

**SSRO**

Single Source  
Regulations Office

Pricing guidance review 2018  
Stakeholder responses to working papers  
October 2018

# Contents

1.	Introduction	1
2.	Summary of the working papers	3
3.	Requirements of Allowable Costs (the AAR test)	5
4.	Research and development	14
5.	Capital servicing adjustment	20
6.	Other changes and future review	26

# 1. Introduction

- 1.1 Section 18 of the Defence Reform Act 2014 (the Act) requires that the Secretary of State, or an authorised person, and primary contractors have regard to guidance issued by the SSRO in relation to any of the six steps for determining the contract profit rate for a qualifying defence contract (QDC) or qualifying sub-contract (QSC). Section 20 of the Act states that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs. The SSRO aims to keep its guidance current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 The current pricing guidance was published in spring 2018. It includes guidance on:
  - a. Allowable Costs<sup>1</sup> (Allowable Costs guidance); and
  - b. the application of the six-step process to calculate the contract profit rate<sup>2</sup> (profit rate guidance).
- 1.3 The SSRO, in consultation with stakeholders, prioritised the following areas where its pricing guidance would be reviewed in 2018:
  - a. the requirements of Allowable Costs (the AAR test);
  - b. research and development costs (R&D);
  - c. capital servicing adjustment (CSA); and
  - d. cost risk.
- 1.4 As part of the review, which commenced in April 2018, the SSRO:
  - a. issued working papers on the first three of the topic areas to the SSRO's Operational Working Group 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 OWG to discuss the issues raised by the working papers; and
  - c. received written responses to the working papers from 13 stakeholders (Table 1).

**Table 1: Stakeholder responses to working papers**

Stakeholder	AAR test	R&D	CSA
MOD	✓	✓	✓
ADS	✓ *	✓ **	✓ **
Contractors	10	4	4
Other	1	1	1
<b>Total</b>	<b>13</b>	<b>7</b>	<b>7</b>

\* The ADS response was explicitly supported by six of the responding contractors.

\*\* The ADS response was explicitly supported by one of the responding contractors.

- 1.5 The SSRO would like to take this opportunity to thank these stakeholders for sharing their views with us.

<sup>1</sup> SSRO (2018) *Allowable Costs Guidance*.

<sup>2</sup> SSRO (2018) *Guidance on the Baseline Profit Rate and its Adjustment 2018/19*.

- 1.6 This paper provides a summary of the three issued working papers, and stakeholders' responses to these. Input from stakeholders has helped the SSRO to develop proposals for revising its pricing guidance in these areas, which have been issued for a public consultation of eight weeks (15 October 2018 to 7 December 2018) in SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20*.
- 1.7 The SSRO's engagement with stakeholders on guidance related to cost risk has been deferred to allow additional time for the MOD to develop its proposals for legislative change in this area following the Secretary of State's review of the legislation completed in December 2017. Details of any proposals for guidance changes related to cost risk will be published in due course and the subject of a separate public consultation.

## 2. Summary of the working papers

- 2.1 This section summarises the topics covered in the working papers and the areas where the SSRO sought stakeholder views.

### Requirements of Allowable Costs (the AAR test)

- 2.2 This working paper focused on the topic of the requirements of Allowable Costs set out in Section 20 of the Act and reviewed paragraphs 3.1 to 3.7 of the current Allowable Costs guidance. The paper presented the SSRO's understanding of the following areas, along with discussion of potential guidance changes:
- a. how the guidance should be applied;
  - b. the evidence required to show that costs are Allowable Costs;
  - c. how the guidance supports the achievement of value for money in government expenditure and fair and reasonable prices to contractors;
  - d. the relevance of a public scrutiny test to the assessment of Allowable Costs;
  - e. the types of costs that are not, or generally not, Allowable Costs;
  - f. the potential for some costs to be inappropriately excluded from Allowable Costs;
  - g. the wording of guidance related to costs needing to be incurred by the contractor and recovered only once; and
  - h. associated requirements to update the reporting guidance.

### Research and development

- 2.3 This working paper focused on the topic of research and development costs and reviewed section D1 of the current Allowable Costs guidance. The paper presented the SSRO's understanding of the following areas, along with discussion of potential guidance changes:
- a. the scope of the guidance and the case for it to reflect defined accounting terms;
  - b. the need to consider research and development separately in the guidance;
  - c. the practical application of the parts of the guidance referring to 'discernible benefit' and to abortive R&D;
  - d. the attribution of research and development to contracts;
  - e. the ownership of created intellectual property and any associated arrangements;
  - f. the treatment of R&D tax credits and reliefs; and
  - g. associated requirements to update the reporting guidance.

### Capital servicing adjustment

- 2.4 This working paper focused on the topic of the capital servicing adjustment and reviewed paragraphs 17 to 23 of the current profit rate guidance. The paper presented the SSRO's understanding of the following areas, along with discussion of potential guidance changes:
- a. using business unit information as an estimate of contract information;
  - b. an exploration of alternative calculation approaches;
  - c. the calculation of capital employed;
  - d. the calculation of cost of production;

- e. the source of data;
- f. the case for the guidance to reflect defined accounting terms;
- g. associated impacts of significant changes to lease accounting standards;
- h. the capital servicing rates; and
- i. associated requirements to update the reporting guidance.

### **SSRO response**

- 2.5 The SSRO has reviewed and considered all of the responses received from stakeholders to the working papers on the AAR test, R&D and CSA. The following sections of this paper summarise the key points made by stakeholders on those topics and, having taken these into account, the SSRO's proposals for guidance change in these areas. Proposed new guidance related to these topics has been published separately alongside this document for public consultation.<sup>3</sup>

---

<sup>3</sup> SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20*.

### 3. Requirements of Allowable Costs (the AAR test)

- 3.1 We set out below a summary of the key points made by stakeholders with regards to the guidance on the requirements of Allowable Costs (the AAR test) and how this has informed the SSRO's proposals for changes to the guidance.

#### General comments

- 3.2 Industry respondents welcomed the approach to engagement on guidance changes although one was concerned that views expressed by stakeholders were not always adequately taken into account in revising guidance.
- 3.3 Contractors highlighted that they incurred costs in accordance with internally agreed policies, processes and governance arrangements which were designed to avoid unnecessary cost wherever possible. One was specifically concerned about the impact that determining costs were not Allowable Costs would have on contractors' future financial sustainability.
- 3.4 A small number of respondents said that interpretation of the existing guidance, and the extent to which the MOD sought evidence to support its assessment of whether costs were Allowable Costs (in some cases for minor items), had resulted in additional effort and delay in the agreement of rates for pricing contracts but with little impact on contract prices.
- 3.5 Industry respondents were concerned that the statutory guidance contained a number of concepts or requirements that were not explicitly stated in the legislation, such as 'evidence', 'value for money for taxpayers' and 'public scrutiny'. They said these caused confusion for stakeholders and distorted the legislative requirements and should only be retained where the underlying principles and standards to meet the requirements were established.
- 3.6 It was suggested the SSRO might publish non-statutory guidance to illustrate the scope of statutory guidance.

