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Allowable Costs Working Papers: Stakeholder Response

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1. Introduction

- 1.1 Section 20 of the Defence Reform Act 2014 ('the Act') states that the SSRO must issue guidance about determining whether costs are Allowable Costs under qualifying defence contracts and qualifying sub-contracts. The current Allowable Costs guidance was last issued on 1 July 2016. The SSRO aims to review its Allowable Costs guidance, as required, to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 As part of the current review which commenced in April 2017, the SSRO has:
- held an initial discussion on three Allowable Costs topic areas at an Operational Working Group workshop on 25 April 2017;
 - issued three working papers on the topic areas on 19 June 2017 to the SSRO's Senior Stakeholder Forum and Operational Working Group whose members are from the Ministry of Defence (MOD), the ADS Group, and individual defence contractors. The scope of these working papers is summarised in section 2;
 - additionally, the papers were sent to other organisations who had indicated an interest in this review. The working papers were not published on the SSRO website;
 - held a second Operational Working Group workshop on 19 July 2017 which gave stakeholders an additional opportunity to discuss the contents of the working papers; and
 - received written responses to working papers from 13 stakeholders (see Table 1 below), including 9 contractors to the MOD. The SSRO would like to take this opportunity to thank respondents for sharing their views with us.
- 1.3 Stakeholders commented positively on the working paper approach adopted by the SSRO. The responses have helped the SSRO to revise its Allowable Costs Guidance, which has been issued for a public consultation of eight weeks (2 October – 24 November) alongside this response document.

Table 1 – Summary of working paper responses

	Government	Industry	Regulators/ Other Government Bodies	Professional Associations	International regulators/ organisations	Total
Number invited to comment	1	38	3	3	3	48
Number of responses received	1	9	0	1	2	13
Response rate (%)	100%	24%	0%	33%	67%	27%

2. Summary of the working papers

- 2.1 The paragraphs below summarise the topics covered in the working papers and the areas where the SSRO sought stakeholder views.

WP1 – Allowable Costs Working Paper – Cost Accounting and Financial Reporting

- 2.2 This working paper focuses on the topic of Cost Accounting and Financial Reporting and reviews sections 7 and 11 of the current guidance. The SSRO notes that the Allowable Costs guidance is used by accountants and non-accountants alike, and therefore seeks to ensure that the use of technical accounting terms is minimised where possible. The paper focuses on the following areas where the SSRO considers greater clarity would be beneficial:

- a. to distinguish between cost accounting principles that apply to management accounting and generally accepted accounting principles (GAAP) or accepted reporting standards that apply to financial reporting;
- b. to improve definition and consistency of terms used;
- c. to describe the treatment of direct and indirect costs;
- d. to explain roles and responsibilities in relation to ensuring the costs of a contract are Allowable; and
- e. to distinguish clearly between the information reported in a company's financial statements and reports on individual contracts.

WP2 – Allowable Costs Working Paper – Tangible and Intangible Assets

- 2.3 This working paper focuses on the topic of Allowable Costs related to tangible and intangible assets and reviews parts of sections 9 and 10 of the current guidance. In particular, the paper focuses on the following areas where the SSRO considers greater clarity would be beneficial:
- a. to distinguish between the treatment of depreciation, amortisation, impairment and revaluation as they relate to tangible, and intangible assets and subsets thereof, such as goodwill;
 - b. to consider issues relevant to the application of the AAR principles of the aforementioned cost items; and
 - c. to improve definitions and the consistency of terms used.

WP3 – Allowable Costs Working Paper – Individual Cost Types

- 2.4 This working paper focuses on the topics of Sales, Marketing and Bid costs, Entertainment costs and Faulty Workmanship and Reworks costs. The approach to these costs is included in section 9 of the current guidance:
- a. Sales and Marketing costs (current guidance paragraph 9.26 and 9.27);
 - b. Bid costs (current guidance paragraph 9.28 and 9.29);
 - c. Entertainment costs (current guidance paragraph 9.30); and
 - d. Faulty workmanship and reworks costs (current guidance paragraphs 9.33 – 9.36).

3. Stakeholder responses

- 3.1 The SSRO has reviewed all the responses received from stakeholders and evaluated the points and issues raised. The key points on the working paper topics are summarised below including the proposed change.

Entertainment costs

- 3.2 Responses received from stakeholders included that entertainment costs:
- should be generally not Allowable, unless agreed by exception;
 - are not a significant expense or issue for defence contractors; and
 - should be Allowable with alignment to HMRC rules or MOD hospitality guidance.

Summary and Proposed Change:

The SSRO proposes that the existing guidance should remain as currently stated as it is difficult to see how these costs could ever be 'appropriate'.

