

SSRO

Single Source
Regulations Office

**Allowable Costs guidance:
overheads and indirect costs**
Consultation on guidance changes
May 2022

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1. Introduction

- 1.1 We are consulting on changes to the Allowable Costs guidance to help contractors and the MOD to reach agreement on costs to be included in the calculation of the price of qualifying defence contracts. Section 20 of the Defence Reform Act 2014 (the Act) states that the SSRO must issue guidance about determining whether costs are Allowable Costs under qualifying defence contracts (QDCs) or qualifying sub-contract (QSCs).
- 1.2 Single source contractors have reported difficulties in recovering overhead costs that the MOD considers do not contribute to contract performance.¹ We are consulting on four proposals (see 4.2) to change our guidance and assist parties in complying with the legislation.
- 1.3 The current Allowable Costs guidance was published in Autumn 2012. The SSRO, in consultation with stakeholders, prioritised a review in 2021 of the guidance relating to overheads and indirect costs. This guidance is in Part 3: The AAR Principles and Part 4: Cost accounting and financial reporting.
- 1.4 As part of the review, which commenced in Summer 2020, the SSRO:
 - a. issued working papers to the SSRO's overheads and indirect cost review working groups whose members are from the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors;
 - b. held group and individual meetings with members of the working groups to discuss the issues raised by the SSRO's review; and
 - c. received written responses to the position paper on guidance changes from stakeholders and contractors.
- 1.5 The SSRO would like to thank working group members for sharing their views with us. Their input has helped the SSRO to develop the proposals for revision to its guidance contained in this document for public consultation.
- 1.6 The Defence Command Paper³ published in April 2022 includes proposals which are aimed at removing barriers to funding innovation through the allowable costs of qualifying contracts, while increasing the speed and efficiency of the regime. We consider our proposals to improve how the Allowable Costs guidance covers overheads, support these discussions and includes new wording around treatment of research and development costs.

1 The following examples were provided in the pricing guidance review 2018: redundancy and restructuring costs; preventative maintenance of buildings and equipment; apprentice training; intellectual property/patent costs; training indirect staff; private venture research and development; development and implementation of strategic business and operational systems; insurance exceeding legal or contractual requirements; investor relations; company group costs; corporate social responsibility, e.g. green initiatives; and membership of trade or professional bodies.

2 [SSRO Allowable Costs guidance Version 5.1 \(publishing.service.gov.uk\)](https://publishing.service.gov.uk)

3 [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations - GOV.UK \(www.gov.uk\)](https://www.gov.uk)

- 1.7 We will continue to work with the MOD on the implementation of their proposals on allowable costs and ensure this is coordinated with revisions to the Allowable Costs guidance. The SSRO invites all interested parties to comment on the draft guidance contained in sections 5, 6 and 7 of this document by 18 July. The proposed timetable for publication and application of the final guidance is contained in section 8. Our consultation questions and details of how to respond to the consultation are contained in section 9.

2. Concepts and terms used in the consultation

- 2.1 The Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations) require that the price paid to a contractor under a QDC or QSC is determined using the formula:

$$\text{Price} = \text{AC} + (\text{AC} \times \text{CPR})^4$$

- 2.2 AC is the contractor's allowable costs, determined in accordance with one of the six regulated pricing methods. CPR is the contract profit rate for the contract.
- 2.3 A cost must be appropriate, attributable to the contract, and reasonable in the circumstances (AAR) to be an allowable cost under a qualifying contract. We refer to the elements of this test as the **requirements of allowable costs**.
- 2.4 The requirements of allowable costs must be met whether those costs are:
- direct or overhead costs; or
 - directly recovered or indirectly recovered.
- 2.5 The approach to determining whether all such costs meet the requirements of allowable costs falls within the scope of the SSRO's [Allowable Costs guidance](#).
- 2.6 The terms set out below and their descriptions are provided to be used in the interpretation of this document. A detailed glossary is provided at appendix 1.
- **Direct cost** means a cost that can be traced to a discrete package of goods, works or services under contract. A **directly recovered cost** is one which is allocated to a contract.
 - **Overhead cost or overhead** means a cost which cannot be traced, or that the parties agree not to trace, to a discrete package of goods, works or services under a contract⁵.
 - **Indirect cost or Indirectly recovered cost** means a cost that is apportioned and assigned to a contract using a cost recovery rate. Indirect costs would typically include overheads. Some direct costs, such as labour, may be applied indirectly as a matter of convenience.

⁴ Section 15 of the Act and regulation 10.

⁵ For example, it may not be possible to trace the costs of an HR function to the provision of a package of manufacturing activity provided under a contract.

- 2.7 The Regulations use the terms “direct cost” and “indirect cost” but do not provide a generally applicable definition of each term. In Part 5 of the Regulations (contract reports), regulation 29(5) defines direct costs and indirect costs for the purpose of the contract costs statement (CCS), which requires the contractor to provide an annual profile of the direct and indirect costs included in the actual allowable costs of a QDC or QSC.

Table 1: relationship between cost types and recovery methods

	Directly recovered costs: a cost that is not applied to a cost object with a cost recovery rate	Indirectly recovered cost: a cost applied to a cost object with a cost recovery rate
Direct cost: a discrete package of goods, works or services that can be traced to a single cost	Where a cost can be traced and it can be applied directly to the cost object, a rate is not involved in estimating attribution	Where the choice is made to estimate the attribution of a group of packages, rather than attribute each discrete package individually
Overhead cost: not a direct cost	Exists where the choice is made to apply a cost that is attributable to many cost objects to a single cost object	Where a cost cannot be assigned to a single cost object and is applied using a rate

3. Overview of Allowable Costs guidance

- 3.1 The SSRO's Allowable Costs guidance is intended to support parties to determine whether the requirements of Allowable Costs are met. The current version of the [Allowable Costs guidance](#) is version 5.1, which applies from 29 September 2021. This section reviews the SSRO's existing guidance on determining whether overheads or indirectly recovered costs are allowable.
- 3.2 Section 3 of the guidance sets out typical characteristics of costs that meet each of the requirements of Allowable Costs. All three AAR requirements (a, b and c below) must be met for a cost to be allowable, but the guidance recognises that judgement will be required as to their relative importance when considering the allowability of any cost⁶ – i.e. a differing standard of evidence may be acceptable to both parties for different types of cost. In broad terms the guidance seeks to have parties consider characteristics that relate to:
- a. the type of activity from which the cost arises (**appropriate**)⁷;
 - b. the relationship between the cost, the contract and the method of recovery (**attributable** to the contract)⁸; and
 - c. the amount of cost sought to be recovered (**reasonable** in the circumstances)⁹.
- 3.3 We identify four characteristics of costs that meet the requirement of being reasonable in the circumstances, which includes that a reasonable person informed of the facts would consider the cost consistent with enabling the performance of the contract in question. We also specify enabling performance of the contract as a characteristic under the appropriate and reasonable requirements. The guidance (paragraph 3.8) gives an inclusive definition, i.e., references to costs that enable the performance of the contract include those suitably and necessarily incurred by the contractor to:
- deliver the contract in question; or
 - deliver multiple contracts including the contract in question and equitably apportioned to those contracts.”
- 3.4 The guidance further provides that “*delivering the contract in question may require sustaining an essential or desirable capability*”.

⁶ Allowable Cost Guidance v.5.1, paragraph 3.3

⁷ Allowable Cost Guidance v.5.1, paragraph 3.11

⁸ Allowable Cost Guidance v.5.1, paragraph 3.12

⁹ Allowable Cost Guidance v.5.1, paragraph 3.13-3.14

4. Overheads and indirect costs as allowable costs in qualifying contracts

- 4.1 This section reviews the evidence provided to the SSRO on the agreement of overhead costs as allowable under qualifying contracts. It sets out our position on updating the allowable costs guidance, to better address how the requirements of allowable costs may be applied to overheads.
- 4.2 The SSRO discussed with stakeholders four proposals for improvements to the Allowable Costs guidance in relation to overheads.

