



GENERAL TERMS FOR COST CONTROL

These conditions only apply to tenders and contracts which are subject to cost control.

NORWEGIAN DEFENCE MATERIEL AGENCY

1 General Conditions

These conditions are based on the rules for contract audit outlined in the Norwegian Defence Acquisition Regulations (DAR), part 17.

1.2 Cost Control

When cost control is imposed, the Contractor is obligated to:

- verify all data
- present the Norwegian Defence Materiel Agency with a detailed estimate showing which costs the Contractor has included as direct costs, and the basis for calculating indirect costs
- present all tenders, purchase orders, estimates, budgets, accounts, vouchers and other calculations used in establishing the contract price
- if so requested, provide copies of the above documentation
- provide all information which the Norwegian Defence Materiel Agency consider relevant to determining the costs
- allow the Norwegian Defence Materiel Agency access to the abovementioned accounting data, documents, and information throughout the entire contract period, and up to one year after final settlement has been made.

Cost Control is performed as a main rule when the purchase is done without competition or when the competition is unsuccessful, e.g. when only one offer is received or there is only one qualified supplier.

1.3 The Financial System

- a Without prior approval from the Norwegian Defence Materiel Agency, the Contractor may not change accounting methods or practices if this will increase the costs of contracts with the Norwegian Defence Materiel Agency.
- b The Norwegian Defence Materiel Agency do not impose separate special requirements concerning the financial system. However, it is assumed that the Contractor has adequately detailed guidelines for cost estimation as well as cost accounting and bookkeeping systems. Accounting practices must comply with current legislation and generally accepted accounting principles and accounting standards.
- c The accounts should be sufficiently itemized to allow identification of those costs dealt with in article on "Unallowable Costs" (ref item 3). In cases of diversified operations, the accounts should clearly distinguish between the separate areas of activity.
- d Should the Norwegian Defence Materiel Agency control body find it necessary to make amendments to the Contractor's accounting practices, such amendments must be agreed upon prior to the Contract being entered into.
- e If the Contractor's accounts have been kept in a manner which does not provide sufficient basis for deciding whether the costs are allowable or unallowable, the procuring authorities will only accept those costs which the Contractor can satisfactorily document as related to the contract.

1.4 Right to Audit

- a If part of the delivery is to be supplied by a subcontractor belonging to the same industrial group as the Contractor, or in whom the Contractor has a controlling interest, or vice versa, the main Contractor shall ensure that the Norwegian Defence Materiel Agency are granted access to all relevant financial information by the subcontractor. The same principle shall apply for agent agreements. The procurement authorities may also decide that these regulations shall apply to other subcontractors.
- b The Armed Forces' control body shall have complete access to documentation and handbooks of the financial accounting- & management information system.

1.5 *Confidentiality*

The Norwegian Defence Materiel Agency are responsible for ensuring that all information, figures, data etc which they acquire knowledge of are treated as confidential, and are not disclosed to third parties. The Office of the Auditor General, however, shall have access to all information that they deem necessary for carrying out their audits.

2 Cost Accounting Method

2.1 *General*

Costs which according to these regulations are not to be included in the cost estimate, will be disapproved by the procurement authorities. Costs incurred prior to the Contract being entered into are only to be approved if this has been explicitly agreed in the Special Contract Provisions. Costs related exclusively to contracts should, in principle, be registered and treated as direct costs. However, these must not include costs that are covered by the overhead cost applied by the Contractor.

2.2 *Calculation method (specification of pricing proposal)*

Preferably, the cost of executing contracts shall follow the full cost concept, and be made up of the following main cost elements:

- direct material costs
- direct labour costs
- other direct costs
- indirect costs
- independent research and development expenses
- capital cost, based on interest-bearing capital.

Cost allocation must be made on the basis of consistent guidelines.

2.3 *Direct Material Costs*

This is the Contractors' cost of materials that are directly attributable to the product. Any material costs connected with rejects, reworks, or scrapping are to be included in this cost element. They are to be charged directly to the order for materials used. Materials requisitioned from stock are to be accounted for in accordance with consistent application of Generally Accepted Accounting Principles. Actual withdrawals from stock, less excess materials, are to be registered. The costs of materials shall be reduced by the discounts that the Contractor receives, or could have obtained. The price level in the calculation must be in accordance with the base level in the tender.

