Annex 10.1.0: Reasons for the non-applicability of certain costs when utilizing Contract Cost Principles 1031-2

(**2004-05-14**)

The following costs are considered non-applicable to government contracts when utilizing contract cost principles 1031-2 for the reasons given.

(a) Allowances for interest on invested capital, bonds, debentures, bank or other loans together with related bond discounts and finance charges.

Interest on borrowing, however represented, is not an acceptable cost. There are several reasons for this. In the first place, it is impossible to know how much of a contractor's capital should be properly provided by equity capital and how much by borrowed capital. If it were fair to allow interest on the borrowed capital (the financial reward to the lender), it would also seem fair to allow dividends (the financial reward to the investor). As dividends are recognized as a distribution of profits and therefore not an item of cost, so too with interest. Another consideration is the determination of what a contractor's capital properly should be, regardless of what it may actually happen to be. If interest were to be an acceptable cost, then a contractor financed by bonds, debentures or long term loans would be in an advantageous position compared to a contractor financed by the sale of equity. The government recognizes the cost-of-money (interest) associated with capital employed, however financed, as a factor in the calculation of profit.

(b) Legal, accounting and consulting fees in connection with financial re-organization, security issues, capital stock issues, obtaining of patents and licences and prosecution of claims against the Crown.

A distinction should be drawn between the occasional expenses in relation to the raising of capital referred to here, which are not an acceptable cost, and the normal recurring expenses associated with the day-to-day management and recording of capital transactions, which are an acceptable cost. The latter expenses include those arising from the registry and transfer of share capital when they form part of the activity of the company secretary, costs of share holders' meetings, normal proxy solicitations, reports to shareholders, submission of required reports to government agencies, reasonable directors' fees and incidental expenses of directors and for committee meetings.

(c) Losses on investments, bad debts and expenses for the collection thereof

Since interest on capital invested in a contractor's business is not considered a business operating cost, neither is interest received by a contractor from funds invested outside the business considered a necessary credit against business operating costs. However, it also follows that any losses sustained by a contractor from these outside investments are not considered to be a business operating cost and thus are not acceptable on government contracts.

Since the government as a debtor always pays its just debts, while it is only the commercial customers who have bad debts on a contractor's books, the losses due to bad debts and the expenses of collection thereof are not an acceptable cost to government contracts.

(d) Losses on other contracts

An excess of costs over income on a contract is not acceptable as a cost to any other contract. This principle also applies to application by a contractor of preferred overhead rates to certain contracts. Where this occurs, the excess of actual overhead over the preferred overhead amount will not be absorbed by government contracts.

(e) Federal and provincial income taxes, excess profit taxes or surtaxes and/or special expenses in connection therewith

In general, taxes which a contractor is required to pay and which are computed in accordance with sound accounting principles are acceptable costs, except for those included under this heading and/or other taxes in connection with financing, refinancing or re-organizing.

On the other hand, all tax refunds, federal or provincial, are not required to be applied to reduce any related expenses.

(f) Provisions for contingencies

A contingency liability is a liability which could arise on the happening of some event which may or may not occur. The initial provision or increase of funding for a contingent liability is considered to be a setting aside of earned profits to meet possible liabilities against future profits and not a business operating cost and therefore not an acceptable cost to government contracts.

There is one exception to the above and that is in respect of the acceptability of costs for the provision of warranties. In any firm price contract, a contractor may include as a cost a reasonable amount to be set aside as a provision for the absorption of expenses associated with warranties given under the terms of the contract. In determining a reasonable amount, the following factors should be taken into account:

(1) the amounts provided for warranty expenses should be separate for each distinctive product or family of products;

(2) the amounts provided should reflect, where available, the previous performance of the product(s) in regard to warranty, using an average of three to five years;

(3) the cost of any provision for warranty charged to a specific contract should reflect any difference in the warranty period from that normally granted by a contractor on the product(s); and

(4) the costs should be net of any warranty contract sales to other customers.

(g) Premiums for life insurance on the lives of officers and/or directors where proceeds accrue to the contractor.

Similarly, proceeds from such life insurance need not be applied to reduce any cost to the contractor.

Premiums on this type of insurance are not acceptable in government contracts since the Crown does not derive any benefit therefrom.

(h) Amortization of unrealized appreciation of assets.

See annex 10.1.2 "Depreciation".

(i) Depreciation of assets paid for by the Crown.

See annex 10.1.2 "Depreciation".

(j) Fines and penalties.

The amounts of fines and penalties imposed by federal, provincial or local authorities are not an acceptable cost to government contracts, for to accept such amounts would be tantamount to the government's supporting financially the offense which gives rise to the imposition of a fine or penalty.

(k) Expenses and depreciation of excess/idle facilities.

For this purpose, excess/idle facilities means the sum of all fixed assets appearing in a contractor's books of account which are not in use or for which no use is anticipated within a reasonable period. The expenses associated with the maintenance and/or the amounts of depreciation attributable to such fixed assets are not acceptable costs to government contracts.

The expenses and/or depreciation of excess/idle facilities, as defined above, which the government has ordered retained for defence purpose, should be charged to a separate contract set up for that purpose.

(l) Unreasonable compensation for officers and employees.

The extra costs associated with the above are not an acceptable charge to government contracts.

(m) Product development or improvement expenses not associated with the product being acquired under the contract.

See annex 10.1.7 "Research and Development Expenses".

(n) Advertising, except reasonable advertising of an industrial or institutional character placed in trade, technical or professional journals for the dissemination of information for the industry or institution.

(1) Assuming that a contractor's employees enhance their knowledge by reading trade, technical or professional journals, and, in turn, government contracts benefit from this increased knowledge by way of increased efficiency and productivity, and that the advertising supports these publications, the expenses of advertising in this manner are an acceptable cost to government contracts, provided:

- it is in the nature of institutional or support advertising only, and not in the form of display advertising;
- it does not advertise a particular product or service of a contractor;
- it is placed in trade, technical or institutional journals (financial publications are primarily for investors, not for an industry or trade; and so do not qualify); and
- the cost is reasonable.

