SSRO

Single Source
Regulations Office

Review of Allowable Costs

Consultation response

November 2022

Contents

1. Introduction

1.1 This paper sets out the SSRO's response to our allowable costs consultation regarding overhead and indirect costs and the resulting changes to the SSRO's statutory guidance. We would like to thank all respondents for their feedback which has shaped our latest guidance v6.0, which is published concurrently with this document.

1.2 We consulted from 24 May 2022 to 18 July 2022 on draft amendments to our allowable costs guidance. The consultation focused on different sections of our guidance (sections 2, 3, 4 and section 5 part D). Our consultation requested feedback on each section individually as well as posing an additional question to elicit wider views related to our allowable costs guidance. During this time, we held a working group with industry and MOD stakeholders. We also engaged directly with an industry stakeholder to walk through our proposed changes.

1.3 We received five written responses to the consultation. Two respondents also provided additional material on the narrative and context in our consultation documents. We have responded to this material within this document under "Issues on which we did not consult". The table below provides a breakdown of responses.

Table 1: breakdown of respondents

	Government	Industry	Trade association	Industry consultant
Number of responses	1	2	1	1

1.4 Respondents welcomed the opportunity to engage with the SSRO on developing our allowable cost guidance. All respondents gave permission for their input to be published, which is done alongside this detailed response[1].

Summary of responses

1.5 We received a range of views, reflecting the variety of stakeholders who responded to our consultation and whom our guidance is intended to assist. Some key themes were:

a. The interpretation and application of the requirements of allowable costs to cost recovery rates agreed with reference to a specified qualifying contract.

b. Application of the characteristics (enabling the performance of the contract and maintaining an essential or desirable capability) that may be typical of a cost which is allowable.

c. How the requirements of allowable costs would guide allocation of a cost pool to a "fair" outcome when applying a cost recovery rate.

1 https://www.gov.uk/government/consultations/allowable-costs-guidance-overheads-and-indirect-costs

Consultation response structure

1.6 The sections below summarise the feedback received, both written responses and issues raised directly at workshops with the SSRO during the consultation period. Stakeholder feedback, our response, and consequent changes to our guidance are structured under the four different sections to which the feedback relates.

1.7 We have comprehensively responded to each point made in the consultation and explained our reasoning. Several stakeholders made similar arguments, which we have sought to sensibly aggregate and in doing so some feedback may be included under different sections to that which they were originally responding.

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 contract price under a QDC or QSC is determined using the formula:

$$\text{Price} = AC + (AC \times CPR)^2$$

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 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 contract[3].
- **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.

2.7 This terminology is intended to maintain consistency with regulations 29(5) and 32(6) that define the terms "direct costs" and "indirect costs" for the purpose of reporting.

2.8 The next sections detail the feedback received and our response to proposed changes to overheads and indirect costs as allowable costs in qualifying contracts.

2 Section 15 of the Act and regulation 10.
3 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.

3. Application of the guidance – section 2

Summary

3.1 We consulted on proposals to update section 2 of the guidance, covering how the guidance should be applied. The changes proposed were to include language that more explicitly recognises that when allowable costs are considered 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.

3.2 Changes were also proposed to:

- draw the reader's attention to the existence of statutory reporting requirements; and
- make 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.

3.3 The main changes we consulted on were to insert new statutory guidance paragraphs 2.2 and 2.5 (consulted on as a new paragraph after existing paragraph 2.4).

Stakeholder feedback and the SSRO response

3.4 The MOD supported the proposed guidance changes to former paragraph 2.6 (now paragraph 2.8) intended to make more explicit the range of evidence which can be used by contracting parties in ascertaining whether costs are allowable, including that some evidence might be held by the Secretary of State or third parties. They emphasised that the onus lies with industry to demonstrate that costs are allowable. We received industry stakeholder feedback that queried whether the MOD would be willing and able to share proprietary information, that they may hold due to contractual arrangements with other contractors, in order to evidence costs as being allowable.