2.4 *Direct Labour Costs*

Labour rates comprise pay and other costs that can be allocated to a specific cost objective. Pay to other personnel is to be treated as indirect costs. Overtime pay will only be accepted if this is necessary for the required time frame for delivery, or stated in the Special Contract Provisions. Man-hour consumption shall be calculated on the assumption that:

- the specified man-hour consumption is in reasonable commensurate with the Contractor's available capacity and planned production period
- the proposed man-hour consumption is based on actual cost calculations for previous, similar productions,
- consideration has been given to learning curves and expected rationalization
- the number of direct labour hours does not include time which, according to the Contractor's cost recording, is to be considered as indirect labour time.

2.5 *Other Direct Costs*

Comprise all other direct costs which don't conflict with article 2.1 above. For example, allowable development and construction costs, tools manufactured by the Contractor, equipment and other nonrecurring costs.

2.6 *Indirect Costs*

Unless special conditions indicate otherwise, the indirect costs shall, as a minimum, be allocated between the following cost centres and cost groups:

- one or more purchasing or material handling centres
- one or more production centres
- one or more sales and administration departments

The Contractor must be able to document the actual costs which form the allocation basis for indirect costs. Cost allocation guidelines must be designed to ensure that indirect costs are reasonably apportioned to the cost drivers.

a Material Handling Overhead

This item comprises indirect costs related to handling materials, stock management, transport costs (if any), purchasing, quality control etc. These increments are calculated as the ratio of material handling costs to total material costs.

b Manufacturing Overhead

This item comprises indirect costs which can be apportioned to the production centre(s). Examples are the costs of pay to foremen, depreciation on machinery and tools, factory rent, electricity, heating, and other running expenses. The overhead is to be calculated either as the ratio of the production centre's indirect manufacturing costs to total direct hours, or as the ratio of total indirect manufacturing costs to total direct labour-cost.

c General, Sales and Administrative Costs

This item includes the company's sales and administration costs. Examples are the costs of the finance/accounting departments, personnel office, sales and marketing, depreciation on buildings and office equipment, and other general expenses. The overhead is normally calculated as the ratio of the company's total sales and administration costs to total production costs.

d Depreciation

Depreciation on fixed assets shall be calculated on the basis of historic acquisition costs, according to a systematic depreciation spread over the estimated useful economic life of the asset. The calculation shall be in accordance with Generally Accepted Accounting Principles (GAAP).

It is assumed that business management and accounting considerations should be used for appraising and depreciating assets. As a rule, the same considerations should apply for appraisals of deliveries to the defence sector.

In those cases where it can be documented that the machinery and equipment are subject to exceptional wear and tear due to a contract with the Armed Forces, separate depreciation rates may be agreed in the Special Contract Provisions. Depreciation in subsequent years will be reduced accordingly.

It is possible to demand that extraordinary costs of repair and maintenance be capitalized.

e Marketing costs

The Norwegian Defence Materiel Agency accept a proportional share of the marketing costs, provided that these are apportioned to all products/contracts according to specific criteria (principle of proportionality).

For calculation purposes, the Contractor can request that non-recurring expenses related to major marketing campaigns may be amortized over several years.

3 **Unallowable Costs**

In order to avoid unreasonable charges to Armed Forces' contracts, some costs are regarded as unallowable. These costs include:

- depreciation on buildings, machinery and equipment which, by agreement, have been paid for, or will be paid for by the Armed Forces.
- actual interest costs
- foreign exchange losses
- losses on contracts and deliveries, including insurance against loss of a contract
- daily fines, and compensatory damages, costs and legal fees for legal action, or preparation of such
- product (oriented) development and construction costs, which are not related to the Armed Forces' contract
- materials wastage above and beyond normal rejection, scrapping, and rework
- gifts which are not tax deductible.
- entertainment costs which are not deductible for tax purposes.
- premium for special life/pension insurance benefiting specific individuals
- costs concerning business development e.g. mergers, acquisitions, joint venture establishments, the Contractor's reorganizations, ownership structure and/or legal status etc, and related financing costs
- state and municipal income tax
- costs which are charged directly to a contract may not be included as an indirect cost, and vice versa
- if a unallowable cost is included in an allocation basis, the base is not to be reduced by the (amount of the) unallowable cost.

Costs which by nature, description or size are clearly unreasonable in relation to the Armed Forces' contract, are regarded as unallowable. Since this list cannot include all cases, it must be regarded as non-exhaustive.

4 Independent Research and Development Expenses

Research and Development costs are the measurable costs that accrue to the Contractor as a result of activities carried out to further develop the company's general and technological know-how and level of competence.

