

SSRO

Single Source
Regulations Office

Assuring value, building confidence

Consultation on revised Single Source
Cost Standards: Statutory Guidance on
Allowable Costs
Consultation response document - July 2016

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Background

1. Introduction

- 1.1 The Defence Reform Act 2014 provides the legislative basis for the Single Source Procurement Framework. Section 20(1) of the Act makes the Single Source Regulations Office (SSRO) responsible for issuing statutory guidance on determining whether costs are Allowable Costs under qualifying defence contracts. To support this, the Act states that Allowable Costs must be 'Appropriate, Attributable to the contract, and Reasonable in the circumstances' (Section 20(2)(a)-(c)).
- 1.2 Contractors and the Ministry of Defence must have regard to the guidance when determining whether costs are Allowable in single source qualifying defence contracts.
- 1.3 The SSRO originally published its Single Source Cost Standards: Statutory Guidance on Allowable Costs on 26 January 2015.
- 1.4 The SSRO has subsequently updated the document, in order to reflect its experience of qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs), as well as feedback we have received through meetings with industry and our Helpdesk.

The Consultation Process

- 1.5 On 20 April 2016 the SSRO issued the updated guidance, and launched a six week public consultation on the document, which closed on 1 June 2016.
- 1.6 In carrying out this consultation we have sought to ensure that as many people and groups as possible had the opportunity to contribute views. We published our consultation on the SSRO's website, and directly emailed our stakeholder contacts.

Workshop

- 1.7 As part of the consultation, the SSRO hosted a workshop with defence contractors and the MOD on the updated guidance. The workshop provided an informal opportunity for stakeholders and the SSRO to discuss and consider the guidance. The SSRO presented its approach and key updates to the guidance, and invited stakeholders to propose topics for discussion.
- 1.8 The SSRO also reflected on feedback received at a separate ADS-hosted workshop, held in May 2016.
- 1.9 The feedback received during the workshops were considered, together with formally submitted consultation responses, in developing the final guidance, which has been published today on the SSRO website¹.
- 1.10 The following two sections of this document provide an overview of formal submissions to the consultation, alongside the SSRO's response to them.

¹ <https://www.gov.uk/government/publications/single-source-cost-standards-statutory-guidance-on-allowable-costs-july-2016>

2. Consultation proposals

2.1 The consultation requested feedback on seven areas of the guidance, which were as follows:

- providing a definition of ‘international co-operation’;
- the inclusion of the impairment of goodwill and amortisation as a potential Allowable Cost;
- clarifying the treatment of marketing and sales costs;
- describing the treatment of costs incurred in contracts signed prior to 18 December 2014 that are subsequently brought under the new regime;
- distinguishing Allowable Cost risk and that which may be eligible for a Cost Risk Adjustment;
- a new section on the treatment of rework; and
- clarifying the type of insurances that may be Allowable.

3. Overview of consultation responses

3.1 We received 15 responses. ADS SSCR Defence Advisory Group provided a consultation response on behalf of its members. Six of the 15 responses received simply indicated support for the ADS response rather than providing separate consultation response forms. The breakdown of respondents is provided in Table 1.

Table 1: Breakdown of respondents

	Government	Industry	Regulators/ Other Government Bodies	Trade and Professional Associations and Think Tanks	Consultancies	Media	Other	Total
Number of stakeholders invited to comment	11	79	16	13	4	7	4	134
Total number of responses received	1	10	0	1	3	0	0	15
Percentage of responses received	7	67	0	7	20	0	0	100*

* Numbers include rounding

4. Key issues raised by stakeholders

4.1 The SSRO observed multiple areas where there was a common position across industry in responses. There were also some areas of common position between industry and the MOD’s response.

4.2 Respondents broadly welcomed the clarification of the guidance in the seven identified areas, with some requesting further clarification in these areas. Respondents also commented on areas of the guidance that were not subject to consultation.

4.3 The following sections provide a high level summary of responses received, our response to these and any updates made to the guidance as a result. Table 2 provides a more specific and detailed summary of responses received.

International co-operation

- 4.4 Some stakeholders stated that the Act and Regulations do not provide for the guidance to address international co-operation.
- 4.5 While we acknowledge that this section is not statutory guidance, we do not consider it is appropriate to remove it altogether. Our intention is to have a stand-alone document to assist contractors, in particular SMEs, to understand the regime. The structure of the guidance has been updated to distinguish between introductory information, which simply provides context, and statutory guidance.