3.5 The purpose of the proposed changes in the guidance is to make more explicit the sources of evidence which may be used by the contracting parties in establishing whether costs are allowable. In response to concerns that industry may not be in possession of some types of information, the guidance (paragraph 2.8) explains that the parties should consider what it is reasonable to expect would be available in determining the type and standard of information required in order to demonstrate costs are allowable. In terms of the question of use, an example would be the use of data from statutory reports held by the Secretary of State being used to assist in the scrutiny of rates claims, which we know to be occurring. We find it uncontroversial that the MOD would refer to its own information to verify the evidence that contractors are providing in support of their claims of allowability. The question of whether they would subsequently share this information is one for the MOD to answer, although the allowable cost guidance encourages transparency in this regard (see paragraph 2.9).

3.6 We received feedback from some respondents that it is not appropriate to include references to reporting guidance within our allowable cost guidance. One stakeholder suggested that information concerning DefCARS cannot be part of statutory guidance on allowable costs as it is a different subject, and instead relates to parts 5 and 6 of the Regulations. Conversely the MOD suggested that it was helpful to reference reporting requirements within the allowable cost guidance and shared their experience from compliance monitoring activities that contractors who may only have a few qualifying contracts are less aware of the reporting requirements.

3.7 Our allowable costs guidance does not repeat existing guidance but draws attention to the existence of DefCARS and the reporting guidance, which is relevant and useful information for someone engaged in the agreement of allowable costs. We consider reference to it within the allowable cost guidance to be appropriate. We do not consider there to be any barrier to publishing material issued under our section 20 guidance function alongside other relevant contextual information aimed at improving the overall utility of the document.

4. The AAR principles – section 3

4.1 Section 3 of the guidance sets out a range of typical characteristics of costs that meet each of the requirements of allowable costs.[4] The requirements of allowable costs must be met for a cost to be allowable, but the guidance recognises that judgement will be required as to the relative importance of each characteristic which is listed under each individual requirement.[5] A differing type and standard of evidence may be acceptable to both parties for different types of cost or in differing circumstances. In broad terms the guidance seeks to have parties consider characteristics that relate to:

- the type of activity from which the cost arises (**appropriate)**[6];
- the relationship between the cost, the contract and the method of recovery (**attributable** to the contract)[7]; and
- the amount of cost sought to be recovered (**reasonable** in the circumstances)[8].

4.2 The section below details feedback we received on the allowability of overhead and indirect costs, alongside our position and any consequential changes we have made to our guidance.

4.3 We proposed changes aimed at ensuring appropriate interpretation and application of this aspect of the guidance. In particular we sought to address an apparent misunderstanding of the term “enabling the performance of the contract” which is listed among the typical characteristics of a cost that would meet the requirements of being an allowable cost.

Stakeholder feedback and SSRO response

4.4 The consultation document stated the SSRO’s view that 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. This is because the requirements make specific reference to “the contract”. We received feedback, questioning why we consider rates agreed outside of a contract were unable to satisfy the requirements of allowable costs, and whether our view was based on rates being agreed on a contract by contract basis. For example, some feedback regarded the SSRO’s view as being that a rate agreed outside of a contract cannot be considered AAR due to the time lag between agreement of a provisional rate and application of this rate to a given contract, and that this time lag induces uncertainty in overall quantum.

4.5 Section 20 of the Act refers expressly to whether “*a particular cost is an allowable cost under a qualifying defence contract”;* and that *“an allowable cost must be “attributable to the contract”.* Therefore, whilst rates may be agreed in the absence of *a contract*, or *the contract*, this is not contemplated under section 20 of the Act.

4 Allowable Cost Guidance v.5.1, paragraph 3.1
5 Allowable Cost Guidance v.5.1, paragraph 3.3
6 Allowable Cost Guidance v.5.1, paragraph 3.11
7 Allowable Cost Guidance v.5.1, paragraph 3.12
8 Allowable Cost Guidance v.5.1, paragraph 3.13-3.14

4.6 We received mixed feedback from industry regarding our proposed changes aimed at clarifying our view that enabling the performance of the contract includes those costs suitably and necessarily incurred by the contractor to ensure the efficient and proper operation of the business of delivering qualifying defence contracts (QDCs) (paragraph 3.9 c). One respondent welcomed our changes which they considered to widen the interpretation of costs which enable the performance of the contract but suggested it was still too narrow and that the costs which contractors incurred to enable them to operate their business of delivering contracts for the MOD were not being considered as enabling the performance of the contract. They challenged us to adapt the wording of "necessary for the overall operation of the business" instead. Another respondent suggested that this proposal should refer to defence contracts, not just QDCs.

