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Capability Acquisition and
Sustainment Group

CASG Cost Principles

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Foreword

The CASG Cost Principles support the Defence objective to standardise applicability and transparency of the cost basis used in Defence contracts. The document details the cost principles that Defence and industry will utilise in costing contracts.

The current release reflects changes due to consultation as well as legislative amendments since Cost Principles of 2015 was promulgated. This document may undergo further refinement in the future to maintain the currency of the principles.



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Cost Principles

Policy Statement

These Cost Principles (the Principles) provide a framework to deliver greater understanding and clarity regarding how costs may be attributed to the Department of Defence (Defence) contracts. The Cost Principles as established by the Capability Acquisition & Sustainment Group (CASG) are applied within the overarching framework of Commonwealth legislative and policy requirements including:

- a) the *Public Governance, Performance & Accountability Act 2013* (PGPA Act), which provides the framework for the proper management of public money and public property by the Executive arm of the Commonwealth; and
- b) the Commonwealth Procurement Rules (CPRs) (2014) with a core rule of achieving value for money with procurements which should:
 - encourage competition and be non-discriminatory;
 - ensure the spending represents an efficient, effective, economical and ethical use of public resources (s23 of the PGPA Act);
 - facilitate accountable and transparent decision making;
 - encourage appropriate engagement with risk; and
 - be commensurate with the scale, scope and risk of the procurement.

The Principles encourage a well-defined, consistent, common, professional and standard approach to Defence contract costs.

Purpose

This Cost Principles document replaces the "DMO Cost Principles", issued September 2015.

Objectives

1. The objectives of the Principles are:
 - a) to provide greater understanding and clarity of what costs may be attributed to (cost-recovered from) Defence contracts;
 - b) to focus on compliance of the accounting framework to the Principles, not the financial accounting system;
 - c) to operate within the test of 'reasonableness'; and
 - d) not intended to mandate what costs Industry is able to incur or not incur, outside of its contracts with Defence.
2. The Principles:
 - a) identify what costs can be passed to Defence (Allowable costs) and what costs cannot be passed to Defence (Unallowable costs);
 - b) require the use of an accounting framework that is compliant with the Principles and relevant to the type of contractual arrangement being undertaken;
 - c) are mandatory for all new procurements greater than two million Australian dollars (AUD\$2.0m), unless:
 - i. the supplier is a Small to Medium Enterprise (SME) whose accounting system cannot provide the level of detail required under the Principles; or
 - ii. Otherwise agreed by the Deputy Secretary CASG.
3. The Principles apply to all procurements, specifically noting the following types, unless agreed otherwise under paragraph 2.c):

- a) cost-reimbursement or time and material contracts, where the contractor is paid on the basis of incurred allowable costs:
 - i. including incentive contracts based on a cost-reimbursement arrangement; and
 - ii. prior Defence approval of the contractor's accounting system has been provided to ensure that claims can be verified;
 - b) sole source procurement (referred to as a single supplier direct sourcing):
 - i. including the determination of annual company billing rates applicable to single supplier direct sourcing procurements;
 - ii. the Principles are to be read as also applying to budgeted costs;
 - c) performance based contracts;
 - d) alliance contracts;
 - e) the operating aspects (but not the financing aspects) of Public Private Partnership/Private Financing Initiative (PPP/PFI) arrangements;
 - f) contracts that are terminated:
 - i. for convenience or by agreement; or
 - ii. otherwise where the contract calls for a cost investigation on termination; and
 - g) Contract Change Proposals (CCPs), unless the contract contains a previously agreed pricing methodology, where the CCP:
 - i. is for new scope/services; or
 - ii. is not previously agreed as a costed contract option.
4. Defence discretion, and the reasonableness test, will apply with regard the use of the Principles for competitively tendered contracts.
5. The Principles are to be used as guidance for all other procurements that fall outside of the circumstances detailed in paragraph 3, and where the Deputy Secretary CASG or SME exceptions apply.

Application

- 6. The Principles continue to apply, in the amended format, to all contracts and CCPs unless specifically exempted.
- 7. As noted above, the Principles may be applied to CCPs issued, and contracts cancelled or terminated.

Cost System

- 8. The contractor's accounting system, for the purpose of ascertaining the contract cost, shall:
 - a) provide for the equitable allocation of costs between cost objectives;
 - b) be based on sound accounting principles, appropriate for the purposes of the contract, and internal control practices, consistently applied;
 - c) be adequate to enable accurate and timely determination of the contract cost in accordance with the Principles; and
 - d) provide explanations of the basis adopted in discretionary areas.
- 9. An Accounting Arrangement (refer paragraphs 34-38) may be established between Defence and the contractor covering the contractor's cost system before accumulation of any costs under the contract. An Accounting Arrangement should be used as the exception rather than the rule.

Contract Cost

- 10. As a guiding principle, Defence will only incur or make payment once for an item of cost and will seek cost re-imburement for any double counting or other duplication of costs. A cost is allowable only when the cost complies with all of the following requirements:

- a) terms and conditions of the contract;
- b) limitations defined in the Principles;
- c) allocability;
- d) Accounting Arrangement (where applicable); and
- e) reasonableness.

11. The guides to assist in determining which costs are allowable and which costs are unallowable are at Annex A: Allowable Cost Decision Matrix and Annex B: Specific Categories of Cost.

Composition of Total Cost

12. The total cost of a contract is the sum of the direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used.
13. While the total cost of a contract includes all costs properly allocable to the contract, the allowable costs are limited pursuant to Annex B or any applicable Accounting Arrangement.
14. Costs applicable to one contract may not be allocated to another contract.

Determining Reasonableness

15. A cost may be reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.
16. Reasonableness of specific costs must be examined with particular care in connection with a company, its separate divisions or associated companies that may not be subject to effective competitive restraints.
17. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by a Defence officer or a Defence representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.
18. Indicators of whether costs are reasonable include, but are not limited to, the level of competitiveness and/or market testing undertaken in the supply chain, any particular specification and performance requirements, any uncertainty involved, the economic environment, the statutory provisions in place at the time of contracting, the expected benefits provided and any alternative options available, for example to justify decisions as to whether to sub-contract or undertake work 'in-house'.
19. In order to assess whether a cost is reasonable, consideration should be given to the following:
- a) whether it is congruent with meeting the contract requirements;
 - b) whether the cost would withstand public scrutiny;
 - c) whether the cost is consistent with any available sector/market benchmarks; and
 - d) whether the quantum of the cost is consistent with good business practice.

Determining Allocability

20. A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a contract if it:
- a) is incurred specifically for the contract;
 - b) benefits both the contract and other work, and may be distributed to both in reasonable proportion to the benefits received; or
 - c) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

Accounting for Unallowable Costs

21. Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed unallowable directly associated costs, shall be identified and excluded from any claim or proposal applicable to a Defence contract.
22. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated cost is also unallowable. Unallowable cost categories are listed at Annex A – Allowable Cost Decision Matrix.

Direct Cost

23. The classification of items of cost as direct cost shall be in accordance with sound accounting principles, appropriate for the purposes of the contract, and consistently applied. That is:
 - a) no final cost objective shall have allocated to it as a direct cost any cost that, if incurred for the same purpose in like circumstances, would have been included in an indirect cost pool to be allocated to that or another final cost objective;
 - b) direct costs of the contract shall be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly; and
 - c) for reasons of practicality, the contractor may treat any direct cost of a minor dollar amount as an indirect cost if the accounting treatment:
 - i. is consistently applied to all final cost objectives; and
 - ii. produces substantially the same results as treating the cost as a direct cost.

Indirect Cost

24. It shall not be permissible to charge part of an allowable cost as a direct cost to a final cost objective and the balance to indirect expense unless:
 - a) specifically provided for in the Principles; or
 - b) paragraph 25 applies and is the subject of an Accounting Arrangement.
25. It shall be permissible to charge part of an allowable cost as a direct cost to a final cost objective and the balance to indirect expense where:
 - a) the cost includes an economically traceable element which can be identified as a direct cost of a final cost objective;
 - b) the amount of the cost charged to indirect expense excludes any elements similar in nature to that charged as a direct cost, which are applicable to other final cost objectives; and
 - c) the practice is applied consistently.
26. Direct cost items for which the cost of identifying them separately would be uneconomic may be classified as indirect expense items provided that practice is applied consistently and produces substantially the same results as those which would have been obtained if such costs had been treated as direct costs.