(2) Expenses associated with the help wanted advertisements are an acceptable cost, provided they are reasonable and only for the purpose of recruiting personnel.

(3) The expenses associated with advertising through any media for other than (1) and (2) above, are not an acceptable cost to government contracts. For this purpose, advertising media are: magazines, newspapers, television and radio programs or "commercials", brochures, direct mail, outdoor advertising, conventions, exhibits, free goods and samples.

(o) Entertainment expenses.

Although expenses for amusement, diversion, social activities and incidentals relating thereto are not acceptable, the expenses associated with meetings and conferences, when called for the dissemination of technical information or discussion of production problems and the like, are acceptable. These latter expenses may include those for meals, transportation, rental of meeting places and other incidentals provided they are reasonable.

(p) Donations, except those to charities registered under the *Income Tax Act*.

Donations, except those to political parties, are an acceptable cost provided they comply with the Income Tax regulations and are taken into overhead in the period they are paid rather than pledged.

(q) Dues and other memberships other than regular trade and professional associations.

The expenses associated with membership, either of the company as a whole or individual officers or employees in associations whose prime purpose is to provide entertainment or recreation, are not an acceptable cost to government contracts.

(r) Fees, extraordinary or abnormal, for professional advice in regard to technical, administrative or accounting matters, unless approval from the Contracting Authority is obtained.

The fees associated with obtaining this assistance are not an acceptable cost, unless a contractor demonstrates, to the satisfaction of the contracting officer, the circumstances giving rise to the need for this assistance.

Annex 10.1.1: Cost Interpretation Bulletin - Number 01
(2004-05-14)

Excess Facilities

Section 07 (k) of Contract Cost Principles 1031-2 provides that the expenses and depreciation of excess facilities shall be considered non-applicable costs to the contract.

This Bulletin explains the costs that should be considered for the purpose of the application of the above section.

Definition

For the purpose of this Bulletin:

"Facilities" in this context means plant or any portion thereof (including land integral to the operation), equipment individually or collectively, or any other tangible capital asset, wherever located, and whether owned or leased by the contractor.

Interpretation

The costs that are associated with facilities that are excess to the contractor's current needs should be examined to determine if these costs are non-applicable.

In examining these costs, the following factors should also be considered:

(a) Vacant, or largely vacant space;

(b) Inactive or unused equipment;

(c) Idle capacity required for stand-by purposes;

(d) Indirect supporting staff no longer required either in full or part;

(e) Other costs such as maintenance, repair, rent, property taxes, insurance, depreciation, etc.;

(f) Management costs that should be reduced because of the reduction in active facilities.

Annex 10.1.2: Cost Interpretation Bulletin - Number 02
(2004-05-14)

Depreciation

Section 04 (2) (e) of Contract Cost Principles 1031-2 provides that Indirect Costs (Overhead) may include a reasonable provision for depreciation.

This Bulletin explains what is meant by a reasonable provision for depreciation for the purpose of the application of the above section.

Definitions

For the purpose of this Bulletin:

"Depreciation" is the gradual exhaustion of the service capacity of fixed assets which is not restored by maintenance practices. It is the consequence of such factors as use, obsolescence, inadequacy, and decay.

"Depreciation Base" is the asset laid down cost less estimated residual value, if any, plus applicable costs of installation and preparation for use.

"Depreciation Accounting" is an accounting procedure in which the cost of a fixed asset less the estimated residual value, if any, is distributed over its estimated useful life in a systematic and rational manner.

"Renewal (Replacement) Accounting" is the accounting procedure in which no charge for expense is made for a fixed asset until replacement occurs; the cost of the replacement rather than the cost of the original asset is then charged to expense.

"Retirement Accounting" is an accounting procedure in which no charge to expense is made for a fixed asset until it is removed from service; the original cost is charged to overhead in the year the asset is retired.

"Capital Cost Allowance" is a deduction, akin to depreciation, allowed in computing income for tax purposes.

"Straight Line Depreciation" is the depreciation amount computed by dividing the depreciation base by the estimated number of periods of service life.

"Diminishing, Declining or Reducing Balance Depreciation" is the depreciation amount computed by a constant fraction of the depreciated cost so that the depreciation base is written off by the estimated date of retirement.

"Production Depreciation" is the depreciation amount computed by that portion of the depreciation base that the production, or use during the period, bears to the total estimated production or use to be obtained from the asset.

"Sum-of-the years'-digits Depreciation" is the depreciation amount whereby the depreciation base is allocated to the individual years on a reducing basis, by multiplying it by a fraction in which the numerator is the number of years + 1 of estimated life remaining, and the denominator is the sum of the series of numbers representing the years in the total estimated life.

"Asset Laid Down Cost" is the cost incurred by a contractor to acquire an asset. This includes the supplier's invoice price (less trade discount) plus any applicable charges for transportation, exchange, customs duties, brokerage duties and applicable taxes.

Interpretation

To be considered reasonable any provision for depreciation should be determined in accordance with the following.

1. The amount should be calculated using one of the following methods on a consistent basis:

   (a) Capital Cost Allowance;

   (b) Straight Line;

   (c) Diminishing, Declining or Reducing Balance;

   (d) Production;

   (e) Sum-of-the-years' digits.

   but for this purpose the following two methods are not acceptable:

   (f) Renewal (Replacement) Accounting; and

   (g) Retirement Accounting.

2. The amount calculated using Capital Cost Allowance (CCA) rates should be no higher than the basic CCA rates published by Canada Revenue Agency (CRA) for income tax purposes. From time to time, CRA permits the use of accelerated CCA rates for income tax purposes, but they are not permitted for 1031-2 purposes.

3. The total amount of depreciation for any one asset should not exceed 100% of that asset's original cost.

4. In general, depreciation should be calculated and included in the cost of production only for accounting periods subsequent to the asset being put into use. During the first year of use, the depreciation amount may be based on the exact fraction of the fiscal year, or by using the half-year convention, if that is the contractors practice. This latter method assumes that all capital acquisitions take place at mid-year.