#### Response and proposed change

- 3.7 The SSRO welcomes the comments on its approach to engaging with stakeholders on the review and development of its guidance. It remains committed to explaining, through documents such as this, how stakeholder views have informed its decisions about changes.
- 3.8 We note contractors' comments on the role played by their internal policies and processes in avoiding unnecessary expense and the concern raised about the impact of the application of the Allowable Costs guidance. The Act requires the SSRO to aim to ensure that its guidance supports the achievement of contract prices that obtain good value for money in government expenditure and are fair and reasonable to contractors. We propose changes to the guidance this year that will emphasise the importance of these objectives to the determination of Allowable Costs.
- 3.9 Through the ongoing development of its pricing guidance, in consultation with stakeholders, the SSRO aims to ensure its guidance is specific enough to be unambiguously interpreted while being flexible enough to be applicable to a wide range of circumstances. Guidance which strikes the right balance between these aims should make it easier for the parties to determine Allowable Costs. This will, in turn, facilitate agreement between the parties and help to avoid the delays in contracting reported by respondents. We would remind the parties, however, that where they cannot reach agreement, the Act makes provision for them to refer matters to the SSRO for an opinion or determination.

- 3.10 The SSRO is required (Section 20(1)) to 'issue guidance about determining whether costs are allowable costs'. The legislation places no restriction on how the SSRO fulfils that obligation other than that it must, in performing this function, aim to ensure good value for money is obtained in government expenditure and contractors are paid fair and reasonable prices. To the extent that the guidance introduces concepts or requirements not explicitly stated in the legislation we believe this helps to clarify the requirements of legislation, rather than distort them. The specific concepts highlighted in paragraph 3.5 are discussed in more detail in paragraphs 3.25 to 3.26, 3.33 and 3.40 to 3.42.
- 3.11 With regard to the suggestion that the SSRO publish both statutory and non-statutory guidance, the Allowable Costs guidance is published to discharge the SSRO's duty under Section 20(1) of the Act. It is statutory guidance to which the contracting parties must have regard. We do not intend to publish a different category of guidance related to Allowable Costs that is non-statutory.

### Applying the guidance

- 3.12 Respondents believed the guidance should continue to be based on principles, as this provided flexibility for the parties. The basis for the principles should be clear, able to withstand legal scrutiny, and support the parties to reach an agreement on Allowable Costs. They suggested that the guidance should additionally set out the bases on which costs might be assessed as *not Allowable Costs*.
- 3.13 In cases when the MOD is not satisfied that the contractor has shown that costs are Allowable Costs, industry respondents suggested the guidance should require the MOD to confirm in writing why it considers the AAR test to not be met. They also wanted the MOD to be required to indicate what additional information it would need in such cases to be satisfied that costs are Allowable Costs.
- 3.14 No respondents indicated a desire to include in the guidance a more exhaustive range of factors to consider, as this might necessitate more frequent guidance updates. However, industry respondents suggested the guidance might usefully encourage the parties to consider the following additional factors:
- a. specific agreements between the MOD and contractors concerning costs;
  - b. custom and practice;
  - c. the desirability of considering costs, particularly overheads, in the aggregate, on the basis that the potential overestimation of some costs would be offset by the underestimation of some other costs; and
  - d. whether costs would be likely to be incurred by companies in the baseline profit rate comparator group.
- 3.15 Other points raised included:
- a. the need for guidance to acknowledge the provision in the legislation (Section 20(4)) for contractors to show that the requirements of Allowable Costs are met by reference to the statutory guidance *or otherwise*; and
  - b. that affordability for the MOD should not influence its assessment of whether costs were Allowable Costs.



### *Response and proposed change*

- 3.16 We agree that the guidance should continue to be principles-based as this will better support the parties to apply the guidance to a wider range of circumstances than if it were rules-based. In developing the guidance, we have endeavoured to identify the underlying principles and related factors which the parties should consider when determining whether costs are Allowable Costs. By extension, these principles should assist the parties to determine whether costs are *not Allowable Costs*.
- 3.17 We think it would be appropriate for both parties to consider what information is necessary to show that costs are Allowable Costs and we propose new guidance related to this. We do not propose, as suggested by respondents, to use our guidance to create an obligation on the MOD to provide specified information to contractors.
- 3.18 We note stakeholders' preference for the SSRO to not provide more exhaustive guidance. While this is desirable to promote flexibility for the parties, we would note that this flexibility brings with it wider scope for the parties to interpret guidance differently, potentially leading to disagreement. With regard to the additional factors proposed for inclusion in the guidance we make the following observations.
- a. We acknowledge that specific agreements between the MOD and contractors and custom and practice concerning costs may influence how contractors incur costs or attribute these to contracts. There is a risk, however, that agreements, customs and practices are inconsistent with the requirements of Allowable Costs as specified in legislation and described in the SSRO's guidance, particularly where these pre-date the Act and Regulations. We do not, therefore, propose to include specific agreements or custom and practice as required considerations within the guidance to avoid the potential for these to have an inappropriate influence on the determination of Allowable Costs.
  - b. We think it unlikely that any underestimated costs would automatically offset any overestimated costs, as suggested by respondents who favoured the consideration of costs in the aggregate when determining Allowable Costs. Indeed, where costs are under- or over-estimated these may be considered not to satisfy the requirements of Allowable Costs described in the guidance, for example, not being the costs (to be) incurred by the contractor. The legislation requires the parties to be satisfied that costs meet the AAR test to be Allowable Costs. We consider, however, that the degree of granularity applied by the parties when determining Allowable Costs is a matter for the parties to decide taking account of the circumstances. We propose changes to the guidance to indicate the need for the parties to take a proportionate approach when deciding what information is required to be satisfied that costs meet the requirements to be Allowable Costs.
  - c. We do not agree that the types of costs incurred by comparator group companies should be a required consideration in determining Allowable Costs in QDCs/QSCs. Comparator group companies are not subject to the requirements of the Act and Regulations. The costs they may incur, in a range of circumstances, for example, costs associated with sales and marketing, would not in our view provide a useful guide in assessing if a particular cost type for a QDC or QSC meets the requirements of Allowable Costs. We do not, therefore, propose to include consideration of whether costs would be incurred by comparator group companies.
- 3.19 As suggested by respondents, we propose to update the guidance in paragraph 2.2 to note more fully the provisions in Section 20(4).

- 3.20 We note the comment regarding affordability for the MOD being a factor that should not influence the determination of Allowable Costs. Affordability is clearly a consideration for the MOD when procuring goods and services. However, to the extent that Allowable Costs should support contract prices that are both value for money for the government and fair and reasonable to contractors, we do not consider that affordability should be an overriding consideration in the determination of whether particular costs meet the AAR test. Affordability does not feature in the guidance at present and we do not propose to include it. We would additionally note that our guidance focuses on matters that *should* be considered and we do not propose introducing factors that should *not* be, of which there are potentially many.