4.7 One industry respondent suggested that changes to paragraph 3.9 c of the guidance was not needed under the umbrella of "enabling the performance of the contract" as they see this paragraph relating more to how to judge reasonableness, which is adequately covered in an alternative paragraph.

4.8 Our guidance is clear that "enabling the performance of the contract" is one of a number of characteristics that is typical of costs which meet the requirements of an allowable cost. We think this should be uncontroversial. In recognising that it is "typical" we are also acknowledging that there are times when it will be less relevant, and so the guidance explains that different emphasis may need to be applied to each of the characteristics listed. A number of characteristics are listed and, where enabling the performance of the contract seems less relevant or unrelated to the cost being claimed, one or more alternative characteristics could be the basis of the claim. We have proposed changes to the guidance which removes references to "enabling the performance of the contract", which might suggest it should be applied contrary to our intent.

4.9 The intention of paragraph 3.9 is to provide a structure through which the characteristic of "enabling the performance of the contract" may be examined. We have consistently encouraged stakeholders to take a broad view of this aspect of the guidance. Adding the sub-clause of 3.9 c is aimed at emphasising this and does not change the current scope. Our intent is that the addition of a sub-clause should not restrict the preceding sub-clauses being used to demonstrate that a cost is enabling. We agree that ensuring the efficient and proper operation of the business may be relevant to thinking about reasonableness, but may also be relevant to the other requirements of allowable costs.

4.10 We have accepted the proposed change to refer to defence contracts, not just QDCs. We are unpersuaded however that being "necessary for the overall operation of the business" is a characteristic of a cost which would be typically allowable, since this could be said to describe the vast majority of costs that a business incurs, whilst it is clearly not typical that all costs are allowable. For example, it could suggest the allowability of costs incurred in the operating aspects of the business which are entirely unrelated to the business of defence and qualifying defence contracts. This does not mean costs which are necessary to the overall operation are not allowable, rather that the contractor will need to explain why, for costs that relate to the business as a whole (rather than just MOD contracts), it is that the MOD should pay them and the extent to which an amount is applicable to MOD activities.

4.11 We received feedback from the MOD that costs incurred in sustaining an essential or desirable capability (paragraph 3.10) would be more likely to be allowable if there were an explicitly recorded agreement between the contracting parties, and to indicate that this concept may be most helpful to the cost of idle facilities. Conversely, industry stakeholders considered this aspect of the guidance to be too restrictive and suggested we widen the range of costs covered in order to support the aims stated by the MOD within their Defence Capability Framework and DSIS. These aims, they said, would cover costs associated with: "the contract in question, similar contracts, and those required by government policy, defence requirements (including the suitable contractor requirements as set out by the Defence and Security Public Contract Regulations (DSPCR 2011)), along with the various regulatory requirements associated with that market."

4.12 We agree with the principle behind the MOD's proposal that the costs of sustaining an essential or desirable capability are more likely to be allowable within a given contract if there is an explicit agreement for the capability to be provided. The presence of such an agreement should make the matter straightforward, but there may also be other factors which would indicate that a capability is essential or desirable in respect of the delivery of qualifying contracts. For example, the existence of relevant government policies as highlighted by industry respondents. This has been reflected in the guidance, although we have not included specific examples to avoid the risk of unintended prescriptive application of the guidance.

4.13 Two respondents from industry argued that if paragraph 3.10 covered all costs required by a compliant defence contractor in sustaining an essential or desirable capability then there would be no need to revise section 4.

4.14 The purpose of section 3 is to provide broad guidance on the assessment of the AAR principles to all cost types. Section 4 is concerned with specific matters in relation cost accounting topics. We view paragraphs 3.9 and 3.10 as encompassing all costs insofar as they have been put to us, and do not see this as a substitute for the guidance in section 4. Given the proposal to expand the SSRO's referrals function to include determining the appropriateness of cost recovery rates, it is prudent that we develop guidance on this subject.

5. Cost accounting, direct costs, indirect costs and overheads – section 4

5.1 In seeking to update our guidance on cost pools and cost recovery bases we sought input from the MOD and industry stakeholders. Matters were brought to our attention in respect of:

- selecting suitable cost recovery bases;
- maintaining consistency of scope between cost pools and recovery bases; and
- striking the right balance in the scrutiny of the scope of costs and recovery bases as well as their quantum.