5. Assets purchased specifically for use on Crown contracts should be capitalized and depreciated using the contractor's normal method, unless title is taken by the Crown, or the Crown pays for the asset under an Assistance Program.

6. Crown funding in any form, including direct or indirect benefits such as the investment tax credits and contribution for capital assistance, should be accounted for using the cost reduction approach. The amount of all such funds received by, or credited to the contractor's account should be deducted from the related purchase price of the assets, with any depreciation or amortization calculated on the net amount.

7. Leasehold improvement costs are similar to capital additions and for depreciation purposes should be amortized over the lesser of the expected useful life of the leasehold improvement or the non-renewable term of the lease.

Annex 10.1.3: Cost Interpretation Bulletin - Number 03 (2004-05-14)

Lease Costs

Under the terms of Contract Cost Principles 1031-2 lease costs are applicable costs for inclusion in a contractor's overhead or as direct charge to the contract, if they are reasonable.

This Bulletin explains what is meant by reasonable lease costs.

Definitions

For the purpose of this Bulletin:

"Lease" is the conveyance by a lessor to a lessee of the right to use a tangible asset usually for a specific period of time in return for rent.

"Operating Lease" is a lease in which the lessor does not transfer substantially all the benefits and risks incident to the ownership of the property.

"Capital Lease" is a lease that transfers substantially all the benefits and risks incident to ownership from the lessor to the lessee.

"Executory Costs" are costs related to the operation of the leased property (e.g. insurance premiums, maintenance costs, and property taxes).

"Interest Rate Implicit in the Lease" is the discount rate that, at the inception of the lease, causes the aggregate present value of:

- the minimum lease payments excluding that portion of the payments representing executory costs to be paid by the lessor and any profit on such costs; and
- the unguaranteed residual value accruing to the benefit of the lessor, to be equal to the fair value of the leased property to the lessor at the inception of the lease.

"Rate for incremental borrowing" is the interest rate that, at the inception of the lease, the lessee would have incurred to borrow, over a similar term and with similar security for the borrowing, the funds necessary to purchase the leased asset.

"Unguaranteed Residual Value" is that portion of the residual value of leased property which is not guaranteed or is solely guaranteed by a related party to the lessor.

Interpretation

To be considered reasonable any lease cost should be determined in accordance with the following.

1. The type of lease must be correctly identified as either an operating lease or a capital lease. In the case of an operating lease, the actual rental cost paid is considered to be a reasonable cost. In the case of a capital lease, the depreciation amount calculated on the capitalized value of the asset in the lease over the lease term or economic life of the asset, is considered to be a reasonable cost.

2. A lease should be classified as a capital lease if one of the following criteria are met:

    (a) the lease specifies the transfer of the property to the lessee by the end of the lease term; or

(b) the lease contains a bargain purchase option; or

(c) the lease term is such that the lessee will receive substantially all of the economic benefits from the use of the leased property over its life span, which will normally occur if the lease term covers 75% or more of the economic life of the leased property; or

(d) the present value of the minimum lease payments, excluding any executory costs, is equal to substantially all (usually 90% or more) of the fair value of the leased property at the inception of the lease; the discount rate to be used in determining the present value of the minimum lease payments for this purpose should be the lower of the lessee's rate for incremental borrowing and the interest rate used in the lease, if known.

3. For a capital lease, the value at which it will be capitalized should be the lower of the present value of the minimum lease payments as described in 2 d) or the fair value of the asset (usually this is the purchase value of the asset).

Annex 10.1.4: Cost Interpretation Bulletin - Number 04
(**2004-05-14**)

Travel Costs

Under the terms of Contract Cost Principles 1031-2 reasonable travel costs are applicable costs for inclusion in a contractor's overhead or as a direct charge to contract.

This Bulletin explains the conditions to be met before any specific travel costs are charged directly to the contract.

DEFINITION

For the purpose of this Bulletin:

"Travel Costs" are the costs for transportation, lodging, meals and incidental expenses incurred by a contractor's personnel on official company business. Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof, provided the method used results in a reasonable charge. Costs for lodging, meals and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge.

INTERPRETATION

1. In order for travel costs to be acceptable as direct costs to a contract, the following conditions must be met:

    (a) such costs are directly attributable to the performance of the work under the contract;

    (b) the practice of charging travel costs to a contract is consistently followed in the costing of both government and non-government work; and

    (c) all directly charged travel costs are eliminated from indirect costs allocated to government contracts.

2. A reasonable amount/percentage may be added to travel costs allocated directly to a contract to cover applicable G&A costs, provided it is the contractor's usual and consistent practice to do so.

Annex 10.1.5: Cost Interpretation Bulletin - Number 05 (2004-05-14)

Head Office Expense

Under the terms of Contract Cost Principles 1031-2 expenses allocated to a contractor which is a segment of an organization by the Head Office of that organization are applicable costs for inclusion in the contractor's overhead provided that the amount allocated is reasonable.

This Bulletin explains the method to be used in the allocation of Head Office expenses in order for the amount allocated to be considered reasonable.

Definitions

For the purpose of this Bulletin:

"Head Office" is an office responsible for the policy direction and management of two or more, but not necessary all, segments of an organization.

"Segment" is one of two or more branches, divisions, product departments, plants, or other subdivisions of an organization reporting directly to a parent/head office, usually identified with responsibility for profit and/or producing a product or service.

INTERPRETATION

1. For the allocation of any expenses to be acceptable, a Head Office/Segment relationship must exist, generally with company policies describing the basis of allocation for these expenses.

2. For the allocation of the expenses to be considered reasonable all, or any combination of the following three methods should be used.

   (a) **Directly Chargeable** - Those expenses included within the Head Office expense pool to be allocated which can be identified as having been incurred specifically and totally for one particular segment. Such expenses should be allocated directly to the particular segment, to the extent practicable.

   (b) **Separately Allocated** - Those individual, or groups of expenses which are allocated only to a limited group of corporate segments. Such expenses are not usually incurred for specific segments but possess objective, measurable relationships to the segments and should be grouped in homogeneous pools for subsequent allocation on a basis which represents these objective, measurable relationships.