### **Evidential standards**

- 3.21 The suggestion in the working paper that the parties should take a proportionate approach to applying the AAR test was widely supported by respondents. They believed the parties should take account of the materiality of particular costs, the availability of evidence from normal business processes and the cost-effectiveness of providing information to show costs meet the requirements of Allowable Costs. Industry respondents believed that the exclusion of costs for which there was limited, or incomplete, evidence was inappropriate as this would result in contract prices that were not fair and reasonable for contractors.
- 3.22 Respondents did not want guidance to be prescriptive about the types of information to be provided when showing how costs met the requirements of Allowable Costs. However, some thought it would be helpful to better define evidential standards to avoid unacceptable subjectivity in applying the AAR test. It was suggested that a range of information related to historic facts and reasonable assumptions about the future might appropriately be provided to show that costs were Allowable Costs.
- 3.23 Industry respondents felt the guidance in paragraphs 2.3 and 2.4 could be more explicit on how the requirements of Allowable Costs applied to QSCs and QSC contractors, although the MOD was content with the guidance as drafted.
- 3.24 Industry respondents indicated that external benchmarking information was difficult for contractors to obtain to support Allowable Costs claims as this was likely to be commercially sensitive. Where the MOD had access to such data, for example, from contract reports, contractors believed it would be difficult for them to challenge conclusions drawn from it. The MOD was concerned that, while benchmarking data provided a guide to efficient costs, it should not preclude consideration of the circumstances of the case when determining whether costs were Allowable Costs.

### **Response and proposed change**

- 3.25 We note the support for the parties taking a proportionate approach to applying the AAR test and stakeholders' comments on the factors that might influence the information expected to show costs are Allowable Costs. The legislation is not prescriptive about what information the parties require to be satisfied that the AAR test is met. We propose changes in the guidance noting that the assessment of whether information is sufficient to show that costs meet the AAR test needs to be made on a case-by-case basis, although we think it would be unreasonable for the parties to conclude costs are Allowable Costs without reference to any information.
- 3.26 While noting respondents' comments on the need for guidance not to be prescriptive, we propose including additional guidance on types of information that may be provided to show that costs are Allowable Costs. This includes reference to the relevant records that contractors are required to keep (Regulation 20 and Section 23) and to other information related to facts, assumptions and calculations.

- 3.27 We note the divergent comments on how the guidance explains the application of the AAR test to QSCs and QSC contractors. The guidance in paragraphs 2.3 and 2.4 was last revised in 2018 and in the absence of specific evidence to support further revision we intend to leave it unchanged this year.
- 3.28 We note the comments on the availability and use of benchmarking information in determining Allowable Costs. We consider that cost benchmarks, where available, remain a relevant consideration but propose revisions to the guidance to explain more clearly the sorts of comparative information that may be considered when determining whether a cost is reasonable in the circumstances.

### **Value for money and fair and reasonable prices**

- 3.29 Respondents questioned the reference in the guidance (paragraph 3.7f) and in the working paper to 'value for money for the UK taxpayer', given the Act refers to obtaining 'good value for money... in government expenditure'.
- 3.30 As discussed in the working paper, there was widespread agreement that it was difficult for the contracting parties to test whether particular costs delivered good value for money given the many factors that would need to be considered for such an assessment, although it was suggested value for money might reasonably inform the development of the SSRO's guidance.
- 3.31 The SSRO's alternative proposal, to include consideration of economy and efficiency for particular costs, was explicitly supported by the MOD and some industry respondents, although some others suggested this was inappropriate as the terms of contracts, the requirements of the legislation, and the MOD's application of the AAR test all led to inefficiency.
- 3.32 Other points raised included:
- a. the need for a better balance in the guidance between value for money and fair and reasonable prices; and
  - b. the potential for 'good business practice' to be too subjective to be a consideration in determining whether a cost was reasonable in the circumstances.

### **Response and proposed change**

- 3.33 The SSRO considers the achievement of value for money for taxpayers and value for money in government expenditure to be synonymous, as the government will seek to secure good value for taxpayers when it spends public money.
- 3.34 We note stakeholders' comments on the consideration of value for money at the level of particular costs. We consider that the achievement of good value for money in government expenditure remains an important consideration when determining Allowable Costs but one that is difficult to ascertain or evidence at the level of particular costs. As discussed in our working paper, we think the concepts of economy and efficiency (which, along with effectiveness, underpin the achievement of value for money) are more readily demonstrable at the level of particular costs. We propose revising the guidance to note that the achievement of good value for money in government expenditure is as an overarching principle and to require consideration to be given in determining whether costs are reasonable in the circumstances to whether the contractor has taken adequate steps to enhance economy and efficiency. Consideration of whether the contractor has taken adequate steps to enhance economy and efficiency, rather than having achieved these, will allow the parties scope to take account of any inefficiencies that may, as indicated by respondents, result from contract terms, the operation of the single source procurement framework or the contractor's historic ways of working.

- 3.35 In light of the inclusion described above, we propose to remove the requirement to consider whether costs are 'consistent with good business practice' when determining if costs are reasonable in the circumstances. We consider that there may be differences of opinion between the parties as to what constitutes good business practice and limited evidence from outside the contracting organisations against which to assess the practices they employ. In general terms we consider that it would be good business practice to minimise cost wherever possible in order to maximise profitability and competitiveness, making the pursuit of economy and efficiency a suitable, and more easily demonstrable, replacement.
- 3.36 We agree there should be an equal focus between value for money and fair and reasonable prices and propose changes to the guidance that emphasise the centrality of both of these objectives to determining Allowable Costs.

### **Public scrutiny**

- 3.37 Industry respondents thought considerations of public perceptions about the nature or level of a particular cost were inappropriate, given the public's limited knowledge of the context or requirements of particular QDCs or QSCs. Their preference was to replace 'public scrutiny' with 'expert scrutiny', such as that which might be provided by the SSRO or Parliament, or for the SSRO to provide more explicit guidance on the principles against which costs should be tested.
- 3.38 Respondents noted that public perceptions were not objective and changed over time, even during the course of a contract, making the application of a public scrutiny test difficult in practice. The MOD, however, supported retention of a public scrutiny test believing its intention was generally well understood. It indicated that public perceptions about spending public money were a key consideration in its assessment of costs which were not Allowable Costs.
- 3.39 Industry respondents did not agree that the SSRO's alternate proposal to consider standards of probity and ethical conduct should have a bearing on the determination of particular costs as Allowable Costs, although they accepted these were relevant considerations for the MOD in selecting QDC/QSC contractors.

### **Response and proposed change**

- 3.40 We note stakeholders' various comments concerning the relevance and application of the concept of public scrutiny in determining whether costs are appropriate and reasonable in the circumstances and on the alternate proposal suggested in the working paper. We have thought further on what it means to consider whether costs 'withstand public scrutiny'.
- 3.41 We believe that at the heart of the public scrutiny assessment is a desire to consider what would be thought appropriate and reasonable expenditure in QDCs and QSCs by citizens and taxpayers. We note respondents' comments on whether the public at large has sufficient expertise, or awareness of the circumstances, to be able to make a reasonable judgement about whether costs should be Allowable Costs. We propose, therefore, to clarify the guidance by including a requirement to consider whether 'a reasonable person informed of the facts' would consider the costs appropriate and reasonable in the circumstances.