Indirect Cost Pool

27. Indirect costs shall be accumulated by logical cost groupings into indirect cost pools and allocated to cost objectives or where appropriate, other indirect cost pools for subsequent allocation, subject to practical considerations. Commonly, manufacturing overhead, selling costs, marketing, business development, and general and administrative costs are separately grouped.

28. The basis on which an indirect cost pool is allocated may be the subject of an Accounting Arrangement and shall:
- be consistently applied;
 - be in accordance with sound accounting principles, appropriate for the purposes of the contract and consistently applied;
 - result in equitable distribution; and
- when an Accounting Arrangement is used, include all appropriate costs whether allowable or unallowable under the Principles.

Credits to the Contract Cost

29. Subject to paragraph 30, and provided the contract does not specifically provide for an alternate procedure, the contract cost where practical shall be credited with the applicable portion of:
- all discounts, rebates, commissions, International, Federal, State or Territory and Local grants and price reductions of any kind received or receivable by the contractor in respect of the purchase of equipment, facilities, intellectual property materials or services that are allowable contract costs;
 - the proceeds of sales of any secondary products resulting from manufacture relating to the performance of the contract. The proceeds shall be net of expenditures incurred for these purposes provided such expenditures are not otherwise recoverable as an element of the contract cost;
 - the agreed value of any such products and materials that are not sold by the contractor;
 - the amounts of costs allowed into the contract cost under the Principles which are recoverable from any source other than from Defence under this contract, excluding costs, expenses, damages or other compensation recovered through litigation or settlement of claims or disputes (the costs of which are not passed to Defence). For example, where costs allowed into contract cost by Defence are recoverable under a "consequential loss" insurance policy, the recoverable amount of the cost originally allowed shall be credited to contract cost; and
 - gains arising from the sale, retirement or exchange of machinery, plant or equipment as outlined in paragraph 8 of Annex B.
30. The contractor shall not be required to credit Defence with:
- the proceeds of the sale of any material when the cost of such material has been excluded from the contract cost; or
 - settlement discounts for prompt payment consistent with normal commercial levels, other than trade discounts or discounts in excess of normal commercial levels, in respect of which the difference shall be credited to contract cost.

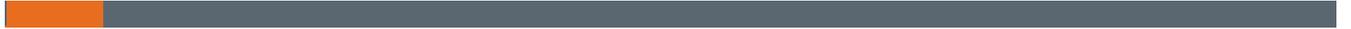
Avoidable Costs and Unnecessary Costs

31. Costs which may be avoided or reduced by the exercise of reasonable standards of skill, care and efficiency, shall be subject to the reasonableness test and, to the extent that such costs may have been avoided or reduced, shall not be allowable as a contract cost.
32. Unless an Accounting Arrangement has been established to the contrary, where prudent business practice would require the contractor to seek competitive tenders or quotes, net additional costs caused by the failure or omission of the contractor to call for tenders, or to obtain competitive quotes, subject to the reasonableness test, may result in the net additional costs to be unallowable as a contract cost.
33. The cost in excess of a reasonable allowance for faulty materials, faulty workmanship and rejected components shall be unallowable as a contract cost.

Accounting Arrangement

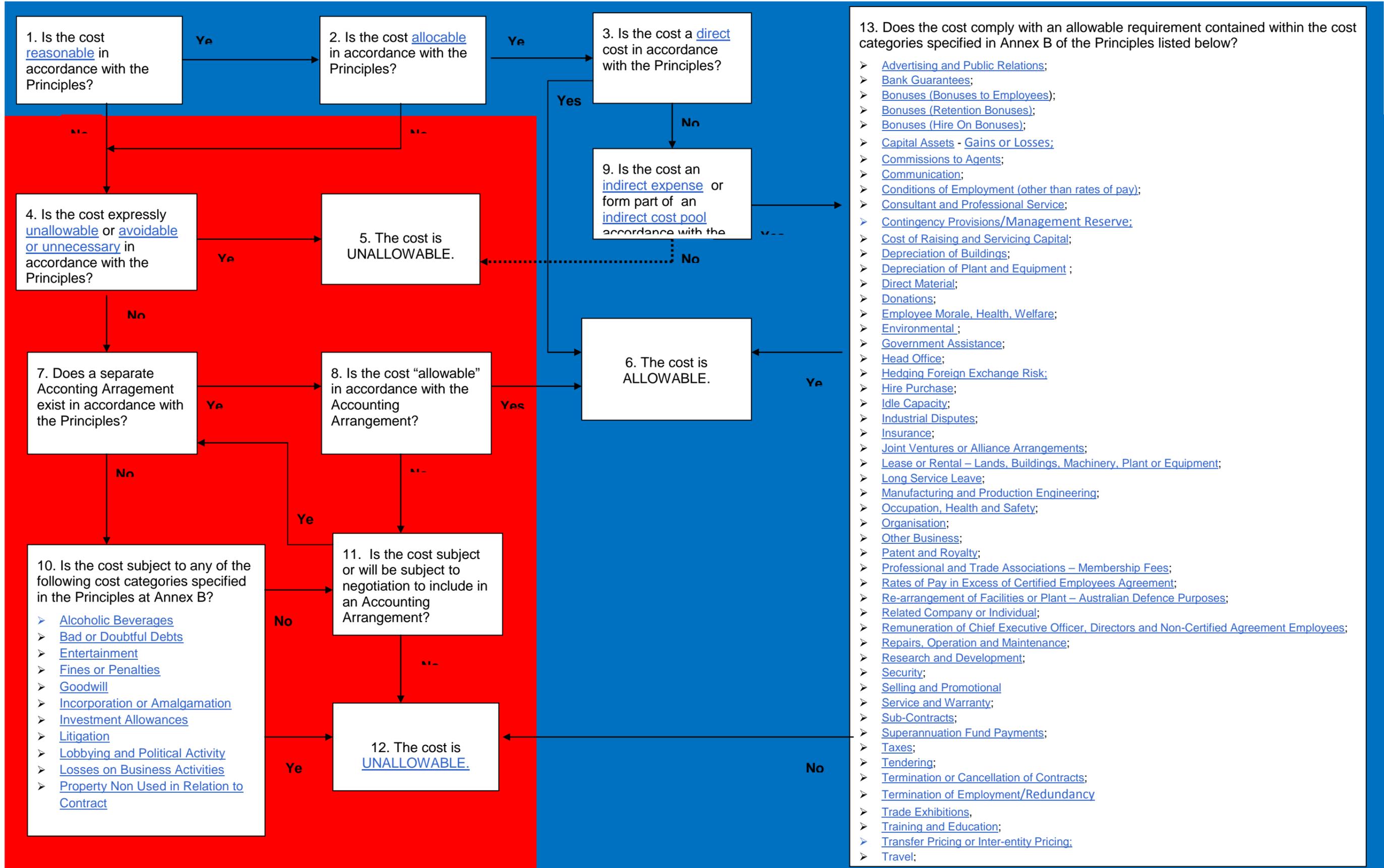
34. An Accounting Arrangement may be established between Defence and the contractor covering the contractor's cost system before accumulation of any costs under the contract. An Accounting Arrangement shall be used as the exception though it may be used to agree a standardised approach between Defence and a contractor, where this is likely to be a recurrent requirement.
35. To eliminate any uncertainty regarding the allowance of items of cost, other than items of cost specifically unallowable as set out at Annex A, (prospective) contractors may seek an Accounting Arrangement in respect of those items of cost where reasonableness or allocability may be difficult to determine. Defence may also initiate such Accounting Arrangement.
36. Defence, in exceptional circumstances, may make allowance for other specified costs within each cost pool providing a business case is made clearly demonstrating value for money to the project(s). Once Defence is satisfied with the cost basis it may elect to impose a "cap" on each cost category. If such a "cap" is applied, the contractor must seek approval from Defence for any reimbursement of expenditure over the "capped" amount. When seeking such an increase a business case must be provided by the contractor to clearly demonstrate value for money to Defence. Any additional cost approvals will be at Defence's sole discretion.
37. An Accounting Arrangement will be in writing and may relate to a particular contract or a number of contracts with Defence. An Accounting Arrangement may be entered into during the course of the contract.
38. If required by Defence, the contractor must furnish a statement of the contract cost and related information in such detail as Defence may reasonably request. Reasonable additional costs incurred in producing such statements shall be allowable into contract cost.