Proposal 1 – Assist parties to agree overheads and costs recovered indirectly by providing additional guidance on the concepts of enabling the performance of the contract and sustaining an essential or desirable capability.

Proposal 2 – Include examples in the Allowable Costs guidance to show how costs should be assessed in circumstances where timing differences make it difficult to apply the requirements of allowable costs.

Proposal 3 – Introduce a new section in the Allowable Costs guidance on indirect costing, giving specific guidance on the application of the requirements of allowable costs to the agreement of cost recovery rates that will be used to calculate allowable costs.

Proposal 4 – Provide guidance that better supports discussions about allowable costs at a business unit level.

Stakeholder feedback and SSRO response

- 4.3 The below section sets out feedback we have received, guidance changes we propose in response, or where we propose no change, we have set out our reasoning. We have consolidated feedback under various headings for ease of reading.

Enabling the performance of the contract

- 4.4 Industry stakeholders submitted that the Allowable Cost guidance is out of step with the intent of the legislation and presents a barrier to claiming reasonable overheads as allowable costs under QDCs. They cited in support the MOD's single source procurement framework¹⁰ where it states that a cost may be:
- attributable if it is necessary to the overall operation of the business, although a direct relationship to any particular contract item cannot be shown; and
 - allocated to MoD contracts on a basis consistent with the contractor's cost accounting practices as applied to MoD single source and other, non-MoD contracts.

¹⁰ MOD single source procurement framework v.3.0, 2014

- 4.5 One suggestion was to remove “enabling the performance of the contract” from the guidance, arguing that it can be difficult to show this for some necessary costs of doing business.
- 4.6 Industry respondents acknowledged that the SSRO’s 2018 pricing guidance review¹¹ had resulted in more consistent reference to costs that ‘enable the performance of the contract’ as potentially suitable for recovery as allowable costs. They felt that it can be difficult to demonstrate that some necessary costs of doing business enable the performance of a QDC or QSC. There was a belief that there are inconsistencies in the interpretation and application of this aspect of the guidance for costs that “enable the performance of the contract”. Industry respondents suggested that the SSRO should:
- remove references to enabling the performance of the contract from the guidance; or
 - provide further clarification on the scope of cost that enable the performance of the contract, particularly with regard to costs that are not proximate, or where the benefits arise outside of contract performance.
- 4.7 The MOD indicated that the challenge in applying existing guidance regarding costs which enable the performance of the contract, is that different considerations are necessary when assessing reasonableness of direct and indirect costs. They suggested closer examination of the concepts of “enabling the performance of the contract” and “sustaining an essential or desirable criteria”.

SSRO response

- 4.8 The SSRO’s guidance that a cost should enable the performance of the contract is consistent with the requirement (in section 20 of the Act) that, to be allowable, a cost must be “attributable to the contract”. We consider this requires a link between the cost and the contract and industry representatives did not identify anything in the legislation which contradicts this construction.
- 4.9 We have considered the MOD single source procurement framework which was referred to by industry¹². That document does not override the legislation. It makes the following statements, which we consider consistent with the intent of our guidance:

“The purpose of the attributable principle is to ensure that only costs incurred for the benefit of the MOD under qualifying contracts are assessed as allowable costs. Otherwise costs incurred on, for example, non-MOD contracts, could be considered both appropriate and reasonable yet bear no relation to a qualifying contract.”

“When considering [the attributability principle] above, the MOD will have regard to the outputs of discussions with suppliers on their long-term overhead plans to determine whether or not a given cost should be passed back to the MOD”

¹¹ [SSRO Pricing guidance revised January 2019 \(publishing.service.gov.uk\)](https://www.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/771111/ssro-pricing-guidance-revised-january-2019.pdf)

¹² MOD single source procurement framework v.3.0, 2014

- 4.10 It is our intention that the guidance should be interpreted in such a way that includes overheads that are incurred to operate as a business as being allowable costs, so long as there is some relationship between the cost and the operations that enable the delivery of QDCs. This need not be strong causal link in the case of an overhead. Such costs may enable the performance of a contract and satisfy the requirements of allowable costs. We have made this clear in our proposed guidance to encourage consistent application.
- 4.11 We would emphasise that “enabling the performance of the contract” is one of a range of typical characteristics set out in the guidance to indicate whether a cost meets the requirements of allowable costs. These characteristics are included to draw the parties’ attention to matters it may be relevant to consider in assessment of AAR; they are neither additional tests nor substitutes for those requirements.
- 4.12 We would expect the parties to recognise that the emphasis and informational requirements in relation to “enabling the performance of the contract” would be different in the case of overheads than for a direct cost. It would not be reasonable to expect an overhead to be evidenced as enabling the performance of a contract in the same way as a direct cost. We clarified this in our proposed guidance changes (see revised para 3.11 in section 6),

Attribution and causality

- 4.13 Industry respondents submitted that a strong causal link was still being sought by the MOD between the cost and the contract, which may not be possible due to the general nature of overheads. They raised concerns about changing guidance to include terminology which requires a causal link or beneficial impact between incurring a cost and delivery of the contract. They thought such wording introduces additional barriers and evidence requirements in agreeing allowable costs not contained in the legislation.
- 4.14 We heard representations from industry that the agreement of a QMAC¹³ provided sufficient evidence that a cost is attributable to the contract. They argued that any additional evidential challenges in the SSRO’s guidance would create unnecessary work.

SSRO response

- 4.15 Section 20(2) of the Act specifies that allowable costs must be ‘attributable to the contract’ and we remain of the view that this requires a link between each cost and the contract. We are unpersuaded that a cost incurred without relation to the past, current, or future conduct of qualifying contracts, should be considered attributable to those contracts¹⁴.

¹³ Questionnaire: Method and Allocation of Costs (QMAC), which discloses in a standardised way the criteria used in deciding which costs are to be treated as direct and which are indirect, to assist in the process of assessing whether indirect costs may be part of allowable cost.

¹⁴ This should not be taken to mean that costs which could have been avoided cannot be allowable costs.

- 4.16 A cost will clearly have the required link to the contract where it is consequent upon activities under the contract, or activities under the contract which result from the cost being incurred. This link may be less apparent for overheads. Overheads by their nature are not traced to the performance of the contract, but may still be considered to enable the performance of the contract. We have expanded the existing paragraph 3.8 in the draft guidance in section 6 of this consultation in order to support this understanding.
- 4.17 We do not refer to causality in the guidance to avoid an over-emphasis on demonstrating a strong or immediate causal link between the cost and the contract. Some general business costs may arise as a clear and direct consequence of delivering the contract, or vice versa, and in such cases the question of attributability should be easily resolved. The required link can be made for costs which are less clearly associated with delivery of the contract, on production of a proportionate level of evidence that the costs are necessary to deliver the contract. The new examples we have included in sections 3, 4 and 5 illustrate scenarios where costs may be allowable despite an indirect route of causality in delivering the contract.
- 4.18 The existence of a QMAC for a given contract is a record of an agreement between MOD and a QBU regarding the approach to the classification and method of allocating costs within the contractor's organisation. The QMAC is not intended to provide evidence that costs under a contract meet the requirements of allowable costs. If parties intend to use the QMAC to support a conclusion that the requirements of allowable costs have been demonstrated for costs to which it relates, then the parties should have regard to the SSRO's guidance when preparing the QMAC and identify the supporting evidence.

Cost of doing business

- 4.19 Industry stakeholders suggested the Allowable Costs guidance should explicitly state that a share of business costs incurred and investments made in operating a going concern, that complies with legislation and government policy,¹⁵ are allowable costs. It was also proposed that the cost of developing and maintaining essential or desirable capabilities that ensure a successful going concern should be allowable costs. Industry respondents argued that such costs cannot readily be shown to enable the performance of a particular qualifying contract¹⁶.
- 4.20 Industry stakeholders provided a list of costs which they consider necessary to sustain the capability to service single source contracts with the MOD. It was suggested that sustaining capability is mainly about the contractor continuing to operate as a going concern, and includes investing in research to secure a future pipeline of work, even if it is not work for the MOD. They argued that paragraph 3.9¹⁷ of the Allowable Costs guidance should reflect that a business must be able to continue to work and fulfil its contracts.