- 3.42 Additionally, we consider the term ‘public scrutiny’ can refer to the scrutiny of public spending that takes place on behalf of citizens and taxpayers, through Parliament, supported by the Comptroller and Auditor General, within the framework of controls that has evolved over time to protect UK taxpayers’ interests and resources. Such scrutiny is concerned with the regular and proper use of public funds and the achievement of economy, efficiency and effectiveness. Industry respondents have indicated a preference for replacing ‘public scrutiny’ with ‘expert scrutiny’, such as that provided by Parliament. We think that a more explicit statement in the guidance of the concerns which underpin public scrutiny would be helpful. Accordingly, in addition to the change noted in 3.41, we propose to introduce a requirement to consider whether costs are ‘consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence’.

### **Costs not Allowable**

- 3.43 Industry respondents highlighted ‘the general costs of doing business’, typically included in overhead (indirect) costs, as those which were most commonly a source of disagreement between the contracting parties when determining Allowable Costs. They said it might be difficult to justify that these were ‘necessary to fulfil the requirements’ of a QDC/QSC, for example, where the expenditure pre-dated the contract. These respondents identified a number of such costs, such as sales and marketing, research, or restructuring costs, which they contended should be Allowable Costs on a proportionate basis within overhead rates. This was justified, they said, as the costs would also be incurred and apportioned to contracts by companies in the baseline profit rate comparator group. They also noted that some costs arising from the regulatory framework may not be met by the MOD where these were apportioned across the business through overheads. The MOD noted that there were already mechanisms in place for material overhead costs to be recovered through QDCs/QSCs.
- 3.44 With regard to any types of costs that the guidance might indicate were not, or generally not Allowable, industry respondents were concerned that the SSRO should set out the principles underpinning any exclusions, rather than merely identifying a list of such costs or allowing the MOD to decide this. It was suggested that greater consideration needed to be given to the achievement of fair and reasonable prices when determining that certain costs were not Allowable Costs.
- 3.45 Industry respondents made a number of specific proposals for revisions to the guidance. Some changes related to aspects they considered confusing, such as the meaning of the word ‘expected’ (paragraphs 3.2, 3.3a and 3.6). Others sought to permit a more inclusive interpretation of costs that are appropriate (paragraph 3.2), for example, to include costs ‘incurred directly or indirectly in the normal business of the contractor or the QDC/QSC’, or attributable (paragraph 3.4), for example, to include costs ‘necessary for the overall operation of the business and appropriate to recover via qualifying defence contract’.
- 3.46 It was suggested that the guidance needed to be clearer that costs may be considered partially Allowable if some element of the cost did not meet the requirements of Allowable Costs.
- 3.47 Industry respondents also noted that there was potential for the guidance on Allowable Costs to be at odds with contractors’ internal policies or cost accounting practices, which might lead contractors to establish specific business units to undertake QDCs/QSCs with a consequential impact on the achievement of value for money in government expenditure.



### *Response and proposed change*

- 3.48 We do not believe the current Allowable Costs guidance excludes 'the general costs of doing business' in principle, as suggested by respondents. As stated in paragraph 4.5 of the Allowable Costs guidance, we consider that costs incurred directly or indirectly which 'enable the performance of a QDC or QSC' may be Allowable Costs provided they satisfy the AAR test. To provide clarity on this, we propose changes to section 3 of the guidance, on the requirements of Allowable Costs, to enhance consistency with the guidance in paragraph 4.5.
- 3.49 The SSRO agrees that the guidance should be principles-based. We do not propose any changes related to types of cost which are not, or generally not, Allowable Costs, but will consider the need for future changes as part of our prioritisation of areas for review in 2019/20. As noted in paragraph 3.36, we propose changes to the guidance this year to emphasise the need to consider both value for money for government and fair and reasonable prices for contractors when determining Allowable Costs.
- 3.50 We have considered the various revisions proposed by stakeholders. In addition to the points discussed already in this section, we propose a number of changes to the guidance where we believe clarification is desirable, for example, to explain that costs which are 'expected' are those which 'a reasonable person, informed of the facts, would consider ought to be or have been incurred', to remove duplication and to enhance consistency.
- 3.51 We do not consider any further guidance is needed related to costs that may be 'partially Allowable'. The guidance already states (paragraph 5.1) that costs will either be 'completely Allowable, Allowable in part or not Allowable'.
- 3.52 We note the comments related to the potential for the Allowable Costs guidance to conflict with QDC/QSC contractors' internal policies or cost accounting practices and the possible consequences of this. We do not consider it appropriate for the SSRO to comment on matters related to contractors' internal organisation or cost accounting related to QDCs or QSCs.

### *Other changes*

- 3.53 A small number of respondents suggested the meaning of 'borne by the contractor' (3.5b) was unclear and should be deleted, although the MOD did not think a change was required.
- 3.54 One respondent suggested the guidance on evidencing that costs were recovered only once (3.5f) be reformulated to refer to cost accounting systems and controls, although the MOD did not think any change was required.
- 3.55 A small number of respondents noted that the guidance needed to address how contingency for uncertainty and risk be treated in the assessment of Allowable Costs and the relationship of this to the cost risk adjustment made in determining the contract profit rate for a QDC/QSC.
- 3.56 Industry respondents suggested that the definition of a 'cost' should be widened to include verifiable market prices, especially with regards to items purchased from overseas, rather than simply referring to the costs contractors incurred.

### *Response and proposed change*

- 3.57 We agree the meaning of 'borne by the contractor' may be ambiguous and does not explicitly consider costs already incurred and those anticipated. We propose a change in the wording of this requirement to provide greater specificity.

- 3.58 We agree that evidencing costs are only recovered once is problematic as it is hard for contractors to demonstrate that something has not happened. However, we believe recovering costs only once remains a relevant consideration. We propose to clarify the guidance in this area to require consideration of whether the contractor has effective controls in place to ensure that costs are only recovered once.
- 3.59 Guidance related to contingency for uncertainty and risk and the cost risk adjustment will be considered in due course, allowing time for the MOD to develop its proposals for legislative change in this area. Any consequent proposals for guidance change will be published in due course.
- 3.60 In relation to market prices, the SSRO notes that these may be helpful comparators when determining whether costs are reasonable in the circumstances but does not support their use as a replacement for Allowable Costs determined through application of the AAR test. The use of market prices in the pricing of QDCs and QSCs was discussed in the SSRO's recommendations to the Secretary of State for his first triennial review of the single source procurement framework.<sup>4</sup>

### Reporting guidance

- 3.61 No stakeholders identified any changes to the SSRO's reporting guidance related to the changes discussed in the working paper on the requirements of Allowable Costs.

### Response and proposed change

- 3.62 We have no proposals for changes to the reporting guidance in this area.

---

<sup>4</sup> SSRO (2017) *Recommendations to the Secretary of State: Review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014*.