Annex A – Allowable Cost Decision Matrix



See next page.





Annex B – Specific Categories of Cost

NOTE: The treatment of specific categories of cost in paragraphs 1 to 66 below is not intended to be exhaustive but rather to indicate those items of cost which, for varying reasons, warrant special mention. Failure to treat a particular item of cost does not imply that it is either allowable or unallowable, and if in doubt prospective contractors should seek clarification from Defence or seek an Accounting Arrangement or both.

1. Advertising and Public Relations

- 1.1. Advertising costs and related administrative costs incurred in relation to:
- staff recruitment; or
 - purchase or disposal of materials; or
 - an insertion in the telephone or trade directories and similar publications; or
 - the requirements of any applicable Federal, State, Territory or Local government legislation,

shall be allowable to the extent that the costs are within the definition of contract cost and are reasonable in both size and nature and must clearly demonstrate a benefit to the contract.

- 1.2. Unallowable cost would include expenses associated with advertising through any media for other than above. 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, the internet, telecommunications.
- 1.3. Unallowable costs also include sponsorship of sporting teams/events or similar activities. Annex A – Allowable Cost Decision Matrix outlines unallowable cost categories.
- 1.4. Allowable costs include activities to promote sales of products normally sold to the Australian Defence Department, including trade shows and Defence sponsored exhibitions, which contain a significant effort to promote exports from Australia are allowable. Allowable costs are limited to the Australian entity cost. However, such costs do not include the costs of memorabilia (e.g., models, gifts, and souvenirs), alcoholic beverages, entertainment, and physical facilities that are used primarily for entertainment rather than product promotion. The costs of overseas representatives attending, and overseas demonstration equipment provided, are unallowable.

2. Alcoholic Beverages

- 2.1. Costs of alcoholic beverages are unallowable. Where these costs cannot be identified and excluded by the accounting system, a reasonable estimation of the alcohol costs will be considered. This cost does not refer to beverages (which may be alcoholic) purchased by individuals as a result of their normal meal and incidental travelling allowance (refer paragraph 65 Travel Costs).

3. Bad or Doubtful Debts

- 3.1. Bad debts, including losses (whether actual or estimated) or provision for doubtful debts arising from uncollectable customer accounts and other claims, related collection costs, and related legal costs are unallowable as a contract cost.

4. Bank Guarantees

- 4.1. Costs of bank guarantees or financial securities required pursuant to the terms of a Defence contract shall be allowable as direct cost.

- 4.2. Costs of bank guarantees or financial securities incurred in the general conduct of the contractor's business and not directly related to other final cost objectives shall be allowable to the extent the costs are within the definition of indirect costs, provided the rates and premiums are reasonable under the circumstances.

5. Bonuses (Bonuses to Employees)

- 5.1. Subject to paragraph 6, bonuses (including share schemes) allocated for payment to employees shall be allowable as a contract cost to the extent that:
- the bonus is due to productivity improvement or achieved Defence contract Key Performance Indicators (KPIs);
 - the bonus agreement is entered into in good faith between the contractor and employee and is a plan established and consistently followed;
 - the amount when added to the other remuneration of the recipient results in a reasonable total remuneration; and
 - provided similar bonuses are paid in respect of similar commercial work.
- 5.2. Allowable bonuses not associated with Defence contract specific KPIs are to be included in the indirect cost pool. Such bonuses cannot be a provision but must be an amount that is allocated and proposed to be paid to employees.
- 5.3. Bonuses due solely to achievement of agreed profit benchmarks shall be unallowable as a contract cost, however bonuses as a result of multiple KPIs (which may include profit) are allowable. The sharing of company profits with employees is not considered a relevant labour cost (direct or indirect).
- 5.4. In a cost reimbursement arrangement or where it is proposed to treat the bonus as a direct cost, the services of the recipient must relate to the contract. Where an employee bonus pool has been approved under the contract, then it must be tied to and paid in proportion with the achievement of contracted KPIs.

6. Bonuses (Retention Bonuses)

- 6.1. Retention Bonuses shall be allowable as a contract cost to the extent that:
- the services of the recipient relate to the contractual obligation of the contractor; or
 - the bonus is due to retention of a key person pursuant to the terms of a Defence contract and allowable as a direct cost only; and
 - the amount when added to the other remuneration of the recipient results in a reasonable total remuneration.

7. Bonuses (Hire on Bonuses)

- 7.1. Hire on Bonuses shall be allowable as a contract cost to the extent that:
- the services of the recipient relate to the contract; and
 - the bonus is due to filling of a key staff position pursuant to the terms of a Defence contract and allowable as a direct cost; and
 - the amount when added to the other remuneration of the recipient results in a reasonable total remuneration..

8. Capital Assets - Gains or Losses

- 8.1. Gains or losses arising from the sale, retirement or exchange of machinery, plant or equipment shall be allowable as a contract cost, provided that the gains or losses are within the definition of contract cost and are:

- a) reasonable;
 - b) the difference between the sale, retirement, or exchange price and the written-down value resulting from the depreciation allowable under the Principles;
 - c) equitable in that the proportion of gains or losses allocated to Australian Defence work subject to the Principles approximates the proportion of total depreciation charges allocated to such Australian Defence work during previous years in respect of the assets which generated the profits or losses;
 - d) included in the year in which the gains or losses occurred as a credit or charge to an indirect cost pool or as a credit or charge to direct expense; and
 - e) not the result of mass or extraordinary sales, retirements or other dispositions.
- 8.2. Gains or losses on the disposal of depreciated machinery, plant or equipment are unallowable as a separate charge or credit where:
- a) such gains or losses are included in a provision for depreciation account and reflected in the depreciation allowable under paragraph 15; or
 - b) the property is given in exchange as part of the purchase price of a similar item and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

9. Commissions to Agents

- 9.1. Commissions due to appointed agents for the specific supplies and services acquired under the contract are an allowable cost within the definition of contract cost. Such costs must be detailed within the definition of contract cost. The appointment of an agent must be a genuine arms-length third party transaction and must not be a related entity or individual for commissions to be allowable costs.

10. Communication

- 10.1. Communication costs incurred for telephone services, local and long distance telephone calls, telegrams, telexes, internet, postage and similar technologies shall be allowable to the extent they come within the definition of contract cost.

11. Conditions of Employment (Other than Rates of Pay)

- 11.1. Costs relating to conditions of employment (other than rates of pay) which are not reasonable are unallowable as a contract cost, except where:
- a) the cost has been the contractor's past practice to incur costs consistent with those sought to be admitted; or
 - b) the contractor is able to demonstrate that circumstances have changed sufficiently to justify such costs.

12. Consultant and Professional Services

- 12.1. "Consultant and Professional Services" means those services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Examples include those services acquired by contractors or subcontractors in order to enhance the contractor's legal, economic, financial or technical positions. Consultant and professional services are generally acquired to obtain information, advice, opinions, alternatives, conclusions, recommendations, training or direct assistance such as studies, analyses, evaluations, liaison with Government officials or other forms of representation.

- 12.2. Costs described in Annex B paragraph 12.1 shall be allowable to the extent the consultant and professional services are within the definition of contract cost, and are not excluded under Annex B paragraph 12.3.
- 12.3. Consultant and professional services performed under any of the following circumstances are unallowable:
- a) services to improperly obtain, distribute or use information or data protected by the contract or applicable legislation;
 - b) services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award, whether award is by the Government or by a prime contractor or subcontractor;
 - c) any other services obtained, performed or which otherwise result in the violation of any statute or regulation prohibiting improper business practices or conflicts of interest;
 - d) services performed which are not consistent with the purpose and scope of the services contracted for or otherwise agreed to;
 - e) services for which the costs are unallowable under Annex B paragraphs:
 - i. 2;
 - ii. 14.3.f);
 - iii. 29.1; or
 - iv. 35.1.