5.2 We consulted on changes which sought to provide a framework to separate direct and indirect costs for the purposes of applying this guidance. We suggested 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. We consider these changes particularly important in light of proposed changes to the regulatory framework set out in the MOD command paper[9] regarding the SSRO taking referrals on rates.

Stakeholder feedback and SSRO response

5.3 Some Industry stakeholders raised concern about the introduction of the term "overhead" to describe a type of cost, and instead wanted to describe it as a cost which has been estimated using a cost recovery rate. It was suggested that the term would be unknown to some audiences (such as contractors in the US), and that since it does not appear in the regulations it should not appear in the guidance either, citing regulation 29(5). Another stakeholder suggested that a later paragraph, 4.7 in the consultation, is removed to avoid using the term "overhead".

5.4 We have included the term "overheads" in order to identify a particular category of costs which are not directly related to the delivery of the contract.[10] We disagree with feedback that the term "overheads" is confusing or not compatible with the Regulations. The term "overheads" is commonly used, and indeed is used in the US FARS system. It is also already used in s.25(2) of the Act, which requires reports "relating to the overhead costs and forward planning" to be submitted. We would therefore expect those engaged with the regime to be familiar with the term. A glossary of terms is included in appendix 1 to aid a reader's understanding.

9 Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations - GOV.UK (www.gov.uk)

10 We have not used the term "indirect" to describe these costs because the Regulations use these terms to describe the use of a cost recovery rate, and wish to avoid dual usage (note that some direct costs i.e. direct labour, may be applied to the contract using rates).

5.5 We received feedback that the guiding principle for allocation of cost pools via rates should be fairness and to achieve this we should remove the proposed guidance which states that: “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”. It was argued that when allocation like this is guided by fairness then the only residual would be that which the MOD chooses to disallow. Even under these principles however it was put forward that there would still be some variance due to the inherent difficulty in aligning costs between a business unit and a specific contract over a significant number of years.

5.6 The purpose of our guidance is to assist the parties to agree if a particular cost under a qualifying contract is AAR. The SSRO is required under s.13(2) of the Act to aim to ensure value for money and fair and reasonable prices, which has guided the development of our guidance. We agree that the method of allocation should be fair and have updated the guidance to reflect this. However, we have not removed the text relating to avoidance of over and under recovery as this is a key aspect of fairness. We do not consider that if our guidance was to only direct the parties to the principle of fairness that this would in of itself assist in the practical application of the requirements of allowable costs.

5.7 One industry stakeholder was concerned that if the SSRO considers a cost to only be allowable within the context of a qualifying contract then the MOD is invited to challenge these costs twice – both at the time of agreeing the rate with the contractor and subsequently its application within a contract to form an indirect cost. Another respondent said that if the SSRO does not consider a rate agreed at business unit level to be subject to the requirements of allowable costs then this would raise difficulties for the proposed MOD changes to legislation to allow the SSRO to take referrals on rates agreed at a business unit level. The feedback asserted that the proposed changes imply that pricing rates at a business unit level are subject to s.20 of the Act, but independent of their use on a qualifying contract, and they questioned how the guidance would achieve the s.13 outcomes.

5.8 Section 20 of the Act is clear that the requirements of allowable costs relate to a particular cost under a qualifying contract. It is not our intent to invite challenge of cost beyond what is necessary to establish that the cost meets the requirements of allowable costs. We are aware that the MOD agrees rates at a business unit level and then these are applied to particular contracts to arrive at the contract costs. However, we would expect the MOD will want to scrutinise both the rate and its application to the contract to ensure the requirements of allowable costs are met.

5.9 We think the SSRO’s position on this may have been misunderstood. Our view is that the requirements of allowable costs ultimately must be met at the point at which the relevant rate is applied as a particular cost to a qualifying contract. We were clear that section 20 should guide the agreement of rates that are intended to be applied to QDCs and the proposed guidance addresses that. Our guidance is written with our section 13(2) duty in mind that when a rate is agreed at a BU level and then applied within a qualifying contract in that way the outcome should support a fair and reasonable price and value for money.