## 4. Research and development

- 4.1 We set out below a summary of the key points made by stakeholders with regards to the guidance on research and development and how this has informed the SSRO's proposals for changes to the guidance.

### **The scope of the guidance and the case for it to reflect defined accounting terms**

- 4.2 Most respondents indicated that alignment to recognised definitions would provide a good basis for the guidance. There were different suggestions as to which framework to use. These included IFRS, FRS 102, and the Defence and Security Public Contracts Regulations (D&SPCR).

### *Response and proposed change*

- 4.3 The SSRO considers alignment to recognised definitions provides a good basis for our guidance on research and development. It allows us to build on established principles and is consistent with the existing guidance on cost accounting and financial reporting.
- 4.4 The proposed guidance draws definitions from accounting standards, in particular, from IFRS and UK GAAP because we consider these are the most relevant for the majority of contractors. The SSRO does not think the guidance should simply reference others' standards because these may change and are not entirely universal. The SSRO does not propose to draw from the D&SPCR because we consider it to be more granular than is necessary for the purpose of guidance. In terms of accounting treatment, 'fundamental research' maps to 'Research' and 'applied research' and 'experimental development' map to 'Development'.

### **The need to consider research and development separately in the guidance**

- 4.5 All respondents agreed that the definitions discussed above showed that research and development are different and should be treated separately. Research was not likely to be specific to any contract, whereas development costs may be.

### *Response and proposed change*

- 4.6 The SSRO notes the feedback from stakeholders that research and development have different characteristics for the purpose of giving guidance and should be presented separately. The proposed guidance reflects this. Stakeholder feedback suggests that research costs are generally allocated indirectly. Development costs, however, are either allocated directly or indirectly and, if indirect, generally allocated at a more granular level than research. Some accounting frameworks also allow contractors a choice between capitalising or expensing development costs as they are incurred. Our proposed guidance recognises this and the different considerations that may be relevant depending on the circumstances.

### **The practical application of 'discernible benefit' and the treatment of abortive R&D**

- 4.7 There were differing stakeholder views regarding the 'discernible benefit' test. Some stakeholders considered that research could never meet the 'discernible benefit' test because the guidance does not allow for costs 'necessary for the business at large'. One stakeholder interpreted the guidance more broadly, to include indirect cost benefit to the MOD, such as increased throughput and sustainability of the business. Another pointed out that 'discernible benefit' may be difficult to determine at the time of agreement before the work has taken place.



- 4.8 There were also differing views regarding abortive R&D. Some stakeholders considered there was no such thing as abortive research because research projects that do not result in a viable product are still valuable. Others accepted that abortive research exists but considered that disallowing the costs of failed research would dissuade companies from spending money on research. They noted similarities to the costs of re-work where 'trial and error' on complex processes was inevitable.

#### *Response and proposed change*

- 4.9 The SSRO recognises there may be several interpretations of 'discernible benefit' and considers that, on balance, the guidance does not appear to be assisting the parties in determining Allowable Costs. However, we do not consider that the current guidance excludes in principle costs that might be described as 'necessary for the business at large'. We propose removing the discernible benefit test from the guidance on research and development. The general costs of doing business are considered in paragraphs 3.43 and 3.48 of this document.
- 4.10 The SSRO considers that abortive R&D does exist because it is possible for a project to not achieve its initial aims. We agree that 'trial and error' on complex processes is inevitable and a normal part of the R&D process, similar to the guidance on re-work and wastage, and that failed research and development may still be of benefit to the MOD. The existing paragraph explaining that abortive research and development may be Allowable will be retained and aligned with the existing guidance on re-work and wastage.

#### **The attribution of research and development to contracts – Accounting choice**

- 4.11 A number of stakeholders raised the issue of accounting choice for attributing costs, with differing views. Some considered that accounting choices should not influence what costs are recovered or when recovery takes place; with the allocation to overhead or contracts reflecting what is most appropriate for the costs being considered. Others considered that costs should be recognised using existing accounting standards. The overriding principle was that costs should be paid for once, either expensed immediately or through impairment/depreciation if capitalised. One stakeholder suggested that, if reliance is placed on the treatment prescribed by accounting standards, the R&D guidance could be removed.

#### *Response and proposed change*

- 4.12 The SSRO recognises that there can be an accounting choice but does not propose changing its existing guidance (that the accounting treatment already established for the contractor's own purposes should normally be adopted). This is on the basis that GAAP provides a suitable framework for recognition. Consistency with reported financial information is a benefit to the regime because of the broad acknowledgement that accounting principles give a true and fair view and because such information is usually audited to some extent by a third party.

#### **The attribution of research and development to contracts – other proposals**

- 4.13 Two other proposals were suggested by individual stakeholders as alternatives to the existing guidance:
- the extent to which R&D costs of all types are recovered should be a matter for negotiation between the parties; and
  - that all R&D expenditure by a business unit should be attributable on the basis there is a causal relationship to all contracts.

*Response and proposed change*

- 4.14 The SSRO considers that there is a need for guidance on Allowable Costs rather than leaving the matter for negotiation. The Act is clear that for a cost to be Allowable the parties must both be satisfied it meets the AAR test, and the SSRO must issue guidance about determining whether costs are Allowable.
- 4.15 The SSRO does not consider that all R&D should be assumed to be attributable on the basis that there must be some control to ensure only relevant R&D is attributed to the Secretary of State's contracts.

**The attribution of research and development to contracts – Direct R&D**

- 4.16 There was a consensus among stakeholders that where the expenditure is directly attributable to a contract it should be an Allowable Cost against that contract and included in the price. One stakeholder noted that where a company chooses to write off the development costs in advance of the contract being placed, consideration needs to be given to enabling these costs to be recovered either indirectly against overheads in the year in question or capitalised and recovered over the life of the contract.

*Response and proposed change*

- 4.17 The SSRO agrees that where the expenditure is directly attributable to a contract it may be an Allowable Cost and included in the price, assuming the AAR test is met. The proposed guidance explicitly refers to R&D that is a direct cost in order to separate it from the considerations of costs that are indirect.
- 4.18 In respect of costs incurred before a contract becomes a QDC on amendment, the guidance already notes that sunk costs may be Allowable Costs and the SSRO has given opinions in the past confirming this. In respect of costs incurred prior to a contract being placed, the SSRO has given an opinion that work undertaken at risk, ahead of the agreement of the contract through negotiation, may in principle represent Allowable Costs under the contract once it is in place if the costs meet the AAR test.

**The attribution of research and development to contracts – Research**

- 4.19 There were differing views on how to determine if research should be attributed to a contract. One stakeholder suggested that research in areas that the MOD agreed may be relevant to future defence contracts should be recovered. Another suggested that research should only be excluded where the link to a defence application is so tenuous that it could be discounted, or where the MOD would not have an interest in the results.
- 4.20 Some stakeholders suggested that, for research costs, it was often the case that a company would typically spend a similar amount each year. One stakeholder considered that allowing current-period investment in research to be used as a proxy for historic investment would assist contractors that have difficulty in agreeing that sunk costs are Allowable.