   (c) **Residual** - These represent the remaining expenses which are allocated to all, or most corporate segments on an overall basis. These expenses should be allocated to segments using a base or bases which represent the total activity of the segments (see 3. below).

   A three part exercise for allocation, as described above, would only be necessary where the dollars concerned were material. In less significant situations, a combination of the Directly Chargeable and the Residual methods might suffice. In low-dollar value situations, the Residual method alone might be appropriate.

3. There are many and varied bases which might be used to allocate residual expenses. However, to be accepted and considered reasonable, the base(s) selected must be representative and consistently applied to all segments of the organization. The following are examples of bases for allocation which are often used:

(a) Number of personnel in each segment of the organization.

(b) Dollar value of production in each segment of the organization.

(c) Cost of goods sold in each segment of the organization.

(d) Total sales in each segment of the organization.

4. Allocations derived from an arbitrary forecasted distribution base are not considered acceptable. Historical and present cost data used to derive the allocation base, along with future economic conditions should be considered and documented.

Annex 10.1.6: Cost Interpretation Bulletin - Number 06
(2004-05-14)

Pension Costs

Section 04(2)(c) of Contract Cost Principles 1031-2 states in part, that "indirect costs may include such items as fringe benefits (the contractor's contribution only)" in overhead pools.

Pension costs are normally included as a fringe benefit in a contractor's overhead pools. This interpretation explains the determination and measurement of pension costs.

Definitions

For the purposes of this Bulletin:

"Actuarial Assumptions" are presumptions about future events that will affect pension costs and obligations. These include theories concerning mortality, withdrawal, disability, retirement, changes in compensation, interest on accrued pension benefits, investment earnings, and asset appreciation or depreciation.

"Actuarial Cost Methods" are methods used to determine the cost of providing pension plan benefits and to allocate that cost to specific time periods.

"Current Service Cost" is the cost of anticipated future retirement benefits accrued during any year usually determined on an actuarial basis; it represents the aggregate estimated cost for one year's service by each employee who is a member of the plan.

"Defined Benefit Pension Plan" specifies either the benefits to be received by employees after retirement or the method for determining those benefits.

"Defined Contribution Pension Plan" is one in which the employer's contributions are fixed, usually as a percentage of compensation, and allocated to specific individuals. The pension benefit for each employee is the amount that can be provided at retirement based on the accumulated contributions made on that individual's behalf and investment earnings on those contributions.

"Experience Gain or Loss" is the measure of the difference between the expected and actual experience of the plan.

"Past Service Cost" is the estimated cost of future retirement benefits accrued in the years prior to the adoption of a pension plan; these costs are normally charged to operations over a reasonable period of years.

"Pension Plan" is any arrangement (contractual or otherwise) by which a program is established to provide retirement income to employees.

INTERPRETATION

The reasonableness of these proposed pension cost amounts should be determined in accordance with the following:

(1) The terms and conditions of the plan are determinant factors in measuring the obligations.

(2) The amount of pension cost for a cost accounting period is periodically determined by use of an actuarial cost method which measures separately each of the components of pension costs.

(3) Each Actuarial Assumption used to measure pension cost must be separately identified and

represent the contractor's best estimates of anticipated experience under the plan, taking into account past experience and reasonable expectations.

(4) Either Defined Contribution Pension Plans or Defined Benefit Pension Plans are acceptable in the calculation of pension costs in accordance with Government Contract Cost Principles (1031-2).

Under Defined Contribution Pension Plans the employer's responsibility is simply to make a contribution each year based on the formula established in the plan. The pension cost for a cost accounting period will normally be the current and past service cost.

Accounting for Defined Benefit Pension Plans is quite complex, because the benefits are defined in terms of uncertain future variables, an appropriate funding pattern must be established to assure that enough funds will be available at retirement to meet the benefits promised. The pension cost for a cost accounting period will normally be the aggregate of current service, plus past service, plus interest, minus expected return on plan assets, plus or minus experience gains/losses.

Annex 10.1.7: Cost Interpretation Bulletin - Number 07 (2004-05-14)

Research and Development Expenses

Section 04 (02) (h) of Contract Cost Principles 1031-2 states that General Research and Development expenses as considered applicable by the Crown may be included in Indirect Costs (Overhead). Section 7 (m) of Contract Cost Principles 1031-2 states that Product Development or Improvement expenses not associated with the product being acquired under the contract are considered as non-applicable costs to the contract.

This Bulletin explains the difference between General Research and Development Expenses and Product Development or Improvement expenses in the light of these two sections of Contract Cost Principles 1031-2. It also explains the treatment required for each of the different type of expenses in a contractor's cost accounting practices for acceptability in Crown contracts.

Definitions

For the purpose of this Bulletin:

"General Research and Development" is a planned investigation undertaken with the hope of gaining new scientific or technical knowledge and understanding. Such investigation may, or may not be directed towards a specific practical aim or application.

"Product Development and/or Improvement" is a systematic program of work, going beyond basic and applied research which is directed towards the creation of a new or improved product, system, component or material, substantially in a marketable form, but excluding any manufacture beyond completion of the new and improved product's prototype.

Interpretation

1. Company funded research and development should be divided into two distinct expenditure categories:

   (a) General Research and Development; and

   (b) Specific Product Development and/or Product Improvement.

2. General Research and Development

   (a) The expenditures relating to general research and development should be included in overhead and allocated to the contractor's total business activity which would exclude those items such as resale activity, warranty, etc., within the current fiscal year.

3. Specific Product - Product Development/Product Improvement

   (a) The Costs within these categories of research should not be included in overhead at the time it is incurred. Proper treatment of these expenditures would be to extract them from overhead pools and segregate these costs for later recovery against product sales.

   (b) Negotiators should consider, as an aspect of their negotiations, overhead applications to these product development costs. In the case of G&A overhead, either the costs are applied at the time that the Product Development Costs are incurred, or at the time the Product Development Costs are recovered against product sales. For guidance on the timing of application of G & A overhead costs, negotiators may look at other G & A recovery applications made to Product Development by the company.

(c) The recovery of the contractor's product development costs should, in the majority cases, be accomplished through the amortization of these product development costs against the sales of the family of products to which the product development pertained.

