributions of profit.
- 4.2.3 The cost of raising and servicing capital, including short-term financing and finance leases.
- 4.2.4 Bad debts and any provision therefore, unless they arise on Government sub-contracts.
- 4.2.5 Discounts allowed on sales.
- 4.2.6 Insurance of goods in transit and any other related to civil work risks unless required for Government work.
- 4.2.7 Notional transactions.

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4 However UK GAAP may be appropriate in circumstances where the parties agree.

- 4.2.8 Unnecessary, extravagant or wasteful outlays. The contractor is entitled to a ~~full~~-written ~~explanation-justification~~ on the exclusion of this type of expenditure<sup>5</sup>.
  - 4.2.9 Loss of profits insurance (profit element only).
  - 4.2.10 Costs and income related to assets excluded from capital employed in accordance with 3.2.1 above.
  - 4.2.11 Subscriptions and donations of a political nature.
- 4.3 Items which are normally treated as direct:
- 4.3.1 Agents' commissions.
  - 4.3.2 Outward carriage of finished products.
  - 4.3.3 Insurance of credit risk, royalties and licence fees where these can be identified as direct costs.
- 4.4 Items which may be partially excluded or deferred:
- 4.4.1 Where the allowable portion of some costs (as negotiated on a case by case basis) is exceptional or abnormal in size and incidence, it may be spread over a number of years. Costs spread forward in this way will be eligible for inclusion in capital employed under 3.2.3.7. Examples of these costs are:
    - 4.4.1.1 Compensation payments of an abnormal nature.
    - 4.4.1.2 Lump sum additions to pension schemes.
    - 4.4.1.3 Bid and Proposal costs.
  - 4.4.2 Research and Development (see 6 below).
  - 4.4.3 Marketing & Selling expenses (including salaried salesmen's commissions). Marketing & Selling is a broad heading which refers to a range of costs and overheads that relate to the function. Expenses should be analysed by type of cost and by product group so as to ensure that the share of the total expenses borne by each product group fairly reflects the correct incidence of costs falling on the product groups which the expenditure was designed to benefit.
- 4.5 Items treated as reducing overhead costs:
- 4.5.1 Credits, grants or refunds generally, in relation both to overhead items and also to direct cost items where the credit cannot be identified to a particular contract.
- 4.6 Other items:
- 4.6.1 Depreciation/amortisation. The amount to be included for depreciation/amortisation should be calculated at the contractor's own rates, provided they are consistent, reasonable, and relate to the fixed asset values, subject to exclusions in 3.2. Amortisation of development expenditure carried forward should be treated as costs to be recovered under 6.2.1. below.

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<sup>5</sup> ~~In cases where only a small proportion of a contractor's turnover is made up of non-competitive Government contracts, there is a presumption that all expenses are reasonably incurred.~~

- 4.6.2 General stock losses and obsolescence, including provisions which cannot be charged directly either to Government or civil work, should be included in attributable overhead costs. This convention requires that the contractor's costing system must provide for the isolation of those stock losses which are directly attributable to civil contracts as well as those that are attributable to Government contracts.
- 4.6.3 Redundancy payments in accordance with the rates laid down by statute will be included in attributable costs; reasonable redundancy payments in excess of such rates should also be included, provided they are made under the terms of a bona fide scheme.
- 4.6.4 Bonuses paid in cash or in kind. Where payments under employees' profit sharing schemes are simply an element of employees' normal remuneration the payments should be included in attributable costs. The cost of providing benefits such as shares or benefits in kind should be treated in the same way as "payments under employees' profit sharing schemes". The cost of shares issued to employees at favourable prices should be arrived at in the manner prescribed by IFRS.

## 5. Rationalisation and/or plant closures

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

- *Site closures;*
- *Substantial redundancy programmes;*
- *Substantial site reorganisation and remodelling;*
- *Where there is no future business at a site.*

*5.2 In such cases where it is agreed that negotiations are to be on a stand-alone basis, any negotiation should consider as its starting point the GACs. Whilst the negotiation of any sum to be paid by the Government department concerned may initially have to be made on the basis of projected estimated costs, the Government department will look to negotiate final settlement on the basis of the actual costs incurred.*

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

- Redundancy payments;
- Employee relocation expenses;
- Job creation scheme costs;
- Transfer costs for equipment;
- Education/learner costs on transferred work;
- Disruption costs – waiting and idle time;
- In the case of total or near total closure of a unit, excess or unabsorbed overheads.

- 5.4 Where a site is closed, the attributable net rationalisation and/or plant closure costs should be recovered in the overheads of the other sites in the same group gaining work as a result of the site closure. For this purpose “site” and “group” should be taken to include Joint Venture arrangements. The amount of the costs would be subject to agreement on a case by case basis between the Government department and the contractor.
- 5.5 Rationalisation and/or plant closure costs should be offset/supplemented by profits/losses from the disposal or alternative use of related assets, calculated on the following basis:
- 5.5.1 Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits exceed such costs the Government department should not be entitled to share in the excess *unless the profits arise on disposal of assets to which the department has contributed significant investment.*
- 5.5.2 The net profit from asset disposals set against rationalisation and/or closure costs should be calculated by reference to the gains realised by the company on disposal of that asset. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed. The amount of any loss realised on asset disposal is to be added to the rationalisation or closure costs.
- 5.5.3 Estimated profits/losses should be calculated at the time that rationalisation or plant closure takes place. Either party should be permitted to re-open this calculation within a limited period, if the assumptions upon which the original calculation was based prove to be materially inaccurate; such period should not, except in the exceptional case, extend more than five years after the date from which the asset concerned is excluded from capital employed for CP:CE ratio purposes.