¹⁵ Footnote 1 provides examples of such costs as submitted to our 2018 consultation on the Allowable Costs guidance.

¹⁶ *Pricing guidance review 2018: Summary of consultation responses*.

¹⁷ Para 3.9 of the Allowable Costs guidance v5.1 states: "Delivering the contract in question may require sustaining an essential or desirable capability."

- 4.21 We received representations that there are overheads associated with operating as a business unit delivering qualifying contracts as part of a company with a group structure, and that these should be considered allowable costs. Examples cited include the costs of group reporting and of professional services delivered at group level to support the activities of its subsidiaries (e.g., financial reporting and investor relations).
- 4.22 Industry proposed that consideration be given to how the guidance describes equitable apportionment of costs to the contract. It was felt that this should encompass costs that are ‘necessary for the overall operation of the business’¹⁸.
- 4.23 An industry stakeholder argued that there is an issue between the treatment of allowable costs and the SSRO’s baseline profit rate methodology. It was submitted that there is an inconsistency due to the following:
- when calculating profit rates of comparator groups, the SSRO explicitly uses all costs on the constituent companies’ accounts; and
 - the resulting baseline profit rate is used to calculate profit on a subsection of the cost of delivering a QDC, as some costs are not allowable.
- 4.24 The MOD considered that guidance indicating costs to maintain a business as a “going concern” are allowable would be unhelpful. In their view, it is too wide a concept to be useful in agreeing the allowable costs of an individual qualifying contract. They argue that this understanding of the guidance would make it possible to argue that all costs incurred by a contractor are in some measure related to maintaining their business as a ‘going concern’.
- 4.25 The MOD emphasised the importance of determining to which customers a particular cost should be allocated in line with management accounting principles of proper cost allocation. The MOD noted the importance of costs not being over- allocated to single source work in order to grant a competitive advance in competitive work – i.e. the MOD are concerned that over-allocation of overheads to single source work could subsidise competitive work.
- 4.26 The MOD consider that the SSRO’s guidance that “Delivering the contract in question may require sustaining an essential or desirable capability” may lead to costs being claimed by contractors that should not be allowable. Rather, the MOD assert that the cost of maintaining an essential or desirable criteria should only apply, when the MOD has made an explicit agreement with the contractor to maintain capability at a specified level. They maintain that different approaches may be required for businesses which are solely delivering single source contracts and those which are delivering for a mix of customers.
- 4.27 The MOD raised the issue of restructuring or redundancy costs in cases where they have not entered into contractual arrangements to sustain a capability. The MOD believes the consideration here is whether the costs arise as a consequence of taking on single source contracts with the MOD, or whether they would have been incurred anyway. In the latter case the MOD argue they would also need to consider whether they have an existing liability, and if so whether it should be written into existing contracts or settled separately.

¹⁸ Comments from the working group with contractors.

SSRO response

- 4.28 We agree with the MOD that the cost of maintaining a going concern is unlikely to be helpful. We think it is too easily contestable and would lead to disagreements and delays in the assessment of allowable costs. We do not propose to include reference to it in the guidance. We hold this view for the following reasons:
- The Act requires all allowable costs to be attributable to the contract and empowers the MOD to require the contractor to demonstrate the requirements of allowable costs are met. The SSRO cannot, in guidance, change the requirements of allowable costs or remove the MOD's expectation that reasonable evidence will be provided to demonstrate they are met.
 - For a cost to be 'attributable to the contract' there needs to be a link between the cost and the contract. We have explained above why we hold this view and the nature of that link in respect of overheads.
- 4.29 There may be many costs which are necessary to deliver a contract, even if they were not incurred directly for the contract. Since we have received feedback that there may be an inconsistency in attribution of these costs to contracts, we propose guidance changes in this consultation (to paragraphs 3.8 and 3.9) which are intended to clarify that "enabling the performance of the contract" can be viewed expansively and that costs suitably and necessarily incurred in delivering QDCs may be considered attributable to the contract.
- 4.30 We do not consider there to be an issue with the profit rate calculations for our comparator group being based on the total cost reported in companies' published accounts, while then being applied to the allowable costs of a given contract. The approach is consistent as long as the correct costs are allowable under the contract and the Baseline Profit Rate is applied correctly, and then adjusted for the contract through the six steps¹⁹. We include the costs comparators incurred to secure their profits and removing them would present a false picture of profitability. For further information please see Q17 associated Q&A for the 2022/23 Baseline Profit Rate²⁰.
- 4.31 We acknowledge that if all costs are not correctly attributed to the contract in accordance with the Allowable Cost guidance this may result in an under or overpayment to the contractor, impacting the profit rate. In response we are consulting on updated guidance; for example through expanding existing paragraph 3.8 in the guidance.

Research and Timing

- 4.32 We agree with the MOD that the allowability of costs in relation to restructuring and redundancy must be judged in relation to the circumstance of the case. We consider our proposed supports this consideration, but welcome further specific input on additional guidance on this topic.
- 4.33 The MOD agreed that it would be useful to focus on research costs, as other examples of costs which are not concurrent with the contract (risk mitigation, performance management) they more frequently consider as allowable direct costs.

¹⁹ Defence Reform Act 2014, Section.17

²⁰ [Key questions and answers regarding the methodology 2022/23 \(publishing.service.gov.uk\)](https://publishing.service.gov.uk/government/consultations/allowable-costs-guidance-2022-23)

- 4.34 Industry stakeholders did not agree with the suggestion of a “sphere of interest” (some respondents refer to this as the “sphere of influence”) consideration in determining whether research costs are allowable. They argued that the research in question may be outside the sphere of interest with regards to the specific contract, but would benefit the going concern and their volume of business. They argue that making the general costs of doing business allowable, would reduce the burden of evidence and make contract negotiations more efficient.
- 4.35 We have received feedback about difficulties associated with demonstrating the allowability of overhead costs that benefit future contracts. Industry have submitted that it may be difficult to attribute research costs to a contract, where enabling research is not concurrent. Industry stakeholders have argued that research may have been undertaken prior to the contract, in order to develop useful technologies which are then employed in fulfilment of the contract. In a previous consultation about changes to the Allowable Costs guidance, contractors have specifically requested that the requirement for Allowable Costs to ‘enable the performance of the contract’ is removed for research costs that are recovered indirectly.

SSRO response

- 4.36 Costs affected by timing issues may meet the requirements of allowable costs. For example, research costs may meet the requirements of allowable costs where:
- goods or services could not have been provided but for the research having been previously undertaken; or
 - research costs were necessarily incurred to sustain the contractor’s skills, expertise and capability to deliver single source contracts of the MOD.
- 4.37 We propose to include these points in the guidance to assist the parties in its interpretation.
- 4.38 The SSRO’s intent in referencing the “sphere of interest” in our proposals was to ensure an expansive view was taken on the type of research that may give rise to an allowable cost under a QDC. It has not been included in the guidance due to lack of support from other stakeholders. Our other guidance on overhead proposals seek to support contractors and the MOD to agree a suitable scope of research costs as allowable.
- 4.39 We recommend a reasonable approach to estimating and evidencing overheads. For example, an appropriate research overhead could be based on current expenditure on research that the parties agree is related to the subject of the contract being priced, or expected to be priced. We would anticipate that this would constitute research expenditure that has enabled the contract to be performed, or relates to similar contracts in the future. We have included an example in the proposed guidance to illustrate this.
- 4.40 It is open to the MOD to set its own policies about how it funds the cost of research and innovation. The MOD may fund research through contract overheads or directly through cost recovery on qualifying contracts. The latter approach may further assist resolution of issues as to how research is paid for. It remains important that a contractor only recovers costs once and avoids recovering the same costs from another source. To help achieve this, the methodology for allocating costs should be agreed with the Secretary of State.