(d) The contractor may recover these expenses on the relevant product sales, including government sales, even if the related expenditures have been written off to the profit and loss account in the year originally incurred. However, in this case the contractor must maintain sufficient records to demonstrate the costs to be recovered and also to substantiate that these costs had not already been recovered in overhead.

4. The following are examples of activities that typically would be excluded from any general research and development and product development project:

(a) engineering follow-through in an early production phase;

(b) quality control during commercial production, including routine product testing;

(c) trouble-shooting in connection with breakdowns during production;

(d) routine, or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations, even though such alterations may represent improvement;

(e) adoption of an existing capability to a particular requirement, or customer's need, as part of a continuing commercial activity;

(f) routine tools, jigs, mould, and dies design;

(g) activity, including design and construction engineering, related to the construction, relocation, rearrangement, or facilities start-up, or equipment, whose sole use is for a particular R&D project, unless specifically approved by the technical authority;

(h) all market research activities, including those directed at market development, verification, identification, demonstration, preference, and customer acceptance development;

(i) pre-production and proposal costs;

(j) cost overruns on previous firm price development contracts.

5. **General Research and Development (R&D) - Other Factors**

(a) Costs acceptable as general research and development must relate to projects classified as basic research, or applied research. Costs applicable to Product Development projects partially funded by the Crown are not acceptable as general research and development costs. Product Development is not considered an overhead item and is recovered by a separate product development expenditure recuperation rate.

(b) In those instances where the general research and development expenditures are the majority of the total G & A cost pool, this fact must be highlighted in the cost rate negotiation report, or a separate general research and development overhead rate developed.

(c) Significant differences between the negotiated and actual costs incurred must be taken into consideration when reviewing audited costs, or negotiating future years general research and development costs.

6. **Product Development (PD) - Other Factors**

(a) Company funded product development will inevitably produce non-marketable products which would not allow these costs to be recovered on related product sales. However, there may be marketable by-products or product advances made.

7. **Product Development Amortization**

(a) Contractors proposing to amortize PD costs of the product developed against future sales to the Crown, must submit an annual cost schedule to the responsible Directorate.

Annex 10.1.8: Cost Interpretation Bulletin - Number 08 (2004-05-14)

Bid and Proposal Expenses

Under Section 04 (02) (g) of Contract Cost Principles 1031-2, Selling and Marketing Expenses which could be considered to include amongst other things, Bid and Proposal Expenses, are listed as one of the items generally considered to be indirect costs. However, in some instances contractors follow a consistent practice of charging Bid and Proposal Expenses of a successful Bid or Proposal direct to the resulting contract.

This Bulletin explains the criteria under which the direct charging of Bid and Proposal Expenses to resulting contracts is acceptable to PWGSC.

Definition

For the purpose of this Bulletin:

"Bid and Proposal Expenses" are the costs incurred in preparing, submitting, and supporting bids and proposals, (whether or not solicited), on potential contracts, including:

(a) direct administrative effort, for the physical preparation of the technical proposal documents, and also the technical and non-technical effort for the preparation and publication of cost data, and other administrative data necessary to support the contractor's bids and proposals;

(b) technical effort, incurred to specifically support a contractor's bid, or proposal, including the system and concept formulation studies, and the development of engineering and production data; and,

(c) purchased services and supplies incurred to specifically support a bid or proposal.

Interpretation

Bid and Proposal Expenses are acceptable to PWGSC as a direct charge to resulting contracts in cases of proposals resulting in subsequent contract negotiations, provided that the bid and proposal expenses are clearly denoted in the proposal and contract documents as forming part of the agreed contract price.

Annex 10.1.9: Cost Interpretation Bulletin - Number 09 (2004-05-14)

Selling and Marketing Expenses

Section 04 (02) (g) of Contract Cost Principles 1031-2 permits selling and marketing expenses associated with the product or service being acquired under a PWGSC contract, providing they are reasonably and properly incurred, to be an acceptable cost to the contract.

This Bulletin explains what constitutes reasonable selling and marketing expenses and how an appropriate share of these expenses for allocation to an PWGSC contract is to be determined.

Interpretation

1. In determining the reasonableness of selling and marketing expenses, consideration shall be given to:

    (a) the nature and amount of these expenses in the light of the expenses which a prudent individual would incur in the conduct of a competitive business;

    (b) the proportionate amounts expended as between government and commercial business;

    (c) the trend and comparability of the contractor's current period cost in relation with prior periods;

    (d) the general level of such costs within a contractor's industrial sector;

    (e) the nature and extent of the sales effort in relation to the cost thereof and to the contract value.

2. Selling and Marketing expenses may include reasonable product demonstration expenses incurred for attendance at trade shows and fairs. However, the following expenses are considered non-applicable:

    (a) Entertainment Expenses, i.e. expenses for amusement, diversion, social activities and incidentals relating thereto. However, expenses associated with meetings and conferences, when called for the dissemination of technical information or discussion of production problems and the like, including the reasonable cost of meals, transportation, rental of meeting places and other incidentals, are acceptable.

    (b) Advertising Expenses, except for expenses referred to in 1031-2 as being acceptable, i.e. those expenses associated with reasonable advertising of an industrial or institutional character placed in trade, technical or professional journals for the dissemination of information for the industry or institution.

    (c) Salaries and Expenses of Personnel Engaged in Lobbying.

    (d) Unreasonable Commissions to Selling Agents.

    (e) Unspecified Payments to a Third Party.

    (f) Depreciation or Write-off Costs of Demonstration Equipment.

3. Allocation to Contracts

To enable a fair and reasonable share of selling and marketing expenses to be charged against PWGSC contracts, the following practice should generally be adopted:

(a) selling and marketing expenses should be clearly identified by a contractor as distinct from other indirect costs to the extent, where warranted, of creating a separate cost pool for these expenses;

(b) where a contractor manufactures more than one particular product or provides more than one particular service, the selling and marketing expenses specifically identifiable with each particular product or service should be allocated directly thereto with any general expenses being prorated equitably across all products or services; and then

(c) a pro-rata share of the selling and marketing expenses allocated in accordance with b) above to the particular products or services or family of products or services being acquired under the PWGSC contract included in the applicable overhead costs of the contract.