## 6. Private venture research and development expenditure

### 6.1 Recording, classification and attribution of expenditure

- 6.1.1 Contractors will classify in their accounting records all expenditure on private venture research and development (R&D) in accordance with the definitions in UK SSAP 13.
- 6.1.2 Private venture research and development expenditure will be attributed as closely as possible to the product groups or, where this is realistic and appropriate, to the specific products which the expenditure is designed to benefit. Product groupings already established for his own purposes by a contractor will normally be adopted and will be disturbed only when this is clearly necessary to achieve a fair attribution of the expenditure.
- 6.1.3 The principles described in paragraphs 6.1.1 and 6.1.2 above will also apply to expenditure incurred by a contracting group at a research and development establishment including those cases where this is operated by a separate company.

### 6.2 Recovery of expenditure

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

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

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

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

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

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

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

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

### 6.3 Abortive expenditure

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

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

### 6.4 Timing of recovery

6.4.1 As a result of the long time span or fluctuating level of some research and development programmes, it may be impossible to reach final decisions on the treatment for pricing purposes of certain expenditure at a time when,



for example, it is necessary to settle an annual overhead rate negotiation or to fix production prices which will be subject to post-costing. In these circumstances it should be possible for an agreed amount of such 'undecided' expenditure to be carried forward for decision as to recovery to be made in a future period.

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

## 7. Pensions<sup>6</sup>

- 7.1 The guidance issued by the Board in its 1990GR which was based on SSAP24, the prevailing accounting practice at that time in terms of pensions, is no longer appropriate now that SSAP24 has, for UK listed companies, been superseded by the introduction of IAS 19, and FRS 17 for other UK companies that have not elected to adopt IAS 19;
- 7.2 Defined contribution plan costs should continue to be allowed in full for pricing purposes;

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### 6 FOOTNOTE

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

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

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


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

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

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

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

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

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- 7.3 The normal annual cost for defined benefit pension plans charged to the Income Statement (including the net financing charge relating to pensions) should be allowed in pricing contracts under the Government Profit Formula arrangements; and
  - 7.4 Actuarial gains and losses arising on defined benefit pension plans should not be allowed as a cost of production in pricing contracts under the Government Profit Formula arrangements.

## APPENDIX E

### The Impact of International Financial Reporting Standards on the GPF

#### Agreed statement between Government and industry to be inserted as Annex E to Section 2 of the GPFAA

As indicated in paragraph 217 of the 2010 General Review MoD and JRBAC continued to review the consequences of the adoption of IFRS by some CP:CE ratio units. The MoD and JRBAC have agreed that:-

##### Financial Instruments; Recognition and Measurement. IAS39.

IAS 39 hedge accounting fair value (mark to market) adjustments represent timing adjustments and should be excluded from contractor returns and submissions for both Cost of Production and Capital Employed.

##### Borrowing costs. IAS 23

Where a contractor capitalises borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, such costs should be included within Cost of Production, Capital Employed and depreciation in the same way as the qualifying asset to which it forms an integral element of cost.

##### The Effects of Changes in Foreign Exchange Rates. IAS21 and IAS39

As required by IAS 21 (except where exchange differences occur on monetary items that qualify as hedging instruments in a cash flow hedge) differences arising on the settlement of monetary items at rates changed from those at which they were translated on initial recognition should be recognised in profit or loss in the period in which they arise.

As required by IAS 39 exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge should be recognised initially in other comprehensive income to the extent that the hedge is effective. IAS 39 sets out the test to determine if a hedging instrument is to be classified as a cash flow hedge or a fair value hedge. Hedging instruments that are not 'highly effective' should be classified as fair value and the hedging instrument should not be linked to related contracts of purchase or sale.

Profits or losses on exchange arising from transactions and balances in foreign currencies that, in the contractor's normal accounting system, are not matched to the contracts of purchase or sale should be treated as financing costs and excluded from cost of production.

##### IFRS for SMEs

Additionally MoD and JRBAC considered the exposure draft of IFRS for SMEs (issued by the IASB on 9 July 2009). MoD and JRBAC noted that the European Union is still considering adoption within the member states. The topics within IFRS for SMEs are very similar to that of IFRS but some of the detailed proposals within the exposure draft are different in key areas. MoD and JRBAC will give further and fuller consideration to the impact of IFRS for SMEs on government accounting when the implementation date and standards to be applied are more certain.

## ADDENDUM

### AGREED STATEMENT BY THE MOD AND THE JRBAC

#### 2011 Annual Review

1. We accept the Review Board's recommendations to revise the profit formula allowances for Government non-competitive contracts, as set out in paragraph 201 of its report on the 2011 Annual Review. The revised rates should be implemented with effect from 1 April 2011, for contracts where pricing arrangements have not already been agreed.
2. We accept the changes to Government Accounting Conventions set out at Appendix D to the report. We accept the refinement of the GPF methodology to deal with intra-group, inter-unit (IGIU) trading, as set out at paras 319-322 of the report. Accordingly, the adjustment to take account of IGIU trading will from 1 April 2011 take place at company group level rather than being a general adjustment within the GPF rate calculation, as previously.
3. Upon implementation of the 2011 Annual Review the 'Government Profit Formula and Associated Arrangements' document will be updated and placed on the main MOD website.

W R J Hockin OBE  
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JRBAC

S Mason  
Director Corporate Commercial  
Ministry Of Defence