5.10 Some stakeholders were unconvinced by the need for targeted guidance to help in the understanding of the AAR principles within the specific context of rates, to supplement the broader guidance already within section 3, which is applicable to both direct and indirect costs. Specific feedback was raised around paragraph 4.10 (iii) which provides guidance for assessing whether indirect costs are appropriate. It was argued that the test for appropriateness is the same for indirect and direct costs, and that this paragraph is therefore confusing.

5.11 Cost recovery rates have unique features which complicate the application of the requirements of allowable costs such as use of cost pools and recovery bases. Our understanding based on engagement with stakeholders is that additional guidance may assist in this regard. We see a difference between the assessment of reasonableness for direct and indirect costs since the former is concerned with an identified amount incurred (or expected to be incurred) whereas the latter is the product of a cost recovery rate and a recovery base. We believe it is important that our guidance is clear on each of the requirements for the allowable cost relating to the agreement of cost recovery rates. We maintain that it is useful to explain appropriateness for indirect costs - as our guidance explains, not all costs within a cost pool need to meet the appropriateness test, but rather only those which are to be allocated and apportioned to qualifying defence contracts.

5.12 Our consultation document provided some examples of types of costs which it may be appropriate to include in a cost pool. We received feedback that:

a. This may lead parties to interpret group level HR costs as being disallowable, because the example only references business unit HR costs.

b. The list could include other costs which enable a business to perform legally and compliantly within a given regulatory framework.

5.13 It is important to emphasise that the examples were intended to provide a general indication of cost types which it may be appropriate to include in a cost pool. This should not be taken to mean the cost types listed are allowable costs or that those which are not listed are not allowable. In response to feedback we have expanded our list of examples of costs which may be attributable via indirect costing.

5.14 We received feedback from the MOD that the quantum of costs in a cost pool cannot be considered reasonable solely on the basis that they are consistent with the contractor's historical average or in line with what the contractor typically incurs in such circumstances, which was the example the proposed guidance included. They suggested that it requires that "the quantum of costs in the pool are justifiable if they are of a similar level to that of a well-run company operating under competitive market pressure to maximise efficiency would be expected to incur and allocate to contracts".

5.15 We do not disagree that the proposed words would describe circumstances in which costs may be considered reasonable. However, we are not persuaded that these are the only circumstances in which a cost would be reasonable, which may not reflect the optimal nature of those described by the MOD. We also have concerns as to the extent it would be practical or proportionate for contractors to always demonstrate the proposed characteristics. For example, what is the basis upon which a company is judged to be "well run"? We have amended the guidance to reflect the circumstances the MOD has highlighted, whilst allowing a wider range of circumstances to apply.

5.16 We received mixed feedback on our use of examples. The MOD emphasised that the examples should not be rigidly applied to the agreement of allowable costs, whilst an industry consultant took the opposite view and wanted examples to more accurately reflect the specific practice in the MOD. Stakeholders from industry and the MOD raised concerns that the examples were not realistic enough, suggesting they were looking for something which could be followed in detail to determine if a cost was allowable. One industry respondent suggested that including simple numbers would be helpful but cautioned that any example with numbers should be discussed with industry and the MOD prior to publication. Two industry stakeholders suggested that a list of costs included in one of our previous documents[11] would be helpful to include in our guidance.

5.17 To date we have not included examples in our allowable cost guidance. This is partially due to the risk that these would be interpreted as being prescriptive of what is an allowable cost or not. Our guidance is intended to assist the parties in coming to their own view on this, noting that the onus is on industry to demonstrate that costs are allowable. Having listened to stakeholders that examples would be helpful, we proposed some examples in this consultation to gauge feedback from stakeholders. These examples were intended to illustrate how the guidance might apply in the contact of a real, albeit highly stylised, setting. The examples were primarily developed by the SSRO but drew on real situations that were shared with the SSRO by stakeholders in meetings and workshops. Contrasting stakeholder feedback suggests it would not be suitable to introduce examples in the guidance at this time. We think more time needs to be taken to gain a consensus on the approach to using examples and we invite stakeholders to provide us with their own examples for consideration and potential inclusion in future guidance development. The list of costs are those industry proposed they may find it difficult to recover under qualifying contracts. We remain content that for the majority of cost types or activities, including those identified by respondents, demonstrating the relationship of costs to contracts should be unproblematic. However we do not propose to include this list in the guidance in order to avoid suggesting these costs types are allowable, when the onus is on the contractor to demonstrate this for each specific contract.