Sales and marketing costs

- 4.41 Contractors have said that sales and marketing overheads associated with securing competitive work should be allowable costs and directly or indirectly recoverable, subject to satisfying the AAR principles. They argue that sales and marketing can reduce overhead rates in general for the MOD by allowing some overhead costs to be spread over a greater number of contracts, providing a future benefit to the MOD²¹. Where such costs are not apportioned over single source contracts with the MOD, contractors submit that other firms who purchase their services must pay a disproportionate amount of sales and marketing overheads.
- 4.42 The MOD consider that an overhead cost which is not a tool to perform the contract should not be attributed to that contract. Contractors will get economic benefit from pooling single source work with competitive work and the MOD should not pay solely on the basis that there is a potential economic benefit that the MOD may or may not receive. The MOD contends that it would be subsidising contracts for competitive customers if contractors recovered sales and marketing costs under qualifying contracts, as discussed in paragraph 4.25.

SSRO response

- 4.43 The [Allowable Costs guidance](#) (Section 5.1 Part C.1.3) sets out the circumstances in which sales and marketing overheads may be considered as allowable costs – i.e. when there is a demonstrated financial benefit to the MOD in expenditure on sales and marketing, or incurring such sales and marketing costs were necessary in the delivery of the contract. Therefore, if as contractors contend, sales and marketing generates economies of scale within the business which the MOD will benefit from, then the guidance already provides for allowability to be evidenced on those grounds. We understand that the MOD's application, which complies with our guidance, is as follows:
- The MOD frequently considers that sales and marketing costs are not allowable because they do not typically relate to the delivery of MOD single source contracts, and there is insufficient prospect of a net economic benefit.
 - The MOD accepts that sales and marketing costs may be recovered if they meet the requirements of allowable costs and relate to the delivery of single source contracts. An example is where the MOD has entered into an arrangement for a contractor to market a particular product or service.
- 4.44 We consider that the requirements of allowable costs as set out in the Act, means the MOD should pay only an equitable portion of shared overheads based on the costs incurred to enable and deliver work for the MOD. Our reasoning is that:
- Charging costs to the MOD which related to securing or conducting work from other customers would not meet the requirement of being attributable to the contract, such costs would in theory be attributed to those contracts.

²¹ If through sales and marketing work, the contractor sells more of a product or service in addition to what it sells to the MOD, some share of the overhead costs can be recovered through non-MOD contracts, thereby reducing the cost of the QDC.

- To secure business from the MOD a contractor is less likely to incur sales and marketing costs, this is reasonable particularly for single source MOD work. However, if sales and marketing costs were incurred in securing work from the MOD then these costs could reasonably be AAR.
- The MOD may engage a contractor to undertake sales and marketing activity, in which case the costs of this would be attributable to MOD contracts and not to non-MOD customers.

4.45 Considering the above points, we propose to maintain our current guidance.

Incentives and efficiency

4.46 Contractors argue that as commercial entities, they already have incentives to be efficient in how they manage their business, and that cost recovery rates should not be a mechanism for incentivising efficiency. They maintain that decisions are made efficiently within the business as a unit or a wider group and SSRO guidance does not have a role in shifting these decisions towards a more optimal resource allocation.

4.47 The MOD argue that cost recovery rates can incentivise contractors to be more efficient in how they deliver qualifying contracts, and that proper cost allocation is essential to good business decision-making. Within the single source procurement framework, the MOD think there is an incentive for contractors to over-allocate cost to qualifying contracts, as these would attract profit, in theory these costs savings could be passed on to competitively tendered contracts.

SSRO response

4.48 We acknowledge that contractors are capable of allocating resources efficiently without SSRO guidance, while also recognising that there could be incentives to over-allocate cost to a single source contract in order to reduce cost (and therefore price) of competitive contracts. It is important that overhead costs are correctly allocated to the contracts they relate to and are apportioned in such a way that they are proportionally attributed to the drivers of the overhead costs. Our proposed changes on attributability and the application of the requirements of allowable costs to rates are intended to support this, by further clarifying a suitable relationship between an overhead cost and the contract and providing new guidance on cost recovery bases.

Additional feedback and responses

4.49 The table below sets out issues which we consider could be addressed with shorter, more straightforward answers, or where points are partially answered in the above discussion but can be explicitly linked in the table below.

Table 2: Summary of other issues and SSRO response

Feedback	SSRO response
Cost of doing business	
Industry raised concern regarding a statement made by the SSRO about the attachment between cost and contract being required for a cost to be allowable, as overheads have a degree of detachment.	We believe this point arises from a misunderstanding, and we agree that overheads feature a degree of detachment. Our intent is to note that overheads are typified by a lack of attachment to the operational delivery of a contract (see paras 4.28 - 4.31 above). Our proposed guidance changes are intended to make that explicit to all parties, but we believe some link should exist even when it is not direct.
Dissatisfaction with the use of the term “reasonable person informed of the fact” consideration in determining whether costs are necessarily and suitably incurred. An example of a reasonable person was requested.	We encourage an assessment based on a reasoned and expert assessment of the evidence at hand. A reasonable person is an established legal tool. The reasonableness test is set out under S11 (1) of the Unfair Contract Terms Act 1977 and asks ‘is it fair and reasonable to be included, having regard to the circumstances which were, or ought reasonably to have been, known to or in contemplation of the parties when the contract was made’.
Industry stakeholders asserted that their understanding of the statutory intent of SSCR pricing is to fully absorb costs.	We agree that full cost absorption is the approach that is adopted by contractors and the MOD. The Act is clear that costs must be AAR, which is the ultimate constraint on meeting full cost absorption but is not necessarily a biting constraint.
Enabling the performance of the contract	
If new terms such as “causality” are included in the guidance then this will need to embrace all necessary costs to the contractor.	The intention of existing guidance and this update is to ensure that all costs necessary to the delivery of the contract are captured as allowable, which is consistent with the AAR principles. We do not propose introducing new terms which could form an additional test to be overcome.

Feedback	SSRO response
Concern was raised that the concept of enabling the performance of the contract is difficult to conceptualise with indirect costs.	We understand that it may be less obvious to see how indirect costs enable a contract than direct costs. It is nevertheless possible to demonstrate that indirect costs enable performance of a contract and we propose to make this more explicit in the guidance.
Sales and marketing	
Industry stakeholders flagged that indirect sales and marketing costs are not being subsidised by the MOD, and were unsure of the SSRO's position on this.	Our position remains unchanged in this update to the guidance – payment of sales and marketing costs remain subject to the AAR test, we would expect them to be covered in so far as they were useful to the MOD – e.g. they enabled the performance of the contract.
Research and Timing	
We received feedback that where a contract is purely orientated towards research for the MOD, then it would be more convenient to contract directly for this, rather than try to recoup the cost via overheads.	We agree this seems like a more convenient approach, but it is a decision for the MOD – the intent in updating the guidance is to make it easier to recover research costs via overheads when they comprise a part of the overall contract cost. Which route to take is the decision of the MOD and contractors.
The MOD sought feedback regarding the range of research costs which should be considered enabling, and asserted that the research costs which are sought to be recovered should be related to the goods or services delivered.	We agree, and this guidance seeks to clarify that it is for the MOD and contractors to agree on a suitable scope under which these research costs fall.
Industry proposed that there should be an MOD technical representative or sponsor who can review and support research as being of potential benefit to the MOD.	This is a question of the MOD's organisational structure and cannot be prescribed by guidance.