Sunk costs

- 4.6 Stakeholders were grateful the issue of sunk costs were addressed as an important step in bringing contracts signed prior to 18 December 2014 within the new regime. However, some sought further assurance that no question would arise in relation to sunk costs or to pricing for the period prior to a contract becoming a QDC.
- 4.7 Respondents also stated that the definition of sunk costs should acknowledge that in long-term contracts there will be some expenditure that was already committed. The MOD considered that this change would encourage contractors to agree that contracts should become QDCs.
- 4.8 The SSRO recognises that the issue of sunk costs, as drafted in the legislation, may act as an obstacle in bringing existing contracts under the regime. As such, we sought to provide some further detail in the guidance on the issue. However, any material update to the guidance on the treatment of sunk costs would require legislative change.
- 4.9 It was suggested that the guidance should provide absolute assurance that sunk costs or pricing for periods before a contract becomes a QDC would not be subject to scrutiny by the regime. We are not able to agree. Amending the guidance to this effect would risk the inclusion of inefficiently incurred costs in QDCs and QSCs. However, we acknowledge that the definition of sunk costs should be interpreted to cover circumstances where all of the output has been defined.

Depreciation, amortisation and impairment

- 4.10 Stakeholders noted that the terminology used in the section may lead to confusion as it was not consistent with Generally Accepted Accounting Principles (GAAP). Some suggested removing the reference to the discretion of the Secretary of State.
- 4.11 In contrast to industry, the MOD stated that impairment of Goodwill should not be an Allowable Cost.
- 4.12 We have updated the terminology used, to support clarity throughout the guidance. The most notable of these updates was replacing the references to 'International Financial Reporting Standards' (IFRS) with GAAP, in recognition that IFRS is only a required standard for listed companies within Western Europe.
- 4.13 We consider that the agreement of the Secretary of State is necessary for any revaluations of assets as well as impairment. The requirement for a prior approval from the Secretary of State is important to ensure that revaluations in assets are scrutinised and assessed.
- 4.14 We do not accept that the impairment of Goodwill should never be an Allowable Cost, as defence companies are acquisitional by nature and often carry significant amounts of Goodwill on their balance sheets. Concerns over the inclusion of Goodwill as an Allowable Cost should be mitigated by the need for the Secretary of State to approve their inclusion in QDCs.

Risk

- 4.15 Stakeholders stated that our proposed drafting did not reflect the complexities involved in pricing contracts and challenged the definitions provided. It was noted that the terminology on risk used in the guidance should be consistent with the Act and Regulations. Stakeholders stated that the guidance would benefit from further clarification as there was much variation in terminology used.
- 4.16 In addition, ADS proposed wording that would allow contractors to price all risks into the contract at the average expected outturn as an Allowable Cost. The Contract Risk Adjustment would then compensate for the variability of that outcome.
- 4.17 The SSRO does not consider such an update appropriate as it would place risk in all instances on the Secretary of State. In addition, it would distort incentives for the contractors to mitigate risks in an efficient manner to minimise the costs incurred. Such arrangements would not deliver value for money for taxpayers. There is also the potential for programme risks to be double counted.
- 4.18 We accept that contractors will not have control over some of their costs, and their ability to forecast and control changes in these costs is accordingly limited. In response to the consultation feedback, we have redrafted the section to clearly articulate the distinction between risk being treated as a potential Allowable Cost and risk that may be subject to an adjustment to the Baseline Profit Rate. The guidance makes it clear that the contractors must be able to estimate or model risk for it to be Allowable. To the extent that estimation or modelling is possible, this correspondingly removes the need to apply an adjustment to the Baseline Profit Rate to reflect cost uncertainty. We also note that while the reference to contingency has been removed to avoid confusion, contingency may still be an Allowable Cost, only when it becomes an agreed risk and if it meets the AAR criteria.
- 4.19 We recognise that contractors may wish to discuss the issue of risk further outside the consultation process. The SSRO is committed to continue engaging with stakeholders on this issue.

Marketing and sales costs

- 4.20 Defence contractors suggested to the SSRO that the guidance should distinguish bid costs from marketing and sales. The SSRO welcomed this suggestion and has added a section on bid costs to reflect the fact that these may be Allowable and should be charged directly to the contract.
- 4.21 In addition, some industry respondents argued that wording used in the guidance was too restrictive due to the requirement for costs to be 'demonstrably linked' to a QDC and the need for such costs to be retrospective in nature.
- 4.22 The SSRO does not consider it appropriate to depart from the proposed wording on marketing and sales costs. This in part reflects that single source contracts by nature generally do not require sales and marketing costs because they are not competed. As a result, allowing marketing and sales costs as part of QDCs should be on an exceptional basis and when the contract has benefited from sales and marketing for other contracts. It is key that contractors demonstrate how these efforts benefited the contract in question. As such, it is important that costs should be 'retrospective' as this provides protections against the inclusion of speculative costs.
- 4.23 It was requested that the guidance should be amended to allow for overhead marketing and sales costs that contractors considered provide benefits to the MOD. The guidance does not intend to disallow such costs but have clarified that sales and marketing costs may be Allowable where they can be apportioned to a QDC and demonstrate a financial benefit to that contract.