13. Contingency and Management Reserve

- 13.1. Contingencies shall be unallowable as a contract cost for cost reimbursement contracts, unless the costs are labour related or relate to a provision for statistically calculated warranty costs with respect to the goods and services being supplied under the contract.
- 13.2. For other contract types reasonable Contingencies/Management Reserve may be allowable. Contingencies/Management Reserve may be allowable if the company provides a fully costed risk register which identifies the risk events that these reserve elements cover.
- 13.3. Unless supported by a fully costed risk register, 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 is an unallowable cost in Defence contracts.

14. Cost of Raising and Servicing Capital

- 14.1. The actual interest component of borrowings for a capital acquisition, if directly related to the contract activity, is an allowable direct cost.
- 14.2. The contractor is expected to have reasonable working capital. The cost of working capital may be considered in an Accounting Arrangement where significant capital outlay is required.
- 14.3. The following costs are unallowable as a contract cost:
- a) interest on borrowings, except as specified at Annex B paragraph 14.1;
 - b) share and debenture issue costs;
 - c) capital re-organisation costs;
 - d) debenture discounts;
 - e) staff equity schemes; and
 - f) professional charges and other costs incurred in connection with Annex B paragraphs 14.3a) to e) above.

15. Depreciation of Buildings

- 15.1. Depreciation of buildings owned by the contractor, to the extent the buildings are used for or in connection with the contract, are allowable in accordance with Generally Accepted Accounting Principles (GAAP). Depreciation charges must be based exclusively on the historical cost of the assets. If fully depreciated no charge is allowable, other than normal building maintenance costs which would be included as an allowable indirect cost.
- 15.2. Where an asset described in Annex B paragraph 16.1 has been fully depreciated, depreciation on revaluation of the asset is unallowable.
- 15.3. Capital Allowance deduction on any building or part thereof which has been funded or gifted from any government source, be it International, Federal, State, Territory, or Local Government, as part of the current or previous contract is unallowable.
- 15.4. In circumstances where a building is required for a specific contract only and has no useful purpose thereafter then, if agreed to in advance, the building may be depreciated over the life of the contract as an allowable depreciation cost.

16. Depreciation of Plant and Equipment

- 16.1. Depreciation of plant and equipment owned by the contractor, to the extent it is used in relation to the contract shall be allowable in accordance with GAAP. Depreciation charges must be based exclusively on the historical cost of the assets.
- 16.2. Where the Australian Taxation Office tax depreciation rates are used, the contractor must exclude any depreciation allowances for special purposes e.g. investment allowances, rebates, accelerated depreciation or similar schemes, which are unallowable.
- 16.3. Where an asset described in Annex B paragraphs 16.1 and 16.2 have been fully depreciated, depreciation on revaluation of the asset is unallowable.
- 16.4. Depreciation on plant and equipment or any part thereof which has been funded or gifted from any government source, be it International, Federal, State, Territory, or Local Government, as part of the current or previous contract is unallowable.

17. Direct Material

- 17.1. Material costs are allowable and include the costs of: raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and in-transit insurance.
- 17.2. In calculating allowable material costs, the contractor may consider including reasonable overruns, spoilage, or defective work (unless otherwise provided in any contract provision relating to inspecting and correcting defective work).
- 17.3. Hedging cost for direct material purchases may be an allowable cost where the hedge arrangement provides risk reduction and is not recoverable by other means.
- 17.4. Standard components or accessory materials manufactured by the contractor and used for the purpose of the contract need not be separately costed. Such manufactured items may be charged at prices not in excess of the most favourable prices for which the items could have been purchased by the contractor from an outside or independent supplier. If the components are not available from an independent supplier the components may be allowable as a contract cost at cost of manufacture calculated in accordance with the Principles.
- 17.5. Adjustments need to be made for the following:
 - a) Costs of material for payment and other credits, including without limit available trade discounts, refunds, rebates, allowances; and

- b) Credit such income and other credits either directly to the cost of the material or allocate such income and other credits as a credit to indirect costs.
- 17.6. Costs relating to materials and parts chargeable to a cost reimbursement contract are unallowable as a contract cost until the costs are physically identifiable with the items to be supplied under the contract, unless:
- a) the conditions of contract provide otherwise; or
 - b) an Accounting Arrangement to the contrary has been established with Defence.

18. Donations

- 18.1. Subject to Annex B paragraph 18.2, donations or contributions to charitable institutions or institutions for promoting social welfare are unallowable as a contract cost.
- 18.2. Donations to an institution capable of rendering assistance to the contractor or the contractor's employees in the case of an emergency, such as a local hospital or blood bank drives, may be allowable to the extent that the costs are reasonable in accordance with the Principles, and:
- a) the action has been the contractor's past practice to make contributions consistent with those sought to be admitted; or
 - b) the contractor is able to demonstrate that circumstances have changed sufficiently to justify such donations.
- 18.3. Donations of a private nature or to institutions such as political parties and foundations are unallowable as a contract cost.

19. Employee Morale, Health, Welfare

- 19.1. Costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) which are for the purposes of improving employee morale, health or welfare are allowable, to the extent that:
- a) the costs are reasonable in accordance with the Principles; and
 - b) the action has been the contractor's past practice to incur costs consistent with those sought to be admitted; or
 - c) where the contractor is able to demonstrate that circumstances have changed sufficiently to justify such costs.

20. Entertainment

- 20.1. Entertainment costs are unallowable as a contract cost, to the extent that they are:
- a) costs of or incidental to, sale, distribution or promotion of its products;
 - b) costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities; or
 - c) costs of membership in social, dining, or country clubs or other organisations having similar purposes.
- 20.2. Costs made specifically unallowable under this Principle are unallowable under any other Principle.
- 20.3. Expenses associated with meetings and industry conferences, when called for the dissemination of technical information or discussion of production problems and the like, are allowable as a meeting cost. These latter expenses may include the cost of meals,

transportation, rental of meeting places and other incidentals provided the costs are reasonable.

21. Environmental

- 21.1. Environmental costs are the costs incurred by a contractor to prevent, abate, or remediate damage to the environment or to deal with the conservation of renewable and non-renewable resources.
- 21.2. Allowable environmental costs are generally those that are incurred for planned known environmental and compliance activities. Costs may include operational or amortised capital items. The following types of environmental costs may be allowable as a contract cost:
 - a) known environmental and compliance costs;
 - b) planned remediation costs; and
 - c) emerging legislative compliance requirement costs.
- 21.3. Unallowable environmental costs will include items such as environmental rework, fines, penalties and related rectification activities. For example environmental rectification costs resulting from defective work or accidental damage are unallowable.

22. Fines or Penalties

- 22.1. Fines or penalties and associated costs resulting from violations of, or failure of the Contractor to comply with applicable International, Federal, State, Territory, or Local Government legislation are unallowable as a contract cost.
- 22.2. For the purpose of Annex B paragraph 21.1, "associated costs" includes costs incurred in defence of actions relating to the fines and penalties.

23. Goodwill

- 23.1. Goodwill, an intangible asset, originates under a business combination when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. The excess is commonly referred to as goodwill. Goodwill may arise from the acquisition of a company as a whole or a portion thereof. Any costs associated with goodwill (however represented) are unallowable.

24. Government Assistance

- 24.1. International, Federal, State, Territory, or Local Government Assistance towards the acquisition of fixed assets is to be recognised as income over the useful life of the asset, thereby matching or offsetting the income with the related depreciation expense. Other Government assistance should be netted off against contract costs.

25. Head Office

- 25.1. Head office costs shall be allowable to the extent the costs are within the definition of an indirect cost pool, provided that the amount is reasonable.

26. Hedging Foreign Exchange Risk

- 26.1. Costs incurred for the purpose of hedging foreign exchange risk are unallowable as a contract cost.

- 26.2. If the component of the total price payable in source currency is 'significant' (i.e. more than \$1 million), the contract should be written in source currency. Where the component of the total price payable in source currency is not 'significant' the contract can be written in Australian currency, and the contract may allow for variation in the price due to exchange rate movements.
- 26.3. Defence will work with the contractor to establish payment schedules under each contract to facilitate the formation of a natural hedge for foreign exchange risks, such that revenue received from Defence in a foreign currency is available in a timely manner to pay known commitments in the same foreign currency to subcontractors and suppliers.