Annex 10.1.10: Cost Interpretation Bulletin - Number 10
(2004-05-14)

Severance Payments

Contract Cost Principles 1031-2 state that the total cost of the Contract shall be the sum of the applicable direct and indirect costs which are, or to be reasonably and properly incurred and/or allocated, in performance of the Contract, less any applicable credits. Such costs may include severance payments to employees.

This Bulletin explains which severance payments and the amount there of that may be an acceptable cost to the contract.

Definition

For the purpose of this Bulletin:

"Severance Pay" means a cash settlement or paid leave granted to employees upon termination of employment for various reasons, or upon retirement. Remuneration for earned vacation credits or compensation for unused sick leave credits is not considered as severance pay. Other payments excluded from severance pay are return of contributions made to pension plans or retirement savings programs.

Interpretation

1. Severance payments should be calculated using one of the following criteria in order to be considered as an allowable cost:

   (a) in accordance with an employment contract, collective agreement or enacted legislation; or

   (b) according to an established company policy; or

   (c) based on the merits of a particular case.

2. In order for the allowable severance payment to be deemed reasonable any amount associated with the following should not be included:

   (a) profit sharing;

   (b) commissions;

   (c) patent or other rights.

Annex 10.1.11: Cost Interpretation Bulletin - Number 11

Pension Plan Refunds

On occasion, there exist credits due to refunds to contractors from companies handling their pension plans. This situation could be as a result of large lay offs of employees, plan terminations and related interest on funds invested.

The accounting issue that arises from these terminations is whether a gain should be recognized when these assets revert back to the company.

Definitions

For the purpose of this Bulletin:

"Pension Plan Settlement" occurs when an employer legally discharges the obligation for accrued pension benefits either by transferring assets directly to plan participants in exchange for their rights to pension benefits or by purchasing annuity contracts in which a third party unconditionally undertakes to pay all accrued pension benefits.

"Pension Plan Curtailment" occurs when the expected years of future service to be rendered by the existing employee group is reduced significantly or when benefits will not be earned by employees for some or all future periods.

Interpretation

1. The pension refund amounts to be deducted from overhead expenditures used to determine costing rates should be the contractor's share of the expected pension credits.

2. Upon a pension plan settlement or curtailment, the employer may have eliminated obligations with respect to the plan, any gains or losses on the transaction, including any unauthorized amounts related to previous plan amendments.

   Changes in assumption and experience gains and losses, should be recognized immediately.

3. On the other hand, if an employer settles only a part of the accrued pension benefits, a portion of any gains or losses including any unamortized amounts should be recognized immediately.

**Annex 10.1.12: Cost Interpretation Bulletin - Number 12
(2004-05-14)**

Company Funded Costs

Contract Cost Principles 1031-2 refer to "costs which are, or are to be reasonably and properly incurred and/or allocated, in the performance of the contract, less any applicable credits."

This bulletin explains the establishment of costs when government assistance has been provided related to costs of fixed assets, research, and product development.

Definitions

For the purpose of this Bulletin:

"Company Funded Costs" are expenditures made from funds over which the enterprise has spending power and which were not provided to the company through the terms of a related agreement or understanding.

"Grant" is an unconditional payment made to a recipient, usually for a specific purpose, for which the donor will not receive any royalties, goods, or services.

"Contribution" is a conditional transfer payment under an auditable agreement for which the donor will not receive any royalties, goods, or services.

"Contribution Arrangement" is an undertaking between a donor department or agency and a prospective recipient of a contribution, describing the obligations of each, and the terms and conditions of payments and which contain conditions for royalties from resulting sales. The arrangement may be as informal as an exchange of letters.

Interpretation

The Company Funded Costs that shall be considered applicable for contracts negotiated in accordance with 1031-2 are:

Fixed Assets

Government Assistance towards the acquisition of fixed assets shall be deducted from the fixed asset acquisition cost and the relevant depreciation thereof calculated on the net asset amount. Depreciation on the net amount may be included in the applicable overhead for cost recovery on Crown Contracts.

Research and Development

Government Assistance in the form of Investment Tax Credits shall not be deducted from the related research and development expenditures when determining the applicable costs.

Product Development

Government Assistance, as well as third party funded assistance, towards a specific product development shall be netted against the relevant product development costs to arrive at the portion to be recovered over the sale of that product or family of products.

Annex 10.1.13: Cost Interpretation Bulletin - Number 13 (2004-05-14)

Executive Compensation

Section 04 2. (f) of Contract Cost Principles 1031-2, states that indirect costs may include "general and administration expenses: including remuneration of executive and corporate officers...". However, section 07 1. identifies "unreasonable compensation for officers and employees" as a non-applicable cost. There are many different considerations that may affect the amount a particular individual may be receiving.

This cost interpretation provides guidelines on the determination and allowability of executive compensation expenses that are included in a contractor's overhead expenditures.

Interpretation

1. Items included in a total compensation plan for any executive, not necessarily all allowable costs, usually consist of four basis elements, these are:

   (a) Salary: reflects the extent of experience and sustained level of performance for a job, or position.

   (b) Benefits: deals with the provision of time off with pay, employee services, health care services, allowable insurance protection and retirement incentives.

   (c) Performance Incentives: rewards the extent of accomplishment agreement targets.

   (d) Perquisites: benefits which are designed only to apply to executives, such as housing loans; these are in addition to benefits offered to other employees.

2. Guidelines for considering what is reasonable executive compensation are:

   (a) compensation paid to executives in similar positions, compared to related executive pay scales surveys;

   (b) the executive's previous experience, experience in other positions within the company and similar appointments in other companies;

   (c) comparison of the compensation paid for the nature and scope of the work, or service, as defined in the contract of service and/or the position description;

   (d) the size and complexity and the corporate management structure;

   (e) the company's general salary policy should be reviewed to ascertain the compensation is uniformly paid, according to set criteria;

   (f) in the case of smaller contractors with a limited number of officers, the amount of compensation paid to executives in the previous year should be reviewed, as a substantial increase over the prior year tends to indicate compensation may be excessive, further investigation should be made to determine whether the executives' salaries are for services rendered, rather than a re-distribution of the business's profits;

   (g) compensation paid to executives through related party transactions.