Feedback	SSRO response
Reporting issues	
<p>The Single Source Contract Regulations (Sections 41-44) currently state that Strategic Industry Capacity Reports (SICRs) must be produced by larger suppliers at the ultimate parent undertaking. It may not be practicable for many large overseas companies to produce SICRs, particularly where UK defence is a relatively small proportion of their business, and a report at the global ultimate owner level may not be useful to the MOD.</p>	<p>The MOD are consulting on allowing contractors to report SICRs at a lower than global ultimate owner level, on a discretionary basis²². Therefore we do not see this as a guidance issue which needs to be addressed.</p>

²² [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations \(publishing.service.gov.uk\) \(Proposal 18\)](https://publishing.service.gov.uk/2018/03/26/defence-and-security-industrial-strategy-reform-of-the-single-source-contract-regulations)

5. Application of the AAR principles to indirect costs

- 5.1 A cost recovery rate is applied to a cost typically because the cost cannot be traced or parties agree not to trace the cost to a discrete package of goods, works or services. The application of the AAR principles to rates has challenges because they may be considered in isolation from the contract and are comprised of recovery bases and cost pools, which themselves cannot be considered as a particular cost under a qualifying contract.
- 5.2 Current guidance specifies that the cost and the method of allocation and apportionment to the contract must satisfy the AAR principles²³. The MOD's commercial policy document states that commercial officers must be assured that all proposed costs (*including rates*) are appropriate, attributable and reasonable (AAR)²⁴. The legislation requires that a cost must be AAR to enter into the price of a QDC as an allowable cost. For an indirect cost, the type of cost (A), its relationship to the contract (A), and amount of the cost (R) are determined through the calculation of rates and their application. Therefore, the requirements of AAR must be considered throughout that process so that both contracting parties are confident the outcome is a cost that is AAR.
- 5.3 The SSRO's guidance on when a cost enables the performance of a contract allows for attributability to the contract to be demonstrated where overhead cost pools are used to calculate recovery rates (and ultimately contract costs). Cost pools are an aggregation of costs and do not relate in their entirety to the contract being priced and therefore must be apportioned using a recovery base. For example, a cost pool may consist of spending on back-office functions which support a range of MOD single source and competitive work.
- 5.4 The current guidance does not refer to the considerations that may apply when calculating a cost with a cost recovery rate. Proposal 3 (see text box under para 4.2) seeks to address this with further guidance. This should distinguish between:
- the requirement that a particular cost is an allowable cost under a QDC (in that it must be AAR) as discussed in section 2; and
 - the role the AAR principles play in supporting the process to determine that costs are allowable (i.e. agreeing rates), which is the subject of this section.
- 5.5 The MOD are consulting on changes to the Single Source Contract Regulations to increase the breadth of referrals which the SSRO can take. These changes include a proposal to legislate to enable the SSRO to make a determination in relation to the agreement of rates that may be used in the pricing of QDCs or QSC²⁵. This highlights the importance the MOD places on the agreement of rates and their use in relation to allowable costs. Improvements to our guidance on the agreement of cost pools and cost recovery bases is consistent with this.

²³ (2021) Allowable Costs working paper

²⁴ MOD Commercial policy

²⁵ [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations \(publishing.service.gov.uk\) \(Proposal 18\)](https://www.gov.uk/government/consultations/defence-and-security-industrial-strategy-reform-of-the-single-source-contract-regulations)

Stakeholder feedback

- 5.6 Evidence from both MOD and industry stakeholders highlighted issues with using the requirements of allowable costs to guide the agreement of cost pools and cost recovery bases and the resulting cost recovery rates. Matters were brought to our attention in respect of:
- selecting suitable cost recovery bases: it was said that labour hours were commonly used as the recovery base, but this was not necessarily the most suitable metric for certain cost types to achieve equitable apportionment;
 - maintaining consistency of scope between cost pools and recovery bases: contractors said the MOD was disallowing costs from the cost pool, without properly revaluating the base leading to under-recovery; and
 - there was an imbalance in MOD scrutiny between the scope of costs and recovery bases compared to their quantum, when both may be equally important.
- 5.7 Contractors suggest there are inconsistencies in the application of the AAR principles by the MOD when calculating the cost recovery base. In their view, some MOD officers allow general business costs to be included in the cost base for the development of rates used in contract pricing, but some MOD officers are wary of permitting such costs and are taking a more literal interpretation of the guidance. Contractors asserted that the determination of what costs can be included in the cost pool for rates depends on the opinions and practices of individual MOD commercial officers or cost accountants.
- 5.8 Contractors note that rates are agreed at a business unit (BU) level and that these rates should be used for all contracts that a BU performs. In contrast, their view is that the current SSRO guidance is written in a way that is contract-specific and it could better recognise that rates should cover a whole business unit. Creating contract-specific rates leads to inconsistencies, and ultimately under- or over-recovery of costs, if different rates are applied to different contracts involving work within the same business unit.
- 5.9 Contractors suggest that MOD commercial officers are challenging indirect costs, for instance the quantum of the hours, and whether there are cost efficiencies to be gained. One contractor suggested that additional training and support in how indirect costs are calculated would be useful, and they would appreciate further guidance on the use of price assumptions in the costing base. They suggested including some worked examples with numbers in the guidance.
- 5.10 The MOD was unconvinced of the need to provide further guidance on how the AAR principles should apply in rate setting. It indicated that their practice in applying the requirements of Allowable Costs is to:
- apply the AAR principles at more than one point in the contract negotiation, and they provide advice within their commercial toolkit to assist this;
 - consider the overall quantum of cost and whether this is appropriate and reasonable;
 - require contractors to demonstrate that the cost recovery base attributes the cost in a reasonable way.

SSRO response

- 5.11 We do not agree that rates themselves can meet the requirements of allowable costs, although the requirements of allowable costs should guide the formulation of the rate and cost base. It can only be determined whether a cost meets the requirements of allowable costs when the rate has been applied to a suitable cost base to arrive at a cost under a contract. This view does not indicate that rates should be agreed on a contract by contract basis, which would appear inefficient.
- 5.12 We propose to clarify in our guidance that the requirements of allowable costs should guide the agreement of a cost recovery rate such that, when applied to a suitable cost base, the rate produces a cost estimate which meets the requirements of allowable costs. Making this clear should promote consistency and support the MOD's intention to allow referrals on the basis of rates and costs pools.
- 5.13 In practice, the requirements of allowable costs can only be met to the extent that the parties understand the specific contract or contracts to which the rates will apply – a rate cannot meet the requirements of allowable costs in the absence of a contract. In the absence of such information, the parties will need to apply judgement, in the type and standard of evidence that it is reasonable for the contractor to provide, to demonstrate that their claimed rates are consistent with the requirements of allowable costs. It cannot be fully determined, however, that a particular cost is an allowable cost under a qualifying contract in accordance with the requirement of section 20(2) of the Act, until the contract under consideration is being priced.
- 5.14 We considered the MOD's explanation of the steps it takes to apply the requirements of allowable costs to indirect costs. The commercial toolkit provides limited detail on how the requirements of allowable costs should be applied to indirect costs. Stakeholder feedback suggests the lack of coverage may be contributing to inconsistent application of the statutory guidance and disagreement as to how the requirements of allowable costs should apply. We welcome more detailed feedback on how current guidance and requirements of allowable costs are being applied to rates. More detailed feedback would allow the SSRO to incorporate existing good practice into our guidance.
- 5.15 Subject to further input from respondents, we propose to update our guidance to reflect the following consideration about the application of the requirements of allowable costs to costs determined through the use of rates. Applying these considerations should result in a cost recovery rate such that, when applied to a suitable cost base, produces a cost estimate which meets the requirements of allowable costs:
- i. **Appropriate** requires that cost pools comprise costs arising from activities which enable the performance of contracts of the type to which the rate is anticipated to apply. It is not a requirement that a cost included in a cost pool meets the requirements of allowable costs. Examples of appropriate costs may include: the HR cost of the relevant business unit delivering the contract(s); research in the domain of the contract(s); and other business enablers that exist for the benefit of the customer or are required for the contracting company to function lawfully or efficiently

ii. Attributable requires the recovery base to apportion the cost pool in a way that reflects the expected utilisation of the resource for the contract(s) to which the rate may apply, and should result in the correct quantum of cost being recovered. The scope of the recovery base should match that of the cost pool. The approach taken may account for the impact on efficient and productive behaviours and business structures.

iii. Reasonable requires the quantum of costs in the pool and of the recovery base to be justifiable with respect to what a contractor typically incurs in similar circumstances, and achieving suitable levels of efficiency and productivity. For example, the quantum of cost in the cost pool should be consistent with historical trends given the outputs, accounting for any changes in circumstance, cost control measures, and planned or assumed productivity improvements.

- 5.16 We've also proposed guidance changes (new paragraph 2.2 in the below guidance changes) to ensure the guidance is applicable to discussions regarding costs held at both a contract and business unit level.