27. Hire Purchase

- 27.1. Hire purchase costs shall be allowable to the extent that such costs are within the definition of contract cost.

28. Idle Capacity

- 28.1. Idle capacity means the unused capacity, both human and mechanical, and including land and buildings which occurs when, through causes other than usual shut-downs, the normal productive capacity of the contractor's plant is not fully utilised.
- 28.2. Idle capacity costs shall be allowable to the extent that:
- a) such costs come within the definition of an indirect cost pool; and
 - b) the period for which the idle capacity exists is reasonable having regard to the initiative taken by the contractor to reduce or eliminate it in accordance with sound business, economic or security practices, for example by:
 - i. subletting;
 - ii. renting;
 - iii. sale;
 - iv. redeployment of labour; or
 - v. standing down of labour, and
 - c) the capacity is necessary to meet fluctuations in workload, or if not, the capacity was necessary when acquired and is now idle because of changes in program requirements, contractor efforts to produce more economically, reorganisation, termination, or other causes which could not have been reasonably foreseen.
- 28.3. The contractor's accounting system or framework is to record idle capacity separately to enable the contractor to submit to Defence the necessary facts relating to the amount involved and reasons for the idle capacity, to enable a determination to be made.
- 28.4. The cost of maintaining unused land and buildings, or any other fixed assets are unallowable unless an Accounting Arrangement to the contrary has been established with Defence.

29. Incorporation or Amalgamation

- 29.1. Costs incurred for the purpose of incorporation or amalgamations of companies are unallowable as a contract cost.
- 29.2. Costs covered by Annex B paragraph 29.1 include incorporation fees and costs of solicitors, accountants, brokers, promoters and organisers, management consultants and investment counsellors, whether or not employees of the contractor.

30. Industrial Disputes

- 30.1. The cost, either direct or as a consequence of an industrial dispute is allowable to the extent that the costs are reasonable in accordance with the Principles, however loss of profit as a result of industrial dispute is unallowable.

31. Insurance

- 31.1. Premiums, including statutory imposts incurred by the contractor in relation to risks usually insured against in the contractor's industry are allowable to the extent the costs are within the definition of contract cost, and include:
- a) the portion of the premium for the standing charges element of consequential loss insurance cover which relates to items of indirect expense allowable under the Principles;
 - b) reasonable cost for Directors Liability for the local entity only; and
 - c) premiums (or the applicable portion, as appropriate) for insurance on the lives of named key executives, for the benefit of the contractor to the extent that the costs are reasonable in accordance with the Principles.
- 31.2. The following premiums are unallowable as a contract cost (or the applicable portion, as appropriate) for insurance:
- a) against risks in respect of which the contractor does not effect insurance in the ordinary course of business (unless the conditions of contract provide otherwise or an Accounting Arrangement to the contrary has been established with Defence);
 - b) against that element of "consequential loss" insurance which relates solely to loss of profit and protection of income (as distinct from standing charges insurance cover see paragraph (a)); and
 - c) against risks in respect of which the conditions of the contract provide that Defence accepts liability for loss or damages.
- 31.3. Premiums for insurance may be allowable to the extent the costs are within the definition of contract cost and are allowable under Annex B paragraph 31.1. when:
- a) paid to a related company; or
 - b) allocated from a global policy on a reasonable basis as part of a global overhead allocation; or
 - c) charged by the contractor for risk carried by the contractor (provided any loss is to be borne by the contractor).
- 31.4. The contract cost shall be credited with the applicable portion of any recovery under a consequential loss insurance policy, to the extent that the amount received relates to costs allowed under paragraph 28.c) of the Principles.

32. Investment Allowances

- 32.1. Investment allowances or similar arrangements granted by the Australian Taxation Office are unallowable as a contract cost.

33. Joint Ventures or Alliance Arrangements

- 33.1. Joint Ventures or Alliance Arrangements are allowable costs and may include ongoing operational costs related to such arrangements and are acceptable to the extent that the costs are considered reasonable and may be allocated to the contract using GAAP.

- 33.2. These arrangements must not submit a price proposal based on average rates. Each member's workload will be priced separately using appropriate costing procedures. The total of all the joint venture member prices will be the total proposed contract price.
- 33.3. For non-competitive contracts, i.e. sole sourced (single supplier direct sourcing), intended to be awarded to a joint venture or alliance, special costs that may be attributed to such arrangement alone, such as legal, accounting and consulting fees in connection with the setting up of the joint venture, are unallowable costs.

34. Lease or Rental – Land, Buildings, Machinery, Plant or Equipment

- 34.1. Lease or rental costs (cash outflow) shall be allowable to the extent that the costs come within the definition of contract cost and to the extent that they do not give rise to partial ownership of the property (such as an option to renew or purchase at a below-market rental or price).
- 34.2. This Principle applies to a "Finance lease," as defined by Australian accounting standards. Finance leases are to be treated as purchased assets, i.e., be capitalised, and the capitalised value of such assets be distributed over their useful lives as depreciation charges or over the leased life as amortisation charges, as appropriate, except that:
- a) lease costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed if the contractor retained title, computed based on the net book value of the asset on the date the contractor becomes a lessee of the property adjusted for any gain or loss; and
 - b) if it is determined that the terms of the finance lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges are unallowable in excess of those that would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

35. Litigation

- 35.1. Litigation costs are unallowable.

36. Lobbying and Political Activity

- 36.1. Costs, either directly or indirectly, associated with lobbying or political activity are unallowable. Such costs include the following:
- a) cost of employee labour or third party labour employed specifically or principally to conduct such activity;
 - b) cost of gaining access to Ministers, including dinners and events; and
 - c) donations to political parties, political party related institutions and election costs.
- 36.2. The labour cost of employees, who in the normal course of business, meet with Government representatives or provide representation to Government is allowable.

37. Long Service Leave

- 37.1. Provisions made, or costs incurred, relating to long service leave are allowable to the extent that the costs are within the definition of a direct cost or an indirect cost pool, provided that:
- a) the contract does not provide specifically for an alternative procedure; and
 - b) the method used by the contractor for accounting for long service leave is equitable, consistently applied and based on sound accounting practice.

38. Losses on Business Activities

38.1. Losses incurred in business activities, either as a trading or investment activity are unallowable costs.

39. Manufacturing and Production Engineering

39.1. The costs of the following kinds of manufacturing and production engineering effort are allowable:

- a) developing and deploying new or improved materials, systems, processes, methods, equipment, tools and techniques that are or are expected to be used in producing products or services;
- b) dand deploying pilot production lines;
- c) improving current production functions, such as plant layout, production scheduling and control, methods and job analysis, equipment capabilities and capacities, inspection techniques, and tooling analysis (including tooling design and application improvements); and
- d) material and manufacturing productability analysis for production suitability and to optimize manufacturing processes, methods, and techniques.

39.2. This Principle does not cover:

- a) basic and applied research effort related to new technology, materials, systems, processes, methods, equipment, tools and techniques. Such technical effort is governed by R&D; and
- b) development effort for manufacturing or production materials, systems, processes, methods, equipment, tools, and techniques that are intended for sale is also governed by R&D.

39.3. Where manufacturing or production development costs are capitalized or required to be capitalized, allowable cost will be determined in accordance with the requirements of depreciation.

40. Work Health and Safety

40.1. Work Health and Safety (WH&S) costs are the costs incurred by an entity to meet the requirements of the Work Health and Safety Act 2011 (Cth) (WH&S Act), and other applicable Federal, State, Territory, or Local Government OH&S legislation.

40.2. Allowable WH&S costs are generally those costs that are incurred for planned known WH&S legislative compliance activities. Costs may include operational or amortised capital items. The following types of WH&S costs may be allowable as a contract cost:

- a) known WH&S legislative compliance costs; and
- b) emerging legislative compliance requirement costs.

40.3. Unallowable WH&S and compliance costs includes items such as WH&S rework, fines, penalties and related rectification costs of non-compliances. For example WH&S rectification costs resulting from accidents or defective work are unallowable.