Annex 10.1.14: Cost Interpretation Bulletin - Number 14
(2004-05-14)

Mobile Repair Party Requirements

Section 5 of Contract Cost Principles 1031-2 recognizes that indirect costs should be accumulated and allocated based on a principle of similarity of costs in the pool and a causal relationship to the contracts to which the costs are allocated.

Repair work is normally carried out in a contractor's plant but, on occasion, it is necessary in meeting the requirements of a customer department, to have repair work performed at other locations.

This cost interpretation provides guidelines on the determination of overhead expenses applicable to Mobile Repair Party requirements.

Definition

For the purpose of this Bulletin:

"Mobile Repair Party" is the individual, or group of individuals, performing work away from the contractor's plant.

Interpretation

The overhead rate on Mobile Repair Party work normally will be at the full plant rate, however, it should be noted that under the three conditions below, the overhead rate could be different:

(a) where the estimated hours to be expended for Mobile Repair Party work exceed 5% of the estimated total direct labour hours for both commercial and defence repair and overhaul work during the contract period; or

(b) where the estimated hours to be expended for Mobile Repair Party work are less than 5%, but the contracting officer considers that a significant number of direct labour employees are hired for Mobile Repair Party work only; or

(c) where the contractor maintains adequate cost records to permit the calculation and negotiation of a separate Mobile Repair Party rate.

In the circumstances contemplated under alternatives a) and b) above, an overhead rate should be negotiated to reflect the reduced costs applicable to Mobile Repair Party work.

Notwithstanding the Cost Interpretation on Travel Costs, all travel costs for direct personnel for Mobile Repair Party requirements, should be charged to the contract directly and not included in any overhead pool.

Annex 10.1.15: Cost Interpretation Bulletin - Number 15
(2004-05-14)

Environmental Costs

According to Section 04 of Contract Cost Principles 1031-2,"Indirect Costs" are those costs which, though necessarily having been incurred during the period of the Contract performance for the conduct of the Contractor's business in general, cannot be identified and measured as directly applicable to contracts.

An element that is becoming a more significant portion of indirect costs is environmental costs. This cost interpretation provides guidelines on applicable environmental costs included in a Contractor's indirect costs.

Definition

For the purposes of this Bulletin:

"Environmental costs" are the costs incurred by an entity to prevent , abate , or remediate damage to the environment or to deal with the conservation of renewable and non-renewable resources.

Interpretation

1. Any direct or indirect benefits, for example, tax credits, insurance benefits, or government assistance, should be accounted for using the cost reduction approach. The amount of all such benefits received by or credited to the contractor's account should be deducted from the related environmental cost and any amortization of the cost should be calculated on the net amount.

2. Notwithstanding the other sections of this bulletin, no fines, or penalties, or any other non applicable cost as determined under Section 07 of Contract Cost Principles 1031-2 are allowable.

3. Environmental costs can be grouped according to the periods when the cost is incurred and the periods that the cost relates to.

   (a) Current period operations.

   An example of this type of cost is the disposal of waste from current period operations.

   These costs should be allowed and allocated on the appropriate base in the current period.

   (b) Current period past operations.

   An example is clean up costs for activities that occurred previously.

   Any current period cost that is a material amount should be deferred and amortized over a reasonable number of future periods.

   (c) Current period future operations.

   An example is depreciable equipment purchased to control hazardous emissions.

   These costs should be amortized over the periods for which benefits are expected from the costs incurred.

Annex 10.1.16: Cost Interpretation Bulletin - Number 16 (2004-05-14)

Take-out Rates

Section 05 of Contract Cost Principles 1031-2 states: “Indirect costs shall be accumulated in appropriate indirect cost pools, reflecting a contractor's organizational or operational lines and these pools subsequently allocated to contracts in accordance with the following two principles:

(a) the costs included in a particular indirect cost pool should have a similarity of relationship with each contract to which that indirect cost pool is subsequently distributed; further, the costs included in an indirect cost pool should be similar enough in their relationship to each other that the allocation of the total costs in the pool provides a result which would be similar to that achieved if each cost within that pool were separately distributed.

(b) the allocation basis for each indirect cost pool should reflect, as far as possible, the causal relationship of the pooled costs to the contracts to which these costs are distributed.

This bulletin provides interpretation on how take out rates reflect the allocation of specific cost from indirect cost pools to suit the related costs and circumstances of the contracts. However, a fair level of overhead, or G&A costs must be charged to the particular products or services in question.”

Definition

For the purpose of this Bulletin:

“Take-Out Rate” is the negotiated rate applied for the recovery of overhead costs on goods and services which do not form the major portion of the company's business but are in themselves significant relative to a government contract. The resulting rate, in most cases, should be somewhat less than that which applies to other work processed through the company's facilities.

Interpretation

1. Take-out rates may be established to apportion overhead expenses on a fair and reasonable basis on goods and services which requires less overhead effort than the company's regular activity.

2. The task of identifying where and when a take-out rate is applicable is left to the discretion of the negotiators, who are in the best position to establish the need, based on the information available at the time.

3. Some of the areas for applications of take-out rates are:

    (a) Subcontracts;
    (b) Drop shipments, other resale and high value purchases;
    (c) Mobile repair party and field services;
    (d) Other specialized applications such as for travel and living that are charged directly to a contract.

4. The purpose of a take out rate is to allocate costs to a contract. Other overhead recovery rates must not include any of the costs of any contracts that are subject to take out rates. This means that take out rates that are established without taking into account the full costs of specific situations may result in unrecovered overhead as this overhead cannot be recovered on other contracts. As an example; this situation can arise if a contract is established using a take out rate that is set to limit the total price of the contract and the rate is not sufficient to allow full cost

recovery.