6. The Allowable Costs guidance

6.1 This section sets out proposed changes to the guidance, reflected the feedback and evidence set out above. Amendments are proposed to the following sections of the Allowable Costs guidance:

- Section 2 – Application of the guidance
- Section 3 – The AAR principles
- Section 4 – Cost accounting and financial reporting
- Section 5 - Guidance on specific cost type: Part D – Research and development costs

Section 2: Application of the guidance

- 6.2 This section details the proposed changes to allowable cost guidance we are consulting on. We seek to clarify two issues.
- 6.3 First, the Allowable Costs guidance may be applied to costs for which the rates are agreed at a business unit level. The guidance frequently refers to ‘the contract’ and ‘the QDC in question’, which may limit its application to business unit level discussions about allowable costs. The SSRO proposes to include language that more explicitly recognises that when allowable costs are agreed at a business unit level:
- the specifics of the contract(s) to which the MOD may apply the rates cannot be fully ascertained when rates are agreed, and;
 - the costs may be recovered, in whole or in part, across multiple contracts.
- 6.4 The second amendment in this section is to reference the statutory reporting requirements and identify the relevant supporting SSRO statutory reporting guidance.
- 6.5 Proposed changes to paragraph 2.6 of the guidance makes more explicit the possible sources of evidence that might be used by the parties to qualifying contracts, or the SSRO during a referral investigation, to be satisfied that a contractor’s costs meet the requirements of allowable costs. We note that in addition to the records held by the contractor, the Secretary of State may have information pertaining to costs incurred in performing similar activities and there may be information available from third party sources which can provide insights into the costs typically incurred in the performance of deliverables similar to those required by the contract. We welcome views from stakeholders on this, together with examples of the circumstances in which it may be appropriate or necessary to rely on third party information in determining allowable costs under qualifying contracts.

Existing guidance	Proposed guidance	Purpose of changes
New 2.2 paragraph	<p>This guidance is intended to assist the parties to determine whether costs are allowable under qualifying contracts. It sets out advice and information on how the parties should assess particular costs under a QDC or QSC against the AAR test. It may also be used to support the formulation of cost recovery rates, which may in due course form part of the price of a qualifying contract. An example is where cost recovery rates are agreed at a business unit level, but not yet applied for the purposes of determining a discrete cost under a contract.</p>	<p>This paragraph clarifies that the primary purpose of the guidance is to support the application of the requirements of Allowable Costs guidance to a particular cost under a contract, but that it may also support earlier agreements of cost recovery rates, at which stage the assessment of allowable costs in accordance with Section 20 of the Act cannot be concluded.</p>
New paragraph after new paragraph 2.2	<p>We have provided some illustrative examples to help practitioners interpret and apply the guidance in various situations. The examples should not be rigidly applied. They are intended to assist negotiating parties to use the guidance to determine whether costs are allowable and should not be taken as mandating a particular outcome from application of the AAR test.</p>	<p>To clarify the intent of the examples and how they may be used.</p>

Existing guidance	Proposed guidance	Purpose of changes
New paragraph after existing paragraph 2.4 in a new section called Statutory Reports (before Records and Information section in Part 2)	The primary contractor (or sub-contractor) must provide statutory contract reports for any QDC (or QSC), as described in Part 5 of the Regulations. Suppliers may also be required to provide statutory reports on overheads as described in Part 6 of the Regulations. These reports include requirements where contractors and suppliers must report estimated and actual Allowable Costs, including the reporting of cost recovery rates and cost recovery bases used to calculate Allowable Costs. The SSRO has provided separate contract reporting ²⁶ and supplier reporting ²⁷ guidance which will assist with preparing and submitting the reports required. The reports should be submitted to the MOD and the SSRO using the Defence Contract Analysis and Reporting System (DefCARS).	<p>This paragraph is consistent with paragraph 1.9 of the SSRO's guidance on adjustments to the baseline profit rate²⁸ and covers both contract and supplier reports.</p> <p>This new paragraph also covers the use of the DefCARS system so existing paragraph 4.8 can be deleted.</p>

²⁶ [Reporting guidance on preparation and submission of contract reports - Version 10.1 – 26 January 2022](#)

²⁷ [Reporting guidance on preparation and submission of supplier reports - Version 8.1 - 26 May 2021.](#)

²⁸ SSRO Baseline profit guidance version 7.2 – 31 March 2022

Existing guidance	Proposed guidance	Purpose of changes
<p>2.6 The Act and Regulations do not specify what information is required in order to be satisfied that a cost is an Allowable Cost. In determining what type and standard of information is required, the relevant parties identified in paragraph 2.2 should take a proportionate approach considering:</p> <ul style="list-style-type: none"> a. the specific requirements and circumstances of the contract; b. the materiality of particular costs; and c. what it is reasonable to expect would be available. 	<p>2.6 The Act and Regulations do not specify what information is required in order to be satisfied that a cost is an Allowable Cost. Information used for this purpose might include relevant records kept by the contractor, information held by the Secretary of State or information available from third party sources. In determining what type and standard of information is required, the relevant parties identified in paragraph 2.2 should take a proportionate approach considering:</p> <ul style="list-style-type: none"> a. the specific requirements and circumstances of the contract; b. the materiality of particular costs; c. the information that is available and its relevance; and d. what it is reasonable to expect would be available. 	<p>To make more explicit the sources of evidence which may be used by contracting parties in establishing whether costs are allowable.</p>

Section 3: The AAR principles

- 6.6 This section details proposed changes to guidance in response to feedback on the allowability of overhead costs. The primary propose of the changes is to further clarify the scope of costs that may be considered to enable the performance of the contract both in terms of the proximity of costs to the operational delivery of the contract, clarifying the acceptability of time mismatches between cost and deliverables.

Existing guidance	Proposed guidance	Purpose of changes
3.1 A contractor's costs (which include those already incurred and those which are anticipated) are Allowable Costs in a QDC or QSC to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. These three requirements apply whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost.	3.1 A contractor's costs (which include those already incurred and those which are anticipated) are Allowable Costs in a QDC or QSC to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. The requirements of allowable costs are that they must be appropriate, attributable, and reasonable. Each of these must be met whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost.	Clarified that to be allowable a cost must be all of appropriate, attributable and reasonable.

Existing guidance	Proposed guidance	Purpose of changes
3.2 The guidance in this section sets out the typical characteristics of costs that meet the requirements of Allowable Costs. The relevant parties should consider the characteristics when evaluating whether a particular cost incurred by the contractor meets each requirement.	3.2 The guidance in this section sets out the typical characteristics of costs that meet the requirements of Allowable Costs. The relevant parties should consider the characteristics when evaluating whether a particular cost incurred by the contractor meets each of the requirements of allowable costs, i.e. the AAR principles.	<p>This is intended to ensure the distinction in the guidance between:</p> <ul style="list-style-type: none"> the requirements of allowable costs (the AAR principles) which must be met in order for a particular cost to be allowable, and the characteristics included as an aid to decision making which the parties should consider in determining of the requirements of allowable costs have been met.
3.4 In determining whether each requirement is met, the relevant parties may place differing emphasis on the characteristics described in the guidance and require different information to be satisfied that the cost demonstrates the characteristics. It is unlikely, however, that a requirement will be met where the relevant parties cannot conclude positively that the particular cost possesses at least one of the related characteristics.	3.4 The relevant parties may agree on differing standards and types of information in evidencing each of the three characteristics of allowable costs.	Main impact is to remove the final sentence, which may be construed as meaning a cost may be allowable if only one of the three requirements are met.

Existing guidance	Proposed guidance	Purpose of changes
New paragraph after existing paragraph 3.4	3.5 An assessment against the requirements of allowable cost cannot be fully concluded until a cost is claimed as allowable under a contract. Where this guidance is applied in advance of a cost being applied to a particular qualifying contract (for example when agreeing cost recovery rates for a business unit), the parties should agree which aspects of the requirements of allowable costs can be demonstrated at the time, and those which should be considered once the circumstances of the contract are known. Section 4 of this guidance provides additional guidance on the application of the requirements of allowable costs in the agreement of cost recovery rates.	Clarify what the related characteristics are and provide reference, and that the AAR test may be applied at more than one point in time.