*Response and proposed change*

- 4.21 Research costs are Allowable Costs if they satisfy the AAR test. The proposed guidance on the AAR test considers that Allowable Costs are those that 'enable the performance of the contract'. To ascertain which historic indirect research costs are attributable to the contract a contractor would consider all research carried out historically that enables performance of the contract, calculate what was spent, and allocate it appropriately. This would effectively simulate a capitalisation and amortisation approach for an intangible asset.

- 4.22 The SSRO understands that this approach may be costly to administer because it does not align to common accounting practice. The SSRO considers that in the specific context of research, and as an alternative, indirect research undertaken while the contract takes place may be used as a guide to the costs that are Allowable if the parties agree that it is of potential interest to the Secretary of State in the context of the contract in question. There is a presumption that the amount would generally be similar to the amount identified using the historic-spend approach, where annual spend on research is typically similar each year. However, we are clear that costs must only be recovered once.
- 4.23 In relation to apportionment of research as an indirect cost, the SSRO accepts that the nature of research is such that it may be apportioned broadly. However, it is not reasonable for the costs of research that are wholly unrelated to the specific requirements of a contract to be attributed to it. This is already addressed by the existing guidance on cost accounting and financial reporting related to indirect costs and we do not propose to add specific guidance.
- 4.24 In assessing whether research costs are reasonable in the circumstances, the SSRO considers that the parties could consider a contractor's historic levels of research, or levels of research undertaken by others carrying out work that is similar in nature to the products or services being procured under a specific contract. The SSRO accepts that year-on-year fluctuations might be expected given the nature of such work, but it is not reasonable for the Secretary of State to fund significant expansion of a contractor's research programs.

#### **The attribution of research and development to contracts – Indirect development**

- 4.25 There was a consensus among stakeholders that development is carried out with a known application in mind and that where costs are indirect these can be allocated to production units.

#### *Response and proposed change*

- 4.26 The SSRO considers that, while the existing guidance remains appropriate, it seeks to tell contractors how to deal with costs in their accounting system. We consider that costs should be allocated and apportioned using a consistent approach that satisfies the AAR test, but that our guidance should not be too prescriptive about how this is achieved in practice.

#### **The ownership of created intellectual property (IP) and any associated arrangements**

- 4.27 Issues regarding IP were not widely commented on. One stakeholder indicated that existing levy mechanisms outside the scope of single source procurement that deal with IP owned jointly or wholly by the MOD worked well, and no specific guidance was required;
- 4.28 Two specific matters were raised by another stakeholder, suggesting that:
- a. where the MOD registers an interest in a patent or registered design the costs incurred in registering and maintaining these should be attributable to the contract that generated it; and
  - b. where licence fees are required to be paid in respect of technology or processes used either during the contract period or because they are incorporated in contract deliverables, the whole of the licence fee and its associated costs should be a direct charge against the project.

### *Response and proposed change*

- 4.29 The SSRO agrees that matters relating to the future exploitation of IP, such as Commercial Exploitation Levies, are not relevant to the Allowable Costs of a contract because they relate to costs incurred and sales made as a result of relationships with other parties, not in the delivery of the QDC or QSC. We do not propose to introduce any specific guidance on the matter. Similarly, the costs of registering or maintaining a patent are attributable to the future exploitation of the IP and should not generally be a direct cost to the contract that generated the IP.
- 4.30 The SSRO agrees that licence fees, royalty payments, and the like that are directly attributable to a contract may be Allowable Costs but we do not consider specific guidance is necessary in addition to that provided on the requirements of Allowable Costs.

### **The treatment of R&D tax credits and reliefs**

- 4.31 Most stakeholders referred specifically to the Research and Development Expenditure Credit (RDEC) in responding on this topic. A number of them pointed out that the nature of RDEC means its accounting treatment does not fall clearly under the IFRS definitions of grants or of taxation. It is therefore accounted for by analogy as one or the other, but different companies may have different treatments.
- 4.32 A number of respondents considered that RDEC should not be offset against Allowable Costs on the basis that these are incentives to industry from HM Treasury to invest in UK R&D and that the incentive is removed if the MOD claws back the money. One respondent believed that the treatment of R&D tax credits should not be covered in guidance at all because the guidance should be equally applicable to all contractors, irrespective of jurisdiction for tax purposes, and the guidance elsewhere on application of the AAR test was sufficient.
- 4.33 One respondent that considered tax credits and other reliefs more generally, suggested that a distinction could be made in the Allowable Costs guidance between specific government funding, which might be offset, and generic/non-project specific incentives through the tax system, which should not be.
- 4.34 A number of stakeholders also pointed out that there are difficulties in forecasting future credits and reliefs because they are dependent on future assessments by others and may also be affected by changing definitions or rates.
- 4.35 One stakeholder pointed out that the costs associated with making tax credit claims should also be Allowable if the claim itself is offset.

### *Response and proposed change*

- 4.36 The SSRO recognises that the UK's Research and Development Expenditure Credit (RDEC) is a major consideration for stakeholders and for this specific cost type but we note that there are innumerable tax credits and other reliefs in place globally. We consider that any guidance should be principles-based rather than written with a specific credit in mind so that it can be generally applied.
- 4.37 The SSRO notes there are currently two relevant sections of the guidance that relate to offsets against costs, which might include credits, refunds, grants, and other transactions of a similar nature:
- section D.1.6 refers to any credit gained through the taxation system as a result of research and development; and
  - section E.4.1 refers to reimbursements, credits, grants or refunds received that cannot be identified to a particular contract.

- 4.38 We consider that offsets against costs should be dealt with in a single section of the guidance. A particular Allowable Cost should reflect the net cost incurred by the contractor. This means the particular cost claimed as an Allowable Cost should take account of any amounts received by the contractor that directly reimburse a part or all of that cost. For example, a refund under warranty of a faulty part, trade discounts, volume rebates, prompt settlement discounts, or insurance settlements received would be offset against the costs to which they are related when determining whether the cost is an Allowable Cost.
- 4.39 However, we are persuaded that it would not be necessary to offset benefits received by the contractor which are not intended to reimburse a particular cost. Generic grants and tax credits are not given with a view to reimburse particular costs and we do not, therefore, consider them to be relevant to the determination of Allowable Costs. We consider that such payments are made as a matter of government policy and we do not propose to give guidance that alters those policy objectives. Examples of such transactions are general local government incentives to support growth, the Research and Development Expenditure Credit (RDEC), accelerated capital allowances, or reduced rates of corporation tax for profits arising from patents. Examples of transactions we do not consider to be generic are grant funding to purchase assets, reduced business rates for operating in a certain area, or grants to train staff because there is a clear link to the costs incurred. We propose revised guidance to clarify this.
- 4.40 The SSRO agrees that the costs associated with making claims should be Allowable if the claim itself is offset against an Allowable Cost, but we do not consider specific guidance is necessary beyond the AAR test.

#### **Reporting guidance**

- 4.41 One respondent considered the reporting guidance did not need changing as a result of the changes discussed in the working paper.