5.18 Comments were made on the guidance that additional care will be needed where the contractor's costing system for work under contracts to the Secretary of State is different from that used for other work, as the costing systems may not be directly comparable. One respondent queried the suggestion that the costing system may be different, as that was not their experience. Another respondent said the cost system for QDCs is usually used for that purpose only.

5.19 This part of the guidance has been in place for a number of years and it was not proposed to be updated in this consultation. Our guidance is clear that the contractor may agree a methodology for allocation and apportionment of costs with the Secretary of State. The guidance does not preclude any of the approaches proposed by industry and therefore we have not changed the guidance in this update.

11 SSRO Pricing guidance summary of consultation responses January 2019 (publishing.service.gov.uk)

6. Guidance on specific cost types: Part D

6.1 The consultation proposed changes to the guidance on research and development costs. Our aim was to assist the parties to apply the requirements of allowable costs to circumstances where timing differences arise between the research cost being incurred and the pricing of a qualifying contract.

6.2 One respondent said that if costs were only allowable if they enable the performance of the contract then research costs would only be recoverable on a historical basis or, as the guidance proposes, where the research costs were necessarily incurred to sustain the contractor's skills, expertise and capability to deliver the contract and others like it. It was said if the wording "and others like it" were interpreted too narrowly by the MOD, some legitimate research costs may not be deemed allowable.

6.3 The guidance does not say that research must have enabled the performance of the contract in order to be allowable, so we see nothing to address in that regard. However, we do see a case to explicitly state that where research did enable the performance of the contract this would be a positive characteristic in terms of allowability, which is reflected in the guidance. Beyond that, our proposed guidance encourages an expansive view to be taken of allowable R&D costs, whilst recognising it would not be appropriate for the MOD to pay a portion of research costs on matters entirely unrelated to defence.

6.4 The MOD suggested that we make two changes to our guidance on research costs. They suggested the guidance should state that costs are more likely to be allowable where:

- there is an explicit agreement about the scale and nature of research that is necessary for the contractor to undertake to meet the MOD's long-term needs; and
- the goods or services could not have been provided but for the research, or research of a similar nature, having been undertaken in the past.

6.5 Where the MOD and the contractor have an agreement for research to be undertaken the question of allowability of costs should be uncontroversial. We have reflected in the guidance the suggestion that research of a similar nature to the contract in question may be an allowable cost, but do not see it necessary to qualify that it was undertaken in the past.

7. Issues on which we did not consult, and other issues raised

7.1 One industry stakeholder suggested that the US FARS 31.201-4 presented an acceptable method of demonstrating attributability of costs to the contract, with particular reference to FARS 31.201 part c, which suggests that this would be costs which are “necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown”.

7.2 It is our view that this approach would be too permissive and would indicate that any costs incurred to operate the business should be allowable even if they are entirely unrelated or unnecessary to the capabilities provided to the MOD.

7.3 We received written feedback from one industry contractor that all contracts should bear some of the allocation of costs that a business is required to sustain itself. It was said that if costs go unallocated to contracts then companies cannot achieve reference group profitability levels which undermines our principle of comparability whilst our BPR methodology is predicated upon profit levels of comparator groups. It was argued that this profit level cannot be achieved within a qualifying contract when some costs are disallowed. This issue was also raised separately with direct reference to sales and marketing costs, and the respondent suggested that we had previously directed them to the BPR documentation as an answer to this previously raised question[12].

7.4 We agree that proper allocation of business running costs is essential to achieving value for money and a fair and reasonable price. However, there is no case for the MOD to bear the costs of sustaining business activity which has no relation to anything it might have a need for. For example, where a business has operations in a different sector, or conducts activities that have no bearing on the operations for the MOD. Where shared services support MOD contracting activity, the MOD should pay only its fair share and our guidance supports this. Were the MOD to support unrelated business activities this would represent a cross subsidy and not be value for money or fair and reasonable. In effect we seek to benchmark the profit rate for a company as a whole and apply that to the relevant part of the company cost for the MOD’s contracting purposes. Costs incurred by the company but not relevant for the MOD should attract profit from the end customer or user of those costs.