In addition, development activities where the outcome is relevant to all products in a product group which represent a significant part of the company's total product range, or represents know-how and competence building related to the defence sector's expected needs can be approved as Independent Research and Development Expenses.

Direct development costs associated with concrete projects (product oriented development) are to be paid by the purchaser.

Independent Research and Development costs are calculated as a percentage mark-up of operating costs, normally limited to a maximum of 4 percent. The rate is only used after an assessment of the development activities and their associated costs.

Contractors who believe they are entitled to have Independent Research and Development costs covered are expected to prepare annual statements and descriptions of their total development activities.

5 Capital Cost

The capital value used for calculating capital cost and profit/risk compensation is termed interest-bearing capital. It represents that part of the Contractor's essential operating assets which is financed by owner's equity and interest bearing debts. The value is based on total assets as per current balance. The total balance sheet value is reduced by the value of non-essential operating assets and non-interest-bearing debt. Interest-bearing capital shall be assigned a return based on a Calculated Interest Rate.

The Calculated Interest Rate shall be equal to average "annual interest rates (paid in arrears), monthly average calculation of the interest on representative 10 Year Government Bonds" for the preceding 12 months, plus 1,5 percentage points. The interest rate is intended to compensate for a company's average cost of capital, both short-term and long-term.

For contracts subject to cost control an average interest rate for each year of the contract implementation period should be established.

When calculating the mark-up for capital cost the following equations shall be used:

$$(1) \quad K(\%) = \frac{R(r) - yield}{D} 100$$

where:

K	=	Mark-up for Capital Cost
R	=	Interest-bearing Capital
r	=	Calculated Interest Rate
D	=	Contractor's total operating cost based on the same structure as the calculation method in part 2.2
Yield	=	deduction of return received on liquid assets accepted as part of essential operating assets based on the following calculation:

$$(2) \quad Yield = \left(\frac{Accepted \ liquid \ assets}{1 + 0,5r} \right) * 0,5r \left(\frac{Interest - bearing \ debt \ and \ equity}{Total \ debt \ and \ equity} \right)$$

6 Profit/Risk compensation

The profit is added to owner's equity to cover risk. The profit shall cover general business risk, and any special risks. General business risk (u1) is fixed at 2 percent of Interest-bearing Capital (R). Special risk (u2) is risk associated with individual contracts and can only be covered when the Contractor proves what special risk he is exposed to. Such risks shall be specified as detailed as possible in the Contract. Special risk is calculated as a percentage of Interest Bearing Capital (R).

Special risk is dependent on:

- A The duration of the Contract
- B Complexity/ degree of innovation
- C Contract type

Relationship between risk increment and risk reduction

Risk element	Basis		Deduction point c	Total
Duration of Contract	0 – 4,5%		100 – 0%	0 – 4,5%
Complexity	0 – 12,0%		100 – 0%	0 – 12,0%
Total increment u2	0 – 16,5%	70%– 0%	100 – 0%	0 – 16,5%

Calculation of u2

$$(3) \quad u_2 = (a + b)x(1 - c)$$

Where:

- u2 = special risk measured as a percentage of Contract operating costs
- a = risk increment concerning the duration of the Contract
- b = risk increment concerning the Contract's level of complexity/innovation
- c = reduction of risk due to contract type

Calculation of mark-up for total risk compensation:

$$(4) \quad (\sum u_1, u_2) xR / D = [u_1 + (a + b)x(1 - c)] xR / D$$

7 Price adjustment

- a The price of future acquisitions must be based on a given cost level at a given point in time prior to the Contract being entered into. In such cases, the contract may specify how the price is to be adjusted later, in order to reflect changes in the cost level during the contract period. This only applies to changes beyond the Contractor's control. To achieve this, a price escalation formula must be linked to the basic price.
- b In the case of delayed deliveries which are not caused by the Norwegian Defence Materiel Agency or force majeure, compensation shall not be awarded for increases in cost of materials or labour for the duration of the delay.
- c Special rules and regulations apply in cases when the authorities have introduced salary and/or price freezes. These may completely or partly override the price adjustment conditions of the Contract.
- d The price escalation formula must be formulated so that none of the parties gain nor lose from cost level fluctuations. As a general rule, a price adjustment clause should only be applied to contracts with a duration of one or more years. For contracts of shorter duration, the risk associated with expected cost variation is of lesser magnitude. Any anticipated variation should therefore be negotiated and included in the contract price.