41. Organisation

41.1. Costs related to the following matters are unallowable:

- a) planning or executing the organisation or reorganisation of the corporate structure of a business, including mergers and acquisitions;

- b) resisting or planning to resist the reorganisation of the corporate structure of a business or a change in the controlling interest in the ownership of a business; and
 - c) raising capital (net worth plus long-term liabilities).
- 41.2. Expenditure related to the above matters includes incorporation fees and costs of attorneys, accountants, brokers, promoters and organisers, management consultants and investment counsellors, whether or not employees of the contractor.

42. Other Business

- 42.1. Other business costs shall be allowable to the extent that the costs are considered a normal cost of conducting business operations.
- 42.2. Other business costs should be reasonable in both size and nature and must be equitably apportioned across relevant business activities or contracts, and may include:
- a) recurring expenses such as registry and transfer charges resulting from changes in ownership of securities issued by the contractor;
 - b) cost of shareholders' meetings;
 - c) costs of normal proxy solicitations;
 - d) costs of preparation and publication of reports to shareholders or employees;
 - e) costs of preparation and submission of required reports and forms to taxing and other regulatory bodies but excluding costs incurred in disputations concerning taxes;
 - f) incidental costs of directors' and committee meetings; and
 - g) cost similar to those covered by paragraphs (a) to (f) above.

43. Patent and Royalty

- 43.1. Amounts claimed in respect of use of a contractor's own patents or patents owned fully or partially by a related company or individual that are part of the same tax consolidation group are unallowable into contract cost. This does not apply to amortisation of research and development costs, which are allowable.
- 43.2. Patent and royalty costs include costs incurred by the contractor:
- a) in relation to investigating the state of the current trends, identifying current patents and making necessary application for use thereof;
 - b) for royalties, fees or lump sum acquisition costs to acquire industrial property rights; and
 - c) for legal, accounting and consulting services in connection with paragraphs (a) and (b).
- 43.3. Costs covered by Annex B paragraph 43.2 shall be allowable to the extent the costs are within the definition of direct expense and provided that:
- a) Defence has no entitlement to use free of royalty or other charges; and
 - b) except as otherwise agreed, lump sum acquisition costs shall be allowed into direct expense by way of amortisation using sound accounting principles.
- 43.4. A prospective contractor should seek an Accounting Arrangement with Defence before incurring costs, if there is any doubt concerning the allowability of the cost as a contract cost.

44. Professional and Trade Associations - Membership Fees

- 44.1. Corporate membership fees of industry or trade associations, which benefit and are reasonably necessary to the conduct of the contractor's business, shall be allowable into contract cost.
- 44.2. Membership fees of clubs or associations of a non-business or social nature are unallowable as a contract cost.

45. Property Not Used in Relation to Contract

- 45.1. Any rent, rates, taxes and depreciation charged in respect of land, buildings, plant, equipment or other property which is not used for or in relation to the subject matter of the contract and any expenses of protecting and maintaining such may be allowable to the extent the costs are within the definition of an indirect cost pool, provided that the amount is reasonable.

46. Rates of Pay In Excess of Certified Employees Agreement

- 46.1. Rates of pay, in excess of certified agreements, agreed by the contractor shall be allowable provided the costs are within the definition of contract cost and meet the following criteria:
- a) the contractor's approach to wage determination is acceptable to Defence and is consistent with the contractor's past practice;
 - b) the payments applied to Defence work;
 - c) the payment was reasonable in terms of:
 - i. other payments being made in the same geographic area for similar classifications of labour;
 - ii. the level of payment is necessary to attract and preserve the workforce or to retain the skill base necessary to the contractor's operations;
 - d) the need for the contractor to provide special or unusual skills for the purposes of the contract; and
 - e) there is a benefit to Defence.

47. Re-arrangement of Facilities or Plant – Australian Defence Purposes

- 47.1. Where Defence has approved the re-arrangement of machinery and plant to facilitate the execution of a specific Defence contract and an Accounting Arrangement to this effect has been established with Defence, related costs shall be allowable to the extent the costs are within the definition of direct expense. Such costs include the costs of installing machinery and plant supplied at no charge by Defence for the purpose of the contract.
- 47.2. Re-arrangement and installation costs, which are not directly attributable to a specific contract, shall be allowable to the extent the costs are within the definition of an indirect cost pool. Re-arrangement and installation costs for non-Australian Defence purposes are unallowable.
- 47.3. Costs incurred in re-arranging the contractor's machinery and plant to the same condition existing immediately prior to an approved re-arrangement (as in paragraph 47.1 above) are unallowable as a contract cost unless an Accounting Arrangement to the contrary has been established with Defence.
- 47.4. In circumstances other than those described in Annex B paragraphs 47.1 to 47.2, the costs of installing machinery and plant shall be allowable as a depreciable charge to the extent the costs are within the definition of an indirect cost pool.

48. Related Company

- 48.1. A related company includes a holding, subsidiary or associated company or trust of the contractor or any individual or group of individuals that are part of the same tax consolidation group.
- 48.2. The contract price payable to the contractor for goods or services which are provided by a related company must not exceed a reasonable contract price which would be payable to the

contractor if the contractor were to acquire those goods or services under an arms-length transaction with a non-related company, and in compliance with Annex B paragraph 64. Reasonable contract price shall be determined by reference to the definition of “reasonableness” in this Cost Principles document paragraph 16 to 20.

- 48.3. Any payment to, a related company to, the extent that such exceeds an amount which is reasonable is unallowable as a contract cost.
- 48.4. Where a contractor pays a related company for the use of machinery, plant or equipment, the amount allowable as a contract cost may be equivalent to either the depreciation which the owner would be allowed for income tax purposes or fair market value as provided in the Principles, provided the cost are within the definition of contract cost.
- 48.5. Where a contractor pays a related company for the use of land or buildings the amount allowable as a contract cost may be equivalent to either the costs which would be allowable under Annex B paragraphs 15.1 and 15.2 if the contractor owned the land or buildings, or fair market value as provided in the Principles, provided the costs are within the definition of contract cost.
- 48.6. Where charges made by a related company are proposed as direct cost, the related company shall be deemed to be a sub-contractor and Annex B paragraph 55.2 shall apply in addition to Annex B paragraphs 48.1 to 48.5.

49. Remuneration of Chief Executive Officer, Directors and Non-Certified Agreement Employees

- 49.1. Subject to Annex B paragraph 49.2 remuneration of the CEO, directors and non-certified agreement employees, may be allowable to the extent the costs are within the definition of contract cost provided the contractor’s approach to the fixing of the remuneration of such personnel is reasonable and is consistent, having regard to:
- a) the size and character of the contractor’s business;
 - b) the nature of the services rendered by the personnel; and
 - c) the remuneration usually paid for such services in businesses of a similar nature and risk profile.
- 49.2. Allowability of severance payments made to the CEO, directors and non-certified agreement employees, shall be determined in accordance with Annex B paragraph 59.1.

50. Repairs, Operation and Maintenance

- 50.1. The costs of repairs, operation and maintenance include those costs that have been incurred by the contractor’s central service organisation or at the departmental level for the administration, supervision, operation, maintenance, preservation and protection of the contractor’s physical plant. Repairs, operation and maintenance costs may include costs normally incurred for items such as janitorial and utility services; repairs and ordinary or normal alterations of buildings, furniture and equipment; and care of grounds and maintenance and operation of buildings and other plant and facilities. The repairs, operation and maintenance category may also include on-costs applicable to the salaries and wages included therein, and depreciation.
- 50.2. Incurred costs relating to repairs, operation and maintenance, or reasonable provisions for the costs, may be allowable to the extent the costs are within the definition of contract cost. Where provisions are allowed, actual costs are unallowable as a contract cost.

51. Research and Development (R & D)

- 51.1. R & D costs for the purposes of the Principles are categorised as:

- a) specific – that is, associated with the development of a specific product or products; or
 - b) fundamental and general – that is, of a general nature which cannot be related to any specific product but have general application and benefit various types of work including that subject to the Principles.
- 51.2. Specific R & D costs should, wherever possible, be allocated or charged direct to the cost of the products concerned.
- 51.3. Fundamental and general research and development costs may be allowable into an indirect cost pool, provided the amount and method of allocated cost is reasonable:
- a) to the extent it is not sponsored by a contract, grant or like arrangement;
 - b) is net of any realised eligible tax offset or R&D deduction; and
 - c) is accepted by Defence as being of potential benefit to Defence.