#### ***Response and proposed change***

- 4.42 The SSRO does not consider any updates to reporting guidance in this area are required.

## 5. Capital servicing adjustment

- 5.1 We set out below a summary of the key points made by stakeholders with regards to the guidance on the capital servicing adjustment and how this has informed the SSRO's proposals for changes to the guidance.

### Using business unit information as an estimate of contract information

- 5.2 Most stakeholders considered that the current guidance did not need to change fundamentally and that the current approach to calculation was well understood by the parties. One stakeholder noted that the flexibility of the current guidance to allow the use of information at a contracting entity level was a benefit. However, some stakeholders were concerned that the working paper suggested that the guidance should focus on specific contracts, rather than consider the business unit or entity delivering the contract.

### Response and proposed change

- 5.3 The SSRO does not propose to move away from the business unit CP:CE ratio method of calculating the capital servicing adjustment as an approach.
- 5.4 In respect of the current option to calculate the CP:CE ratio at the contracting-entity level, rather than using the business-unit level, the SSRO proposes that the requirement to only do this in 'exceptional circumstances' be removed from the guidance. We observe in DefCARS that the contracting entity is often already a subsidiary company within the structure of a larger group and so going to a more granular level within the business structure may be unnecessary in achieving a reasonable estimate.
- 5.5 There were some concerns that the working paper referred to capital employed by a 'specific contract' and to 'contract-level capital'. Regulation 11(7) states that the capital servicing adjustment is to ensure that the contractor receives an appropriate and reasonable return for the capital employed by the contractor *for the purpose of performing the contract*. In the working paper we used 'specific contract' and 'contract-level capital' to reflect the intent of that regulation.
- 5.6 The SSRO believes that the Regulations are clear that the parties should consider capital employed for the purpose of performing a contract, and that the business unit CP:CE ratio method is an acceptable way of estimating this (Regulation 11(8)(c)). In doing so, the parties assume that the capital intensity of the business unit is equivalent to the capital intensity of the performance of the contract. This is on the understanding that a business unit will normally perform many contracts of a similar nature under similar conditions and it is reasonable to expect that the QDC or QSC will be performed under the same circumstances with equivalent capital requirements.
- 5.7 It may be the case that a business unit or contracting entity is newly set up for the purpose of performing a QDC, in which case historic financial information will not be available and the method described in the guidance may not be possible. We consider this situation will be rare and that the resolution would depend on the facts and circumstances of the specific contract. As such, no guidance is proposed.



### **An exploration of alternative calculation approaches**

- 5.8 As noted above, most stakeholders consider that the current guidance did not need to change fundamentally and that the current approach to calculation was well understood by the parties. It was noted that the alternate methods, such as the specific-contract approach suggested in the working paper may require new information, be much harder to agree between the parties and may require corresponding changes to the adjustment made to the profit of the BPR comparator group when calculating the baseline profit rate. Respondents expressed a preference for methods that used data drawn from companies' financial statements rather than estimates.
- 5.9 A number of stakeholders suggested the guidance should permit other methods of calculating the capital servicing adjustment, provided that those methods meet the essential principles that the capital is necessary for performing the contract or has been estimated in a reasonable way.
- 5.10 The US Facilities Capital Cost of Money (FCCM) and weighted guidelines approach was suggested as an option on the basis that this could be understood by non-typical suppliers. Another stakeholder considered that where assets are bought specifically for a contract this should be considered as a direct cost.

### **Response and proposed change**

- 5.11 Stakeholders have suggested that alternative approaches to the business unit CP:CE ratio method may be more appropriate in some circumstances. The SSRO considers the business unit CP:CE ratio method to be the approach that best compensates for servicing all capital employed for the purpose of performing the contract. We do not propose to move away from this method on the basis that it is well understood by the parties. However, we propose simplified guidance to make it easier for non-typical contractors to understand.
- 5.12 We consider that if the recommended approach and the guidance on Allowable Costs is not followed (such that some financing costs are determined to be Allowable Costs) the contractor must ensure that the capital servicing adjustment is reduced to reflect that some costs of capital are compensated for elsewhere, maintaining the overriding principle that costs are only recovered once. However, we do not propose that our guidance presents alternative approaches.

### **The calculation of capital employed**

- 5.13 Most stakeholders agreed that the guidance on the calculation of capital employed would benefit from a thorough review to ensure it reflected current ways of working. It was suggested that a number of paragraphs in the guidance require clarification, and that the guidance should not include long lists of exclusions that duplicate other guidance or accounting principles.
- 5.14 Respondents indicated that discussions on the allowability of cash continued to be difficult and stakeholders welcomed further guidance or specificity around what would be considered 'surplus'. One stakeholder considered that the guidance for cash should place the onus on the contractor to demonstrate that cash is required, rather than demonstrating it is surplus. Some stakeholders highlighted a specific issue whereby cash was swept into a central group account rather than being held by the business unit. It was suggested that the guidance should permit such cash to be included in capital employed.
- 5.15 One stakeholder considered that the guidance should remove capital where the supplier has not made reasonable efforts to minimise its capital base.
- 5.16 Another stakeholder considered that the calculation should not be unnecessarily onerous or attempt to achieve spurious accuracy.

- 5.17 The situations suggested in the working paper whereby the MOD might pay for an asset directly or grant the use of an asset to the contractor were not considered by stakeholders to be relevant as the asset would not appear on the contractor's balance sheet and would not be included in capital employed.

*Response and proposed change*

- 5.18 The calculation of capital employed will start with a general calculation that uses defined accounting terms and then describe specific exclusions that are typically made to that general definition. The SSRO agrees that long lists of exclusions that duplicate other guidance are not necessary and the proposed guidance reflects this.
- 5.19 The SSRO considers that the guidance on cash should permit an amount to be reflected in the calculation where the business unit's cash is pooled in a group arrangement (and so is 'off balance sheet') on the basis that this is an artificial arrangement. To the question of more-specific guidance around the level of cash that might be considered reasonable, the SSRO does not consider it can offer more-specific guidance because the amount will vary depending on the nature of the operations of the specific contractor. For example, it may be affected by supplier payment terms, customer payment terms, retentions, the length of payroll periods, the use of asset finance, seasonal demand, and cash required to settle other short-term liabilities at the balance sheet date. The overarching principle is that the cash recognised should be the amount required to fund the normal operations of the business.
- 5.20 In respect of minimising a capital base, the SSRO does not agree that 'minimise' is the appropriate term to use and considers that the capital employed calculation should reflect a capital base that is reasonable in the circumstances.
- 5.21 In respect of situations where the MOD pays for an asset directly or grants the use of an asset to the contractor, the SSRO notes that there is a choice when accounting for granted assets (for example, under IAS 20 Grants). We accept, however, that common practice may be to not recognise such assets and that no specific guidance is necessary.