7.5 We received feedback that there is a discrepancy between our guidance and how the MOD operates in practice. An industry stakeholder provided feedback that the MOD do not allow a portion of sales and marketing costs even where there is a demonstrable financial interest to them in doing so due to reduced unit costs arising from a wider customer base.

12 Q_and_A_Briefing.pdf (publishing.service.gov.uk)

7.6 We understand the contractor is referencing paragraph C.13 of our statutory allowable cost guidance, which provides that if the contractor can demonstrate to the MOD that the cost attributed to the contract is reduced due to sales and marketing costs then some of these sales and marketing costs should be allowable under the contract. The guidance goes further in suggesting the evidential barrier and the quantum of cost which may be considered allowable. We consider that our guidance is clear. However, we would be grateful to be provided with examples in which a contractor had demonstrated such benefit to the MOD but that the cost was disallowed regardless, as this may inform our future development of guidance. In the event there is disagreement as to the extent to which a particular cost is an allowable costs, it is open to either the MOD or the contractor to seek an opinion or determination from the SSRO.

7.7 We received feedback suggesting that the phrase "the costs of maintaining a going concern" should be added to the guidance as an allowable cost. The feedback pointed to the MOD's commercial toolkit which they said requires "a going concern capable of discharging the contract". Although we could not identify this particular requirement in the MOD's commercial toolkit, commercial policy statement (May 22) does express an need to ensure the financial position of a supplier would not "place public money or services at unacceptable risk". The response also highlights the Defence and Security Public Contracts Regulations (DSPCR) 2011, in particular regulations 23 to 26, which explain the criteria for rejection of a contractor, requirements regarding a contractor's economic and financial standing and their technical and professional abilities in the context of competitive tendering. The toolkit also covers the requirement to support UK prosperity and innovation.

7.8 The SSRO understands the term "going concern" as per the guidance in FRS 102[13] paragraph 3.8: "An entity is a going concern unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue." We know from feedback that contractors frequently take a variety of work on both MOD and non-MOD contracts, all of which may form the basis for the contractor to be considered a "going concern". As such, to suggest that the "the cost of maintaining a going concern" would be allowable seems overly broad. Existing guidance on allowable costs should provide scope for the MOD and Contractors to determine what elements of contractors' costs are or are not allowable.

13 FRS 102

Minor amendments

7.9 We received some feedback which we feel does not need substantial explanation. We have grouped this feedback and our response (including consequential changes) into the table below.

Feedback	Response
Contrary to text in consultation we received feedback that a contractor will always use their records as evidence to demonstrate a cost is AAR.	In proposed guidance para 2.6 (para 2.8 of guidance version 6) we have changed “might” to “will”.
Stakeholders requested that our guidance confirm that rates are agreed at a business unit level rather than at a contract level.	This has always been our understanding and we view the guidance as reflecting this. We have addressed drafting to make this clearer.
One stakeholder disliked the use of the term “reasonable person” and argued that a reasonable person may not have the necessary financial expertise or knowledge to assess “reasonableness” as it relates to AAR.	The purpose of this guidance is to reinforce the need to assess allowability in a reasonable and informed way. We would be surprised if stakeholders supported anything to the contrary. We maintain the position set out in our consultation document[14] that a “reasonable person informed of the facts” is an established legal standard not based on the ‘average’ or ‘typical’ person and are not therefore persuaded by the argument raised by the stakeholder. We are open to considering this further if interpretation of the term proves problematic in practice.
One stakeholder suggested an amendment to our proposed paragraph 3.1 of the statutory guidance, appending to the final sentence “have been calculated using a cost recovery rate”.	We find this a helpful suggestion and have made the change in the final guidance.
We received feedback that the word “allocated” was preferred to “traced” when describing how rates are used to apportion cost pools to a contract.	We consider tracing a cost to be a prerequisite to a cost being allocated. A cost which is not traceable is difficult to allocate to a specific contract, while one which is traceable should be able to be allocated.
We received minor suggestions from the MOD to alter the definitions of direct, indirect, and overhead costs.	These changes have been accepted and are reflected in the updated guidance.