52. Security

- 52.1. Security costs, subject to Annex B paragraph 52.2, may be allowable to the extent the costs are within the definition of an indirect cost pool. These costs may include:
- a) wages, uniforms and equipment of personnel engaged in security of premises, plant or equipment; and
 - b) depreciation of equipment for the security of premises, plant or equipment.
- 52.2. Security costs incurred in excess of the contractor's normal level of security, may be allowable to the extent the costs are within the definition of:
- a) direct expense, when the contract necessitated or stipulated the additional security; or
 - b) an indirect cost pool allocable only to the final cost objectives which necessitated the additional security, when more than one final cost objective is involved.

53. Selling and Promotional

- 53.1. Selling and promotional costs which are common to the marketing of the contractor's products to Defence and to other commercial customers, may be allowable to the extent the costs are within the definition of contract cost, and are of the nature of:
- a) providing technical data and specifications;
 - b) disseminating printed matter containing instructions for operating and maintaining the contractor's products;
 - c) liaison between customer representatives and the contractor's personnel; and
 - d) other similar activities.
- 53.2. Selling and promotional costs other than the sort of costs covered by Annex B paragraphs 53.1 and 53.3 are unallowable as a contract cost, and include:
- a) entertainment expenses, i.e. expenses for amusement, diversion, social activities and incidentals; and
 - b) unreasonable commissions to selling agents or related parties.
- 53.3. Expenses associated with meetings and industry conferences, when called for the dissemination of technical information or discussion of production problems and the like, may be allowable as a meeting cost. The latter expenses may include the cost of meals, transportation, rental of meeting places and other incidentals provided the costs are reasonable.

54. Service and Warranty

- 54.1. Service and warranty costs include those costs arising from fulfilment of any contractual obligation of a contractor to provide services such as:
- a) installation;
 - b) training;
 - c) correcting defects in the products;
 - d) replacing defective parts; and
 - e) making refunds in cases of inadequate performance.
- 54.2. Costs described in Annex B paragraph 54.1 or provisions for the costs, may be allowable to the extent the costs are within the definition of contract cost unless the costs are inconsistent with the conditions of the contract or paragraphs 31 to 33 of the Principles (Avoidable Costs and Unnecessary Costs).

55. Sub-Contracts

- 55.1. Sub-contract costs are allowable, subject to any relevant special conditions of contract.
- 55.2. Where the sub-contractor is paid on the basis of a cost-reimbursable contract for costs incurred in the performance of the sub-contract, the contractor is to take reasonable steps to ensure that any agreement between the contractor and the sub-contractor specifies that:
- a) the cost basis of such payment shall include only those amounts which may be allowable under all relevant provisions of the Principles;
 - b) the sub-contractor will, on request, furnish to Defence cost statements; and
 - c) Defence shall be given right of access to the sub-contractor's records for the purpose of verifying any claim. Defence shall not be entitled to exercise its rights under this paragraph without prior notification to the contractor.
- 55.3. Where a holding, subsidiary or related company is a sub-contractor, Annex B paragraph 48.2 shall apply in addition to Annex B paragraphs 55.1 and 55.2.

56. Superannuation Fund Payments

- 56.1. Contributions to superannuation funds shall be allowable to the extent the costs are within the definition of an indirect cost pool and provided that:
- a) the fund has been established in good faith and the amounts payable to the employees, together with all other remuneration payable to the employees, are reasonable;
 - b) payments to the fund are allowable deductions for taxation purposes;
 - c) the amount allowable shall be limited to the contribution which the contractor has undertaken to pay to the Trustees of the fund; and
 - d) due credit shall be given for contributions refunded to the contractor.

57. Taxes

- 57.1. Taxes, however described, which are assessed on income or profits, and any costs incurred in controversies concerning these taxes are unallowable as a contract cost.
- 57.2. Fringe Benefits Taxes are allowable, provide the taxed activity:
- a) is incurred specifically for the contract; or
 - b) benefits the contract, and is otherwise related to costs that are within the definition of an indirect cost pool.

58. Tendering

- 58.1. Tendering costs are the costs incurred in preparing, submitting or supporting formal tenders, quotations, offers, registrations of interest or other approaches to the market in relation to potential Government or non-government contracts.
- 58.2. Tendering cost will not be allowable as a direct cost in a Defence contract unless specifically provided for in the contract or in the request for tender and shall be consistent with the relevant clauses in the Conditions of Contract or Conditions of Tender.
- 58.3. Tendering costs maybe allowable as a direct cost to the extent that:
- a) the costs directly relates to the tender/contract;
 - b) the contractor consistently applies sound practices when accounting for tendering costs; and
 - c) the costs are reasonable.
- 58.4. Tendering costs maybe allowable as a indirect cost to the extent that:
- a) the costs come within the definition of an indirect cost pool;
 - b) the contractor consistently applies sound practices when accounting for tendering costs; and
 - c) costs are reasonable;
 - d) Defence does not incur an unreasonable amount of non Defence tendering costs; and
 - e) where Defence accepts tendering costs into direct costs, costs of a like nature are unallowable as an indirect cost.

59. Termination or Cancellation of Contracts

- 59.1. These Principles apply to a contract that is terminated for convenience or by agreement.
- 59.2. The contractor may submit a claim for compensation and Defence shall pay to the contractor such sums as are fair and reasonable in respect of the termination or cancellation. All claims or provision for payment need to be substantiated to the satisfaction of Defence, noting that:
- a) the contractor is not entitled to claim compensation in respect of any work done or expenditure made contrary to the provisions of the contract;
 - b) the contractor is not entitled to claim for loss of anticipated profits;
 - c) Defence is not liable to pay any sum which, in addition to any sums paid or due or becoming due to the contractor under the contract, would together exceed the full price of the complete work ordinarily payable under the contract by Defence;
 - d) initial or advance payments made by Defence are to be offset against the total amount payable in respect to the terminated contract by Defence; and
 - e) the contractor is entitled to payments for work undertaken under the contract prior to the effective date of the termination and any other costs incurred that are directly attributable to the termination.

60. Termination of Employment

- 60.1. Allowability of payments made to certified agreement employees on severance or termination of employment shall be determined in accordance with Annex B paragraph 11 (Conditions of Employment (Other than Rates of Pay)) of the Principles.
- 60.2. Payments made to directors and non-certified agreement employees on severance or termination of employment shall be allowable to the extent that:
- a) such payments are within the definition of contract cost;
 - b) the remuneration of such employees is allowable under Annex B paragraph 49.1;

- c) the severance payments are not in excess of the conditions of entitlement which would be allowable under the provisions of Annex B paragraph 11; and
- d) the circumstances of the severance of employment are allowable under the provisions of Annex B paragraph 11.

61. Redundancy

- 61.1. Redundancy costs will not be allowable as a direct cost in a Defence contract unless specifically, agreed, for example at completion of projects in remote geographical locations, and is provided for in the contract. In such cases the scope and quantum of the redundancy payment shall be consistent with the relevant clauses in the Conditions of Contract and the payment should only relate to the period of service of the recipient against the contract.
- 61.2. Redundancy costs are only allowable into an indirect cost pool such as company General & Administrative (G&A) or overheads, to the extent they are for the purpose of obtaining ongoing cost reductions for the organisation as a result of restructuring an inefficient workforce and or work practice.
- 61.3. Where the Commonwealth allows for redundancy costs as a direct contract cost it is not permissible to claim any element of the cost, such as the balance of the costs not recovered directly, as an indirect cost.
- 61.4. Allowability of payments made to employees under a Certified Agreement on severance or termination of employment shall be determined in accordance with Annex B paragraph 11. (Conditions of Employment (Other than Rates of Pay) of the Principles. Redundancy payments made to non-certified agreement employees should not be excessive or unreasonable. In considering the reasonableness of the redundancy amounts it will also take into consideration the Fair Work Commission guidelines.
- 61.5. Defence is not liable for redundancies costs that could be avoided or reduced by the effective management of the workforce.
- 61.6. Defence is not liable for redundancy payments made to employees in respect of time spent by the employee working on non-Defence contracts.
- 61.7. Redundancy costs will only be allowable where the claim is reasonable and is in accordance with Cost Principles.