**The calculation of cost of production**

- 5.22 The matters raised on the calculation of the cost of production topic were not widely responded to by stakeholders. One stakeholder suggested that the guidance could simply rely on the definition of cost of production in Section 4 of the guidance and IFRS. Another agreed with the suggestion in the working paper that guidance should not include long lists of exclusions that duplicate other guidance or accounting principles.
- 5.23 One stakeholder considered that the requirement that costs which were not Allowable Costs under SSRO guidance should be excluded from the calculation of the cost of production was not appropriate. Where costs were not Allowable this was generally because they were not attributable to single source contracts, but nevertheless formed part of the overall costs of the relevant business unit and are related to the capital employed by that unit.

*Response and proposed change*

- 5.24 The SSRO considers that some guidance is required to ensure alignment between the cost of production calculation and the capital employed calculation. However, we agree that long lists of exclusions that duplicate other guidance are not necessary and the proposed guidance reflects this.



- 5.25 The SSRO proposes to clarify the requirement that 'any other costs not considered Allowable under the guidance published by the SSRO' should be excluded from the calculation of cost of production. It is not apparent how the costs that are incurred by a business unit overall could readily be judged against the requirements of Allowable Costs, which are intended to be applied at a contract level. We think it would be clearer for the guidance to state that capital employed and costs of production which are generally not relevant to single source MOD contracting should be excluded from the calculation.

#### **The source of data**

- 5.26 Several stakeholders stated a preference for statutory accounts to be used because of the standardisation of information that is available, the ability to link to the contracting entity, that they are independently audited and that this aligned with the approach taken for determining the baseline profit rate.
- 5.27 There was cautious agreement that it could be appropriate to compute adjustments for forward-looking balance sheets where there was expected to be a material change from the historic position. However, respondents did not think it would be appropriate to do this unless the impact was significant as the use of forecast information may cause an inappropriate level of debate about forecasting processes.
- 5.28 One stakeholder pointed out that, in using statutory accounts, a monthly-average balance sheet would not be possible.

#### **Response and proposed change**

- 5.29 The SSRO considers that information drawn from statutory accounts, or the financial systems used to produce them, are generally of high quality and should be used where possible. However, we do not consider it necessary to state this explicitly in our guidance.
- 5.30 The SSRO agrees that where significant transactions have occurred or are expected to occur this may mean that the balance sheet information used to calculate capital employed will not be reflective of the capital that will be employed over the life of the contract. In these situations, it may be appropriate to make an adjustment. However, we consider that such adjustments should be limited to known events that are significant. It is not the SSRO's intention for the parties to engage in forecasting. The presumption should be that the latest available balance sheet information is reflective of the capital that will be employed over the life of the contract.
- 5.31 In respect of averaging, the SSRO considers that capital employed should be the average capital employed over the same period used to determine the cost of production. At a minimum, this is the average of the opening and closing position. Similar to the treatment of forecast future events, we consider that an adjustment may be made if the calculated average is not reflective of the capital that will be employed over the life of the contract due to the timing of a significant transaction.

#### **The case for the guidance to reflect defined accounting terms**

- 5.32 Most stakeholders considered that using accounting terms would be beneficial. One stakeholder took this further and suggested that contractors should be required to restate their financial information to a consistent standard, for example IFRS, in order to eliminate differences between accounting frameworks.

### *Response and proposed change*

- 5.33 The SSRO will endeavour to use accounting terms drawn from IFRS and UK GAAP where possible but will not simply reference others' standards because these may change and are not entirely universal.
- 5.34 The SSRO does not consider that contractors should be required to restate financial information to a specified accounting framework. The costs of conversion could be significant and consistency with reported financial information is a benefit because that information is usually audited to some extent by a third party. The SSRO notes that the majority of contractors adopt either IFRS as adopted by the EU, the IFRS reduced disclosure framework as prescribed by FRS 101, or 'new UK GAAP' as prescribed by FRS 102. There is a broad alignment between these frameworks and we do not consider the differences to warrant further consideration in guidance.
- 5.35 In respect of the definition of 'unit of business' given in the guidance, accounting frameworks refer to the concept of a 'cash-generating unit', which is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The SSRO is mindful that stakeholders suggest alignment to accounting definitions may be beneficial, however, in this situation, we consider that the examples of units of business (subsidiary company, division, Qualifying business unit (QBU) or site location) are more appropriate.

### **Associated impacts of significant changes to lease accounting standards**

- 5.36 Some stakeholders pointed out that the administrative burden of the new accounting standard may increase costs, would be complex to implement and that a standard and simple implementation plan is required for the guidance. However, another stakeholder suggested that IFRS should be the basis of comparability and no changes are required to the guidance.
- 5.37 Stakeholders pointed out that the treatment of leases in the calculation of the capital servicing adjustment for companies in the baseline profit rate comparator group should be consistent with that for QDCs/QSCs. They suggested that the BPR would require restatement under its three-year averaging process. The absence of any adjustment would disadvantage contractors because they expect Allowable Costs to fall as a result of new standards, but a corresponding increase to profit will take time to come through the three-year averaging process.

### *Response and proposed change*

- 5.38 As discussed in our working paper, there are new, broadly similar, leasing standards scheduled to become effective for entities reporting under IFRS and US GAAP. There are currently no plans to implement similar changes in UK GAAP's FRS 102. There are alternative transitional arrangements for those that are adopting the new standards. There is therefore considerable scope for divergence between contractors on this issue, and the SSRO does not consider we can offer specific guidance on the adoption of this standard.
- 5.39 We understand that the adoption of this standard could have large effects for some contractors and companies in the baseline profit rate comparator group. We will continue to monitor financial reports as they become available. We welcome any further feedback from stakeholders on the specific detail of the impact on them.
- 5.40 We believe the guidance for the capital servicing adjustment will continue to function before and after the implementation of these new standards. The proposed guidance will explicitly allow adjustments to be made to the calculation where a significant change has occurred in the business, which could include a transition period for accounting change.

- 5.41 The Allowable Costs guidance says that costs are to be consistent with the contractor's overarching cost accounting practices or use a methodology that is agreed with the Secretary of State. This could allow adjustments to be made to accounting practice to reflect accounting change if a transitional arrangement is to be made.

#### **The capital servicing rates**

- 5.42 No responses were received from stakeholders regarding the capital servicing rates.

#### *Response and proposed change*

- 5.43 No changes are proposed.

#### **Reporting guidance**

- 5.44 One respondent considered the reporting guidance did not need changing as a result of any potential changes discussed in the working paper.

#### *Response and proposed change*

- 5.45 The SSRO does not consider any updates to its reporting guidance related to the capital servicing adjustment are required.

## 6. Other changes and future review

- 6.1 Stakeholder responses to the working papers included an observation that the term 'contract' within Regulation 5 extends beyond that of a single agreement and can also be the aggregation of many agreements. Every component of a 'contract' in this sense may then have a different 'contract profit rate'. The term 'contract profit rate' therefore could have a dual meaning in some circumstances, being both the individual profit rates of the components and the aggregate profit rate calculated as the weighted profit rate of all the components. The SSRO does not believe this is causing significant confusion for contractors and we have observed reports in DefCARS using weighted profit rates on this basis, but we would welcome any further examples in this area.