Rework

- 4.24 Some industry respondents requested further clarity through the inclusion of wastage and distinguishing between rework and faulty workmanship. In addition, it was argued that complex processes were not always necessary for rework and wastage to occur. The MOD suggested that the guidance should explicitly state the requirement to evidence rework and wastage.
- 4.25 We considered the inclusion of wastage appropriate and have therefore updated the guidance to include this. We have also updated the guidance to make a clearer distinction between rework and faulty workmanship. We accept that the complexity of the contracts should not be a determining factor for the allowance of rework or wastage, and have therefore removed the reference to 'complex process'. The extent to which rework and wastage will be allowed should be determined based on the nature of the specific contract, with more complex contracts likely to attract a higher level of rework and wastage.
- 4.26 We agree with a suggestion made by the MOD that the guidance should clarify that contractors should have appropriate quality management systems in place to demonstrate the causes of rework and wastage. A sentence has been added to the guidance to this effect. This is based on the need to ensure that only the costs incurred at an efficient level are being passed onto the Secretary of State.

Insurance

- 4.27 Industry sought clarification that product liability insurance could be an Allowable Cost in certain circumstances. One contractor stated that this was particularly relevant for sea trials in submarine and naval ship contracts.
- 4.28 It was suggested that the exclusion of faulty workmanship should be limited to 'contractor abnormal levels of faulty workmanship, and own manufactured defective parts'. Some industry respondents also stated that the guidance should not prohibit insurance for sub-contractors' faulty workmanship. They stated that insurance for sub-contractors' breach of contract and faulty workmanship should be Allowable.
- 4.29 The SSRO maintains that contractors can recover the cost of warranties and insurances for the purposes of trials. Amendments to the structure of the guidance, detailed in Table 2, help to clarify the treatment of insurance.
- 4.30 While product warranties may be an Allowable Cost, the SSRO maintains that faulty workmanship is not Allowable irrespective of how far down the chain of production it occurs. Incorporating significant risk premiums into a contract from the outset does not set appropriate incentives as it allows for all such costs to be passed on to the Secretary of State. Furthermore, it does not support the objective of delivering value for money for taxpayers. The management of sub-contracts is exclusively the responsibility of primary contractors. Consequently, the MOD should not pay for the mitigation of this risk.

Other comments

- 4.31 Respondents offered comments on many aspects of the document that were outside of the areas identified by the SSRO. In particular, stakeholders suggested a range of amendments aimed at providing further clarity.
- 4.32 In light of the responses received, a number of structural changes to the document have been made. The guidance now distinguishes between the statutory guidance and the preamble, which is in the Introduction section. The language used in the three AAR definitions has been updated to clarify their use. We have also incorporated the section on sunk costs into Section 7 to make it clear it constitutes guidance.

- 4.33 In the interest of clarity, items are now addressed more substantially in Section 9, which details the treatment by specific cost type. We have aggregated the sections with common themes such as pensions and research and development. This has resulted in a more succinct document. In addition, Section 14 has been deleted to reduce any non-essential general guidance included.
- 4.34 Multiple minor updates have been made to the text to support clarity, simplify sections where possible and standardise terminology, none of which constitute substantial policy change.
- 4.35 Some respondents requested that the guidance should include further detail, notably on defining the standard of evidence required, or providing methodologies for calculating costs. The Act (Clause 20) requires the SSRO to issue guidance about determining whether costs are Allowable. The Regulations² require that the contractor must provide a contract pricing statement for the QDC and that this should:
- a. set out any Allowable Costs;
 - b. set out the date and version of any guidance that applied at the time;
 - c. describe any known deviation from the guidance;
 - d. describe the facts, assumptions and calculations relevant to each element of Allowable Costs; and
 - e. describe any facts or assumptions provided by the Secretary of State and used by the contractor in those calculations.
- 4.36 The guidance³ clearly states that, in accordance with the Act⁴, the onus rests on the contractor to provide the burden of proof, and this evidence therefore must come from the contractors' own records and it is therefore inappropriate for us to be more prescriptive.
- 4.37 In relation to accounting methodologies, a balance needs to be struck between the granularity of our guidance and the benefits associated with setting these rules against the likely materiality of the impact on the contractors. Given uncertainty around the scale of benefits and the cost of industry, we have decided it is not likely to be proportionate, at least at this stage. Industry is well placed to ensure that its high level accounting practice remains up to date and in line with GAAP, which should be the basis for reporting requirements under the regime. However, we will continue to monitor compliance with the regime and will consider if it may be appropriate to provide some further guidance.
- 4.38 To the extent there is a need to address novel and complex circumstances arising in the contract, parties can seek clarification on such issues through the SSRO Helpdesk: helpdesk@ssro.gov.uk
- 4.39 We have had careful regard to the consultation responses about the implementation of our guidance. We note that these requested a longer implementation period before the new version of guidance takes effect.
- 4.40 The revisions we have made are not material and aimed at providing further clarity based on our experience of the application of guidance to date. In light of this and the fact that none of the revisions constitute a substantial policy change, stakeholders should not require additional time to amend their contracting terms and practices. We therefore consider that it is appropriate and proportionate for the guidance to apply to all new contracts entered into from the date of the publication of this guidance.