Annex 10.1.17: Cost Interpretation Bulletin - Number 17
(**2004-12-10**)

Government Supplied Materiel

Section 05(a) of Contract Cost Principles 1031-2 deals with the allocation of indirect costs according to the principles of "similarity of relationship" and the "causal relationship of pooled costs". Applying these principles requires consideration of both the nature of activities giving rise to the costs and when different activities occur.

The purpose of this cost interpretation is to provide guidance in determining when material handling and general and administrative costs relating to government supplied material are allowable items for cost reimbursement.

Definitions

For the purpose of this Bulletin:

"Accountable Advance Spares" are non-catalogued materiel owned by the government and manufactured or purchased by contractors in accordance with agreements between contractors and the government. Accountable Advance Spares are used in the repair and overhaul of government equipment.

"Laid-Down Cost" is the cost incurred by a contractor to acquire a specific product. This includes the invoice price (less trade discounts) charged to the contractor plus any applicable charges for transportation, exchange, custom duties, and brokerage charges.

"Government-Supplied Materiel"(GSM): Material supplied to a contractor by a government department or agency for incorporation into the end product.

Interpretation

(a) Material handling costs related to the storing and transferring out of storage are allocated to the GSM when they are embodied.

(b) General and Administrative (G&A) overhead expenses and material handling costs that are applicable should be allocated as a cost associated with the embodiment of government supplied material in the year when the materials are embodied. When transfers of GSM, for example from accountable advance spares inventory, are made to the crown for asset disposal, the general and administrative overhead expenses and material handling costs that are applicable are allocated at the time of transfer.

(c) When the contractor stores GSM for the Crown, the cost of the items being stored would normally include the laid-down cost of the purchased GSM; or the applicable direct material, direct labour, factory overhead and G&A applicable to the manufacturing operation of the manufactured GSM.

Annex 10.1.18: Cost Interpretation Bulletin - Number 18
(2004-05-14)

Incentive Remuneration Profit Sharing Plans

Section 04 of Contract Cost Principles 1031-2 explains indirect costs. This section's paragraph 2. (c) indicates that fringe benefits (the contractor's contribution only) are to be included as indirect costs (overhead). A fringe benefit type that **may not** be an overhead cost for 1031-2 purposes is amounts paid under Incentive Remuneration Profit Sharing Plans. The reason these amounts are not considered costs is that normally these plans are considered as a distribution of a portion of earnings to employees. Earnings that are profits or a distribution of retained earnings are not costs. However, since the purpose of these plans is to remunerate employees, it is often argued that payments under these plans should be considered costs.

This cost interpretation is to determine the features of Incentive Remuneration-Profit Sharing Plans that may be considered as allowable cost items in accordance with 1031-2.

Definition

Incentive Remuneration Profit Sharing are plans designed to link the performance of employees to the achievement or organizational objectives, through the provision of additional compensation from the distribution of a defined share of the organization's net profit.

Interpretation

Incentive Remuneration Profit Sharing Plans may be considered as an allowable cost element providing:

(a) The plan includes a documented sharing arrangement, with all employees, and the incentive amounts payable by the employer must be computed with reference to earned profits.

(b) The company pays employees directly or provides the funds for the employee profit sharing plan to a trustee in trust for the benefit of the employees who are members of the plan.

(c) The amount of cost will not exceed the amount of payment made to the employees or the plan trustee.

(d) The cost is recognized only in the year the employee provides services to earn benefits under the plan.

(e) The entire amount recognized as cost must be disbursed to employees (or paid to the trustee) in the fiscal year when the benefits were earned or shortly after the end of the fiscal year (within a few months, but well before the end of the fiscal year following the one for which plan benefits were based).

(f) Any funds payable by the trustee to the employer for over contributions or funds that the plan may earn; shall be used to reduce the current year cost unless these earned funds or over contributions are paid directly by the employer to the employees within that current fiscal year. (see Cost Interpretation 11 on Pension Plan Refunds).

(g) Compensation to owners of closely held corporations, partners, sole proprietors, or members of their immediate families should be in accordance with the personal service rendered rather than a distribution of profits. (see Cost Interpretation 13 on Executive Compensation).

Annex 10.1.19: Cost Interpretation Bulletin - Number 19
(**2004-12-10**)

Purchased Labour -- Personnel Procured From Outside Sources

In accordance with Sections 03, 04 and 05 of Contract Cost Principles 1031-2, Purchased Labour Costs are considered either as Direct Costs or may be viewed as Direct Labour Costs.

Definitions

For the purpose of this Bulletin:

"**Purchased Labour Costs**" are the costs incurred by a contractor/ entity for temporary personnel procured from the outside for skills such as engineers, technical writers, technicians, craftsmen. Purchased Labour normally attract different indirect costs. Care must be taken to ensure that they are not accounted for as the contractor's employees.

Interpretation

1. Contractors' cost accounting method for purchased labour and overhead allocation thereon varies depending on the circumstances under which purchased labour costs are incurred.

   For example,

   (a) some contractors classify purchased labour as direct labour costs when the work is performed in the contractor's facilities under their supervision and otherwise meets section 03(b) of 1031-2 definition of direct labour costs. These contractors cost direct labour using either the purchased labour rate or average labour rate incurred by their own employees for comparable work. However differences between the average labour rate incurred by the contractor's own employees and purchased labour prices are treated as overhead costs and are allocated accordingly.

   (b) other contractors classify purchased labour as subcontract costs.

2. Purchased labour must share in an allocation of certain indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed cost accounting practices.

3. The accounting treatment for purchased labour must be evaluated on a case-by-case basis with consideration given to the materiality of costs involved and the overall effect of the accounting treatment on final cost objectives. Acceptance or rejection of the contractor's treatment of purchased labour must be based upon

   (a) the causal and beneficial relationship of indirect expenses and purchased labour, and

   (b) the nature of the employer/consultant relationship.

4. The preferred cost accounting method for purchased labour is to have a separate direct cost for this activity with an appropriate allocation of applicable overhead. Other methods devised are acceptable providing the accounting method is considered fair and reasonable and meets the relevant Contract Cost Principles 1031-2.