Existing guidance	Proposed guidance	Purpose of changes
<p>3.8 References in this guidance to costs that 'enable the performance of the contract' include those suitably and necessarily incurred by the contractor to:</p> <ul style="list-style-type: none"> a. deliver the contract in question; or b. deliver multiple contracts including the contract in question and equitably apportioned to those contracts. 	<p>3.8 References in this guidance to costs that 'enable the performance of the contract' include those suitably and necessarily incurred by the contractor before, at or after the time of agreement to:</p> <ul style="list-style-type: none"> a. deliver the contract in question; or b. deliver multiple contracts including the contract in question, in which case the cost is equitably apportioned to those contracts; or c. ensure the efficient and proper operation of the business of delivering qualifying defence contracts and subcontracts. 	<p>Clarifies the intended scope of "enabling the performance of the contract".</p>
<p>Expanded existing para 3.9:</p> <p>Delivering the contract in question may require sustaining an essential or desirable capability.</p>	<p>3.9 Delivering the contract in question may require sustaining an essential or desirable capability. This may include a capability that is required to deliver the contract in question or similar contracts.</p>	<p>Clarifies the scope of an essential or desirable capability.</p>

Section 4: Cost accounting and financial reporting

- 6.7 The Allowable Costs guidance provides that indirect costs which enable the performance of a QDC or QSC may be allowable, if both the cost and the method of allocation and apportionment satisfy the AAR principles.
- 6.8 The changes below seek to address these issues by providing a framework to separate direct and indirect costs for the purposes of applying this guidance and giving examples of the considerations to be applied when determining the allocation and apportionment of costs to the contract where a cost is recovered using a recovery rate.
- 6.9 The section proposed below would completely replace paragraphs 4.1 to 4.7 of the current allowable cost guidance. We propose to change the title of this section to *Cost accounting, direct costs, indirect costs and overheads*

4. Cost accounting, direct costs, indirect costs and overheads

- 4.1 When used in this guidance, the terms direct, indirect and overhead costs have the meanings assigned to them in Table 3. Contractors may use terms which differ from those given. Where those terms are synonymous, or otherwise refer to the same thing, the guidance should be construed and applied accordingly.

Table 3: Terms and definitions

Definitions	
Direct cost	A cost that can be traced to a discrete package of goods, works or services under a qualifying contract.
Overhead cost or overhead	A cost that is used by multiple activities and which cannot be traced, or that the parties agree not to trace, to a discrete package of goods, works or services under a qualifying contract.
Indirect cost or indirectly recovered cost	A cost that is apportioned and allocated to a qualifying contract using a cost recovery rate. Indirect costs typically include overheads. Some direct costs, such as labour, may be applied indirectly as a matter of convenience.

Cost accounting

- 4.2 Contractors with QDCs and QSCs may agree with the Secretary of State a methodology for the allocation and apportionment of costs to be used in the contract. A cost accounting methodology includes:
- choosing whether a cost, or class of cost, is to be applied directly or indirectly to the contract;
 - where a cost is applied indirectly to the contract; identifying the cost recovery base for each pool and measuring it; and calculating the cost recovery rates (for example £ per hour of labour).

- 4.3 The methodology may be described in a Quantified Method of Cost Allocation (QMAC) which is agreed between the relevant parties. The agreement of a QMAC does not demonstrate that costs are allowable, however the parties may find its contents informative in applying this guidance. For example, in identifying the type of costs and corresponding cost recovery bases which the parties may agree to recover through application of rates.
- 4.4 In order to be allowable, the contractor must be able to demonstrate that costs have been allocated in a way that is reasonable and which avoids any over or under recovery. Additional care will be needed where the contractor's costing system for work under contract to the Secretary of State is different from that used for other work, as the costing systems may not be directly comparable.
- 4.5 The SSRO is not prescriptive about whether costs are categorised as direct or indirect costs, but the MOD will want to be satisfied with the assignment of costs to contracts (or groups of contracts) and the method by which costs are shared amongst contracts. Section 2 of this guidance sets out the contractor's duty to keep relevant records and submit statutory reports in respect of allowable costs.

Direct costs

- 4.6 Direct costs which are attributable to a single contract should be assessed against section 3 and relevant guidance in section 4 to be claimed as allowable. Direct costs which the contractors seeks to recover following use of cost recovery rates should be assessed against the guidance on indirect costing in paragraphs 6.23 - 6.25.

Overhead costs

- 4.7 Overhead costs considered allowable and not identified as arising from performing a single qualifying contract should be assessed against the guidance in section 3 and any relevant guidance in section 4. Overhead costs which the contractor seeks to recover following use of cost recovery rates should be assessed against the guidance on indirect costing in paragraphs 4.8– 4.10.

Indirect costs and cost recovery rates

- 4.8 Some costs may be determined through the use of recovery rates which are applied to an appropriate recovery base. A contract may contain allowable costs which are both applied directly, and applied indirectly through the use of a rate. A cost recovery rate is a rate of cost per unit of a cost recovery base. For example, a rate of £50 per hour applied to a cost recovery base of 1,000 labour hours would generate a cost of £50,000.
- 4.9 The agreement of estimated and actual rates will be determined between the contractor and the MOD. For cost recovery rates to be consistent with the requirements of allowable costs, a cost recovery rate, when is applied to a suitable cost recovery base, should produce a cost estimate which is allowable. It cannot be fully determined, however, that a particular cost is an allowable cost under a qualifying contract in accordance with the requirement of section 20(2) of the Act until the contract to which the rate is to be applied is being priced.

- 4.10 Because cost recovery rates may be used as the basis of a costs claimed as allowable under a qualifying contract, their formulation should be guided by the requirements of allowable costs. Rates which are not consistent with the requirements of allowable cost are unlikely to be applicable in a way that would be suitable for determining the allowable costs under a qualifying contract. The following are typical characteristics of a suitable cost recovery rate which is consistent with the requirements of allowable costs. The relevant parties should consider these characteristics during the process of evaluating whether a cost recovery rate to be used to price a qualifying contract is consistent with each requirement:
- i. **Appropriate:** cost pools comprise costs arising from activities which enable the performance of contracts of the type to which the rate is anticipated to apply. It is not a requirement that a cost that is included in a cost pool meets the requirements of allowable costs. Examples of costs which may be appropriate include: the HR cost of the relevant business unit delivering the contract(s); research in the domain of the scope of the contract(s); and other business enablers that exist for the benefit of the customer or are required for the contracting company to function lawfully or efficiently.
 - ii. **Attributable to the contract:** the recovery base used to apportion the cost pool is applied in a way that reflects the expected utilisation of the resource by the contract(s) to which the rate may apply. For example, using a recovery base of labour hours may be suitable for direct labour costs, but headcount may be more suitable for back-office functions. The scope of the recovery base should match that of the cost pool.
 - iii. **Reasonable in the circumstances:** the quantum of costs in the pool and of the recovery base are justifiable with respect to what a contractor typically incurs in similar circumstances, and exhibit suitable levels of efficiency and productivity. For example, the quantum of cost in the cost pool should be consistent with historical trends given the outputs, accounting for any changes in circumstance, cost control measures, and planned or assumed productivity improvements.
- 4.11 The parties will need to apply judgement in agreeing the type and standard of evidence that it is reasonable for the contractor to provide in order to demonstrate that their estimated, actual and claimed rates are consistent with the requirements of allowable costs. In determining what type and standard of information required, the relevant parties should take a proportionate approach (see section 2). When determining a proportionate type and standard of information to support the calculation of cost recovery rates, the parties should:
- Consider the types of contracts to which the rates will be applied to ensure the scope of the cost pool and recovery base are suitable.
 - Maintain consistency between the scope of the cost pool and recovery base when adjusting either.

Illustrative example:

The below example is intended to assist in the understanding and application of the guidance. It is not intended to be used as evidence as to whether a cost is allowable in a specific QDC or QSC.

A contract proposed a cost recovery rate for a range of general and administrative (G&A) expenses.