2 Regulation 23

3 7.5 of the January 2015 SSCR and 7.2 of the updated SSCR

4 Clause 24 of the Act

Table of other comments and the SSRO response

4.41 The table below provides a further list of, and the SSRO response to, specific issues raised by respondents.

Table 2: Specific issues raised by respondents

Issue category	Section	Description of issue	Response
Authority of the guidance	Whole document	It is for the MOD and industry to determine whether costs are Allowable. SSCS should be followed or divergence should be fully explained and documented.	The Act states that parties 'must have regard' to the Allowable Costs guidance when determining contract costs (S.20 (3)). As such, the guidance should be adhered to unless there is a good reason not to that is consistent with the legislation and to describe any known deviation from the guidance.
	Whole document	Parties should be able to apply previous versions of guidance in force at the time of estimates costs to actual costs.	The guidance which applies is that which is in force at the time of agreement (which is defined in Regulation 2(1)).
Applicability of guidance	Whole document	Parties should be able to apply previous versions of guidance in force at the time of estimates costs to actual costs.	The guidance which applies is that which is in force at the time of agreement (which is defined in Regulation 2(1)).
AAR criteria	7.1	The second principle of Allowable Costs ('actual costs should be assigned to contracts only once') should be merged with the third ('estimated costs should only be assigned once and not reflected again once they become actual').	These have been merged to encompass both estimated and actual costs.
AAR criteria	7.3 (new section)	The guidance should clarify whether it is for a primary contractor or sub-contractor to evidence that costs are Allowable for QSCs.	The SSRO appreciates the commercial sensitivities with regard to the transfer of costing data between prime and sub-contractors. The guidance now states that the burden of proof for Allowable Costs within QSCs rests with the sub-contractor.
AAR criteria	7.5	The section suggests that the guidance does not apply to all pricing types.	The guidance applies to all pricing methods, and we have therefore removed the paragraph to avoid confusion.

Issue category	Section	Description of issue	Response
Further detail requested	8.1 – 8.4	The guidance should give consideration to costs that only appear in consolidated financial statements and costs that are only required to be computed and disclosed for the group or immediate holding company (e.g. IAS 19 for group schemes). The guidance also needs to be given to on the extent to which costs and credits from IAS 39, the treatment of fair value hedging, and IAS 21 should be recognised as costs.	The experience of QDCs and QSCs to date does not justify inclusion of this in the guidance. We may consider this, but it would be separate to the guidance.
Request for further clarity	8.5 (now 7.10)	It was suggested that the section acknowledge that some direct costs may have indirect elements to them, and that the section be shortened to provide clarity.	The guidance has been updated for clarity.
Request for further clarity	8.6 (now 7.11)	The guidance should note that overhead and indirect costs must be identifiable to be Allowable.	The section has been updated for clarity
Depreciation, amortisation and impairment	10.4 – 10.5 (now 9.5 – 9.7)	The guidance should distinguish between three types of intangible assets, currently treated as a single entity. The guidance should reflect that amortisation cannot apply to tangible fixed assets. Goodwill should be an adjustment to the reference group for comparability, rather than an Allowable Cost.	The section has been updated to distinguish between three asset classes. We acknowledge amortisation cannot apply to tangible fixed assets. We replaced 'fixed assets' with 'non-current assets' to reflect modern accounting terminology.
Research and Development	10.13 bullet 5 (now removed), 10.14 (now 9.22), 10.16 (now 9.21)	Funding from the supplier as general R&D should be Allowable. The reference in 10.14 to 'technology' should be replaced with 'development'. The language in 10.16 should be redrafted to simplify.	We have consolidated section 12.12 – 12.16 with the section on Private Venture Research and Development. We have redrafted the bullet points to ensure clarity. In doing so, we have removed bullet 5 as costs relating to R&D activity that has been funded through other routes would not meet the AAR test. We have replaced 'technology' with 'development' to ensure consistency with GAAP. 10.16 (now 9.21) has been redrafted to clarify the section.