62. Trade Exhibitions

- 62.1. Trade exhibition costs include the reasonable cost of attendance at relevant international trade shows and are allowable as an indirect cost, providing the reassignment of a share of cost from an indirect cost pool results in equitable distribution of this indirect cost item.

63. Training and Education

- 63.1. Training and education costs include the reasonable costs, which are related to the field in which the employee is working or may reasonably be expected to work, and are allowable.
- 63.2. Training or education costs for non bona fide employees (e.g. SMEs, Defence employees) are allowable if undertaken in conjunction with an existing employee-training program.
- 63.3. The inclusion of overseas education, as either a direct or an indirect cost, is allowable where reasonable and justifiable by the contractor.

64. Transfer Pricing or Inter-entity Pricing

- 64.1. Transfer or Inter-entity pricing must meet the requirements of the Income Tax Assessment Act 1936 (CoA) regarding Transfer Pricing at Arm's Length. All documentation held by the

company to meet the legislative requirements must be made available to Defence for review should this be requested.

65. Travel

- 65.1. Travel and living costs of a private nature are unallowable as a contract cost. Travel costs specifically exclude the cost of spouse/partner travel costs. Travelling and living costs related to travel within Australia, which are incurred by a contractor in the ordinary course of business, shall be allowable to the extent they come within the definition of an indirect cost pool.
- 65.2. Travelling and living costs necessarily incurred in the performance of the contract shall be allowable to the extent they come within the definition of direct expense, unless the conditions of the contract provide otherwise. Travel cost entitlements and rates should be reasonable, may include alcohol with a meal, and should have regard to the entitlements applicable for public servants of equivalent rank and using commercial airlines.
- 65.3. Where travelling and living costs shall be allowable into direct expense of the contract, costs of a similar nature, which are direct expense items applicable to other final cost objectives, shall not be allowable into indirect expense.

66. Travelling and Living - Overseas

- 66.1. Overseas travel and living costs of a private nature are unallowable into contract cost. Travel costs specifically exclude the cost of spouse/partner travel costs, except where travel is a result of family relocation due to work requirements or family reunion.
- 66.2. Defence reserves the right to disallow travelling and living costs or part thereof related to travel overseas that are not covered by:
 - a) a contract requirement or, if there is a requirement, not in support of the contract requirement, or
 - b) an Accounting Arrangement, which, if established with Defence, may relate to a specific journey or may be of general application to overseas travel.
- 66.3. Where travel is related to the contract, the cost allowable shall be included in direct expense to the extent, if applicable, of the amount specified in the contract or the Accounting Arrangement for each particular instance of travel. Travel cost entitlements and rates should be reasonable, may include alcohol with a meal, and have regard to those applicable for public servants of equivalent rank and using commercial airlines.
- 66.4. In cost re-imburement contracts, the contractor shall make a submission for approval by Defence detailing:
 - a) the purpose of the journey;
 - b) the benefit to accrue to Defence from the travel;
 - c) the information and reports which shall be made available to as a consequence of the travel;
 - d) an estimate of travel, living and associated costs;
 - e) an estimate of any amount received or receivable in respect to the overseas travel, for example, a grant; and
 - f) the proposed basis/bases for allocating the costs

Annex C – Definitions

For the purposes of the Principles, unless the contrary intention appears, the definitions set out in this Annex C apply.

Term	Definition
Accounting Arrangement	means an agreed approach to the application of the Cost Principles as outlined in writing and approved by Financial Investigations Services (FIS). This may be achieved by an exchange of letters as directed by FIS.
allocate	means to assign an item of cost or part thereof to contract cost, and includes both direct assignment of cost and the reassignment of a share of cost from an indirect cost pool. "allocated" or "allocating" have a corresponding meaning.
allow (allowed or allowable)	means that the cost may be allocated in accordance with the Principles to the contract cost. "allowed" or "allowable" have a corresponding meaning.
company	includes an individual, a partner, or a corporate entity
contract cost	means the sum of all or any of the following allowable costs: <ul style="list-style-type: none"> a) direct cost; b) indirect-expense; and c) appropriate credits as hereinafter defined or as otherwise explained.
contract margin	means that amount additional to allowable costs determined on an agreed basis which is embodied in the contract terms and conditions.
contract price	means the price reached by the addition of contract cost and contract margin.
cost objective	means a functional or organisational subdivision or work unit for which provision is made to accumulate costs. Producing, operating, processing departments or cost centres are examples of cost objectives.
direct cost	means the sum of: <ul style="list-style-type: none"> a) direct expense; b) direct labour cost; c) direct material cost; and d) direct sub-contract cost.
direct expense	means any incurred cost that: <ul style="list-style-type: none"> a) relates to and is economically traceable to the contract; b) can be charged directly to the contract in accordance with sound accounting principles, appropriate for the purposes of the contract, consistently applied; c) is allowable in accordance with the Principles; and d) is reasonable;

Term	Definition
	other than direct material cost, direct labour cost and direct sub-contract cost.
direct labour cost	<p>means a cost that is:</p> <ul style="list-style-type: none"> a) incurred on wages and salaries paid by the contractor for labour performed on and directly applicable to the product, process or service to be supplied under the contract; b) allowable in accordance with the Principles; and c) reasonable.
direct material cost	<p>means a cost incurred by the contractor on materials and fabricated parts that are incorporated in the end product or service, (but not including those materials and parts received from sub-contractors) provided such cost:</p> <ul style="list-style-type: none"> a) relates to and is economically traceable to the contract; b) can be charged directly to the contract in accordance with sound accounting principles, appropriate for the purposes of the contract, consistently applied; and c) is reasonable.
direct sub-contract cost	<p>means a cost incurred by the contractor under a contract with a supplier for the supply, in accordance with design and specifications supplied by the contractor or Defence, of goods or services, and which cost:</p> <ul style="list-style-type: none"> a) relates to and is economically traceable to the contract; b) can be charged directly to the contract in accordance with sound accounting principles, appropriate for the purposes of the contract, consistently applied; c) is allowable in accordance with the Principles; and d) is reasonable.
final cost objective	<p>means a cost objective to which are allocated both direct and indirect costs and which, in the contractor's cost accumulation system, is a final accumulation point. Products, contracts, capitalised projects and Defence cost reimbursement contracts are examples of final cost objectives.</p>
incur	<p>means</p> <ul style="list-style-type: none"> a) in relation to a direct cost or indirect expense, to expend funds to reduce a financial obligation; and b) in all other cases, to accept a legal liability to reduce a financial obligation at some time in the future. <p>"incurred" has a corresponding meaning.</p>
indirect cost pool	<p>means a group of indirect expenses incurred by the contractor which:</p> <ul style="list-style-type: none"> a) can be logically aggregated, and b) can be allocated to cost objectives, or where appropriate, to another indirect cost pool, on an equitable basis in accordance with sound accounting principles, appropriate for the purposes of the contract, consistently applied.

Term	Definition
indirect expense	means any incurred cost which: <ul style="list-style-type: none"> a) can be charged to the contract in accordance with sound accounting principles, appropriate for the purposes of the contract, consistently applied; b) is not chargeable as direct cost to any final cost objective; c) is allowable in accordance with the Principles; and d) is reasonable.
related company	means a company that is connected with or owned by another, company
secondary products	means goods or services produced by an industry other than the primary product of that industry, including any second grade product, material wasted, scrapped, spoiled or otherwise discarded or left over in the process of manufacture.
small to medium enterprise (SME)	a small to medium enterprise is an Australian or New Zealand firm with fewer than 200 full time equivalent employees
sole source or single supplier direct sourcing	have the meanings given by the Commonwealth Procurement Rules 2014 and Defence Procurement Policy Manual (DPPM).
total cost incurred	means total costs of operation during the period, of the specific unit of the contractor's business to which Defence's interest is confined, including general and administrative expenses but excluding exceptions specified at Annex B.
unallowable	means that the cost may not be allocated in accordance with the Principles to the contract cost.