14 Table 2, page 17

Feedback	Response
One stakeholder wrote that the description of a cost accounting methodology is not required and cautioned that that the choice of appropriate methodology will need to meet the requirements of statutory audit.	We consider it aids the clarity when we describe what we mean by particular terms. We do not think our description of what a cost accounting methodology includes conflicts with any requirements of statutory audit.
We received feedback that the costing system used for QDCs will only include costs which are AAR.	The Act requires that the MOD will need to be assured of this regardless. We have also received feedback that some contractors use the same costing system for MOD and non-MOD contracts, so we think there is potential in some cases for not all of the costs in the pool to be AAR.
One respondent questioned our use of the term “money spent” and suggested it may indicate a preference for cash rather than accruals accounting.	We have removed the term “money spent” to avoid confusion and instead referenced the costs incurred.
We received feedback that our guidance should not refer to costs which are produced using a rate, and are agreed to be AAR, as an estimate but rather in more definitive terms.	It is our view that any cost produced using a cost pool and cost recovery rate is by construction an estimate. If the actual apportionment of costs was known, the need to recover via rates would not exist. This is a function of algebraic methodology, and additionally it is important for parties to accept the degree of uncertainty in cost apportionment this way. The apportionment of indirect costs are necessarily estimated, unlike direct costs.
One stakeholder suggested that the SSRO should require all contractors to maintain a QMAC, and this would assist in the allocation and apportionment of actual costs.	This is a matter of MOD policy which is out of scope of this guidance. We understand that not all contractors are required to submit and agree a QMAC. As set out in our consultation document we are supportive of the QMAC being used to agree the allocation and apportionment of actual costs.

Feedback	Response
The MOD suggested changes to the definitions of direct, indirect and overhead costs to include the words "specific" and "particular". The MOD suggested to add to the definition of indirect or indirectly recovered cost that the parties should agree an unambiguous methodology setting out the circumstances in which a cost would be recovered directly or indirectly.	We agree that the inclusion of "specific" and "particular" are sensible modifications to our definitions which is reflected in our updated guidance. We agree that the method of recovery should be unambiguous, but this does not seem to be a defining point of an indirect cost. The guidance explains that the SSRO is not prescriptive about the method of recovery but that the MOD will want to be satisfied with it. In that regard we consider our guidance addresses the point made by the MOD.
We received feedback from industry stakeholders concerned that our guidance was predicated on rates being agreed on a contract-by-contract basis and that this was contradictory to what happens in practice i.e. that rates are agreed at a BU level and over time cost pools are allocated via rates to contracts (both MOD and non-MOD in some cases).	We are clear that rates are typically agreed at a business unit level rather than on a contract-by-contract basis, and our guidance is predicated upon this understanding.
One industry stakeholder argued that if engineering is an essential or desirable capability and research costs are essential in sustaining such a capability then research should be seen as an allowable cost.	We cannot comment on the allowability of specific costs outside of a referral, however the example of research costs is the sort of cost the SSRO had in mind when the guidance on sustaining an essential or desirable capability was introduced. Our guidance does not state that sustaining an essential or desirable capability is necessarily sufficient to consider a cost as AAR.
One stakeholder questioned if the proposed changes to E.4.4. reflected a widely accepted definition of a 'notional transaction'.	We have further reviewed this text and the Review Board documents which introduced this term. On the basis of this we have amended E.4.4. to the following: "Notional values of transactions are generally not allowable costs". In some cases, such as futures contracts, notional values may be reacted to by outside parties (such as the market) as if the values were "real" but these would not be allowable costs.

8. Conclusion and next steps

8.1 Statutory allowable cost guidance version 6.0 is published alongside this consultation response, which supersedes the previous guidance version 5.1 and is effective from 7 November 2022.

8.2 There are no specific plans to further develop allowable cost guidance at this time. However, we remain open to feedback, and any further updates to this guidance will be considered as part of our corporate planning process. In particular we would encourage stakeholders to share concrete examples of application of our guidance.

8.3 We are considering if our guidance on credits should be further reviewed given the MOD's proposals legislative change in this area[15] and the SSRO's determination on the treatment of research and development expenditure credits[16]. We will keep this under review to determine if revised guidance should be considered.

8.4 Finally, we would like to thank stakeholders for the significant involvement in this piece of work and their input across working papers, working group written responses and informal engagement.

15 Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations (publishing.service.gov.uk)

16 SSRO determination on the treatment of Research and Development Expenditure Credit when determining allowable costs under a qualifying defence contract - GOV.UK (www.gov.uk)

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.