Issue category	Section	Description of issue	Response
Pensions	10.17 (9.24 – 9.25)	The paragraph is unclear and should allow FRS102 dispensation to separate the inclusion of pension's information relating to the entity if full disclosure is made at holding or group level. In addition costs are accounted for on an accruals basis and not simply cash contributions.	The section has been amended to give clarity. We have included reference to GAAP which includes FRS102 so far as it applies. We acknowledge that pension costs are accounted for on an accruals basis, and consider that the redrafted section makes our guidance on what is Allowable clearer than previously.
Pensions/ Exceptional or Abnormal Costs	10.17, 12.11, 12.12 – 12.15	Duplication in a number of Sections.	We have revised the format to avoid any duplication and add clarity.
Refunds	10.21 (9.39)	The EU emissions trading system is not a relevant or appropriate example as it concerns carbon allowable/ credits rather than spend.	We note the confusion caused by the example given and have therefore removed it. The last sentence of the paragraph has been deleted as this was causing confusion.
Entertaining	11.1 bullet 6 (now 9.30)	Entertaining should be Allowable where it is part of the deliverables of the contract.	The guidance is clear that Entertainment is not an Allowable Cost.
Exceptional or Abnormal Costs	12.10 (now 10.11)	Why would such agreements need to be reported to the SSRO?	We consider that this requirement enables us to better understand the total cost model.
Exceptional or Abnormal Costs	12.16 (now 9.23)	It should be offset from R&D attributable to the MOD. In normal circumstances R&D would be expected to generate profits from sales to customers and receipts from tax credits.	We have consolidated the section on Research and Development Tax Credits into section 10 which addresses the issue raised.
Cost allocation practices	13.2 (now 11.2)	The guidance should require contractors to declare all 'material' deviations from its accounting systems to the SSRO and Secretary of State.	We agree that it is only necessary to notify 'material' deviations to the SSRO and Secretary of State and have updated the guidance to reflect this.

5. Next steps

- 5.1 The SSRO published the final version of the guidance on its website on 1 July 2016, and will continue to engage with industry to provide further clarity on the treatment of costs using its SSRO Answers facility.
- 5.2 The SSRO will formally review the guidance on an annual basis, and publically consult on any proposed updates.

involvement in the decision-making process. This was done to ensure that the study was relevant to the target audience. The research team consisted of a clinical psychologist, a clinical social worker, a nurse, and a physician. The research team conducted a series of focus groups to explore the needs and preferences of the target audience. The focus groups were held in a private, confidential setting and lasted approximately 45 minutes. The questions were designed to explore the following issues: (a) the importance of patient involvement in decision-making, (b) the barriers to patient involvement, and (c) the factors that influence patient involvement.

The focus groups revealed that the target audience valued patient involvement in decision-making and wanted to be more involved in their care. They also identified several barriers to patient involvement, including a lack of knowledge about their condition, a lack of confidence in their healthcare provider, and a lack of time. The research team used these findings to develop the decision-making tool. The tool was designed to be user-friendly and easy to use. It was also designed to be culturally sensitive and to address the needs of diverse populations. The tool was then tested in a series of focus groups to ensure that it was relevant and useful to the target audience.

The decision-making tool was then used in a series of clinical trials. The first trial was a randomized controlled trial that compared the decision-making tool to standard care. The results of the trial showed that the decision-making tool was effective in increasing patient involvement in decision-making and in improving patient satisfaction. The second trial was a non-randomized trial that compared the decision-making tool to a decision-making tool that did not address patient involvement. The results of the trial showed that the decision-making tool that addressed patient involvement was more effective in increasing patient involvement and in improving patient satisfaction.

The decision-making tool has been found to be effective in increasing patient involvement in decision-making and in improving patient satisfaction. It has also been found to be culturally sensitive and to address the needs of diverse populations. The decision-making tool is now being used in a variety of clinical settings and is being evaluated in a number of ongoing clinical trials.

The decision-making tool is a valuable resource for healthcare providers and patients alike. It provides a structured and systematic approach to decision-making that takes into account the needs and preferences of the patient. The decision-making tool is also easy to use and can be used in a variety of clinical settings. The decision-making tool is a valuable resource for healthcare providers and patients alike and is being used in a variety of clinical settings.

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