The contractor proposed that the cost pool should comprise all G&A costs of the business unit that the MOD was seeking to contract with, as well as some G&A costs of a centralised group function, as it argued these were necessarily and suitably incurred to facilitate operational delivery of contracts by the business unit and therefore appropriate. It proposed that the labour hours of employees in G&A related roles should be used as a recovery base such that the rate was consistent with a cost that was attributable to the contract.

The MOD did not agree that all the G&A costs of the centralised group function should be included in the pool. It said some of these costs only supported the operations of business units that delivered non-qualifying contracts and not the type of contracts the MOD would seek to price using the rate. These costs were removed from the cost pool. In order to maintain consistency, the scope of the recovery base was adjusted, to remove some employees to which removed cost related. The parties also agreed that headcount, rather than labour hours, would better reflect the utilisation of G&A functions across operational activities and therefore modified the recovery base accordingly. It was considered that square footage may be the most appropriate recovery base for the utilities element of the cost pool, but that in taking a proportionate approach it was agreed this element would remain in the G&A pool and not be broken out into a separate rate.

The supplier provided evidence that the quantum of the costs and headcount were in line with recent trends and achieved by the contractor and therefore reasonable in the circumstances. The MOD agreed to this, having undertaken comparative analysis across contractors using the QBUCAR, seeking evidence to explain differences in G&A costs and a review of recent Rates Comparison Reports for the business unit to ascertain if the approach agreed was likely to be associated with under or over recovery of overheads.

Accounting methods

- 4.12 Contracting companies may adopt a variety of accounting policies and practices and make judgements in the preparation of financial statements for statutory reporting purposes (for example, International Financial Reporting Standards and UK Generally Accepted Accounting Practice) and for the preparation of management accounts to inform internal decision-making. Application of these policies and practices to QDCs, will not necessarily result in costs charged satisfying the AAR principles, and contractors must therefore have regard to this guidance.

Section 5: Guidance on specific cost types

- 6.10 The section below details our proposed guidance changes for determining if research costs in response to stakeholder feedback detailed in previous sections. Our proposed changes are aimed at assisting the parties apply the requirements of allowable costs to circumstances where timing differences arise between research the cost being incurred and the pricing of a qualifying contract.

Existing guidance	Proposed guidance	Purpose of changes
<p>D 2.2</p> <p>In determining whether the research enables the performance of the contract, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research may be necessary if it is required to maintain capability to perform the contract.</p>	<p>In determining whether money spent on research enables the performance of the contract, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research costs may be necessary if:</p> <ul style="list-style-type: none"> the goods or services could not have been provided but for the research having been undertaken; or the research costs were necessarily incurred to sustain the contractor's skills, expertise and capability to deliver the contract and others like it. 	<p>To further clarify the scope of research that may be considered necessary.</p>

7. Other changes

- 7.1 We are taking the opportunity to propose the following minor amendments to the guidance aimed at improving clarity and application of the statutory guidance.

Current Allowable Costs guidance (v5.1 – September 2021) ²⁹	
Section 5 Guidance on specific cost types	Issue
A.2.4 (page 11)	refers to “Allowable expense” rather than “cost”. We propose to correct this to refer to “allowable cost”
E.1.1 (page 14)	“obsolescent stock write-offs” – we propose to change this to “stock losses and obsolescence costs” consistent with the remainder of the paragraph.
E.4.4 (page 15)	We propose to clarify that a “notional transactions” means a hypothetical transaction that is not real or measured.
F.2.2 (page 16)	Correction of a typographical error by replacing the word “benefit” with “benefiting”.
H.4.1 (page 21)	Proposed change to the final sentence to refer to “the cost risk adjustment” rather than “cost risk adjustment”

²⁹ [SSRO Allowable Costs guidance Version 5.1](#) (publishing.service.gov.uk)

8. Timetable for publication and application of the guidance

- 8.1 Subject to the outcome of this consultation, we propose to publish revised guidance by the end of October 2022.
- 8.2 We intend to consult on changes to reporting of overheads later in the year some of which may be required to support the implementation of the proposed changes to legislation. Comments from stakeholders on this schedule will inform our planning.

9. Responding to the consultation

- 9.1 This consultation is open to all interested persons. We particularly welcome comments from individuals or organisations with an interest in single source defence procurement and ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that the prices paid under these contracts are fair and reasonable.

The SSRO invites stakeholder views, together with supporting evidence where appropriate, on matters raised above and specifically on the proposed guidance changes which relate to these four sections:

- Section 2 – Application of the guidance
- Section 3 – The AAR principles
- Section 4 – Cost accounting and financial reporting
- Section 5 - Guidance on specific cost type: Part D – Research and development costs

- 9.2 Stakeholder who may wish to propose specific revisions to the text in we are consulting on, as well as any proposed additional or deletions they wish to see are encouraged to.
- 9.3 We are particularly interested in feedback to better align our allowable cost guidance with the MOD's proposals set out in Defence Command Paper³⁰.
- 9.4 Consultees do not need to provide feedback on all these matters if they are only interested in some aspects of the consultation.

³⁰ [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/defence-and-security-industrial-strategy-reform-of-the-single-source-contract-regulations)

- 9.5 A consultation response form containing these questions has been published alongside this consultation document on the SSRO's website. Completed response forms should be sent:
- by email to consultations@ssro.gov.uk (preferred); or
 - by post to SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.
- 9.6 We invite written responses to the consultation, which should be received no later than 5pm on 18 July 2022. Responses received after this date may not be taken into account in updating the guidance, but may be used to inform subsequent consideration of future changes to guidance.
- 9.7 The SSRO also welcomes the opportunity to meet with stakeholders to discuss the proposals during the consultation period. If you wish to arrange such a meeting, please contact us at the earliest opportunity via consultations@ssro.gov.uk.
- 9.8 In the interests of transparency for all stakeholders, the SSRO's preferred practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm in the response form whether they consent to their response being published and to the attribution of comments made. Where consent is not provided, comments will only be published in an anonymised form.
- 9.9 Stakeholders' attention is drawn to the following SSRO policy statements, available on its website,³¹ setting out how it handles the confidential, commercially sensitive and personal information it receives and how it meets its obligations under the Defence Reform Act 2014, the Freedom of Information Act 2000, the General Data Protection Regulation and the Data Protection Act 2018.
- The Single Source Regulations Office: Handling of Commercially Sensitive Information; and
 - The Single Source Regulations Office: Our Personal Information Charter.

³¹ <https://www.gov.uk/government/organisations/single-source-regulations-office/about/personalinformation-charter>

Appendix 1: Glossary of terms

The terms set out below and their descriptions are provided to be used in the interpretation of this document.

Allocation is the direct assignment of a whole cost to a traceable cost object, or group of cost objects. For example, determining the contract(s) that are to bear the costs claimed by the contractor as allowable.

Apportionment is where a cost is shared amongst various cost objects.

Cost object means something to which costs are assigned, for example a location, a department of a company, or a contract.

Cost pool means an aggregation of costs of a business unit that are divided by the quantum of cost recovery base borne by the business unit, to calculate a cost recovery rate.

Cost recovery base is a unit of measure that is traceable to a cost object, for example hours of work, volume of space, number of employees, or value of allocated costs.

Cost recovery rate is the cost per unit of a cost recovery base. It may be calculated for a business unit and used to apportion costs to that business unit's contracts by multiplying the rate by the quantity of the cost recovery base borne by the contract.

Direct cost means a cost that can be traced to a discrete package of goods, works or services under a contract. Directly recovered cost means a cost that is allocated to a contract.

Indirect cost or **Indirectly recovered cost** means a cost that is apportioned and assigned to a contract using a cost recovery rate. Indirect costs would typically include overheads. Some direct costs, such as labour, may be applied indirectly as a matter of convenience.

Overhead cost or **overhead** means a cost which cannot be traced, or that the parties agree not to trace, to a discrete package of goods, works or services under a contract.

Requirements of allowable costs are the requirement that costs must be appropriate, attributable to the contract and reasonable for a particular cost to be an allowable cost under a qualifying contract.