Sales, marketing and bid costs

- 3.3 Responses received from stakeholders included that:
- there is a need to more clearly distinguish in the guidance between sales, marketing and bid costs;
 - bid costs should be Allowable if the MOD withdraws from the negotiations but not if it is the contractor who withdraws;
 - sales and marketing costs may be Allowable if demonstrably linked to a benefit that outweighs the cost;
 - sales and marketing costs are always aimed at providing benefit (not always financial) to the MOD and therefore the costs should be allowed;
 - one contractor stated that it had been possible through a retrospective exercise for them to demonstrate a benefit and claim Allowable Costs, but it was costly to produce the evidence;
 - it is inappropriate to require a demonstrable link or retrospective test (spend is in the past and therefore it is not recoverable); and
 - if the MOD disallows sales and marketing costs it should not receive the benefit of any subsequent sales volumes.

Summary and Proposed Change:

- 3.4 The SSRO proposes to ensure the focus of guidance in relation to these costs is on the provision of evidence that demonstrates a benefit to the MOD in order for them to be considered Allowable. Evidence can be forward looking as well as retrospective and should demonstrate the benefit to the MOD where recovery rates are being maintained or lowered. Stakeholders supported removing the term 'demonstrably linked' as this essentially has the same meaning as 'attributable'.
- 3.5 The proposed guidance has been amended to provide a clearer distinction between bid costs and sales and marketing costs. Bid costs may be Allowable where agreed by the MOD and where they are a direct charge to the contract.

Costs associated with reworks and faulty workmanship

- 3.6 Responses received from stakeholders included that:
- a. reworks and faulty workmanship can never be eliminated and rework is a natural part of some processes;
 - b. a reasonable level of rework is Allowable providing it is supported by appropriate evidence e.g. benchmarking;
 - c. the MOD does not want to pay for 'over engineering' of manufacturing and production processes by contractors;
 - d. it is unrealistic to expect complex goods /services to be manufactured without defect;
 - e. faulty workmanship arising from poor systems should not be Allowable;
 - f. costs of correcting faulty workmanship should be Allowable and subject to negotiation;
 - g. no reasonable costs should be refused if the cost of collecting the evidence is prohibitive; and
 - h. contractors will not share commercially sensitive rework / comparability data to enable benchmarking.

Summary and Proposed Change:

- 3.7 The SSRO proposes that guidance should reflect that there can be an agreement between the contractor and the MOD on reasonable levels of rework and faulty workmanship. However, the proposed guidance states that faulty workmanship due to poor systems are not Allowable. Contractors should have quality management systems which allow them to assess levels of rework, wastage and faulty workmanship and understand what is causing them.
- 3.8 Some stakeholders considered that the term 'acceptable level' should be used instead of 'agreed level'. However, the SSRO considers that to be acceptable the level would have to be reasonable and agreed by both parties and instead focuses its guidance on meeting the AAR test. The actual levels themselves will be largely dependent on the type of contract being delivered, the maturity of the process and industry recognised failure rates. Contractors should maintain and share with the MOD plans to increase efficiency and reduce rework and faulty workmanship, where this is practical.

Tangible and Intangible Assets

3.9 Responses received from stakeholders included that:

- a. it is inequitable for contractors to revalue assets and charge higher depreciation charges or a similar charge for a longer period of time;
- b. only items that have been directly financed by the MOD are those that should not be the subject of further cost recovery;
- c. the MOD should not expect the free use of assets that have been purchased by the contractor;
- d. additional clarification is required over the treatment of assets that have been jointly funded by the contractor and the MOD;
- e. the revaluation of assets does not require the approval of the Secretary of State;
- f. the impairment of goodwill arising from business acquisitions should be generally not Allowable;
- g. funding of Intellectual Property by the MOD does not necessarily make it the owner of the Intellectual Property Rights. The MOD may receive an appropriate levy on any export business;
- h. the treatment of amortisation is best dealt with as an Allowable Cost rather than through the Baseline Profit Rate;
- i. the comparator group used to calculate the Baseline Profit Rate should be restated to include impairment of goodwill and business combinations;
- j. the MOD rarely allows costs associated with intangible assets; and
- k. it is difficult to establish the cost and method of charging for intangible assets, especially those within group companies.

Summary and Proposed Change:

- 3.10 The SSRO proposes some principles in relation to assets and associated non-cash costs (e.g. depreciation and amortisation) that should be considered when determining whether those costs are Allowable. This expands the current guidance on depreciation, amortisation and impairment. The proposed guidance makes clear that the treatment and valuation of assets resulting in increased asset values or impairments is the responsibility of the Directors of contracting companies.

Accounting Issues

3.11 Responses received from stakeholders included that:

- a. companies should be free to select their own accounting systems and processes;
- b. the principles contained in the guidance should remain generic. These issues are the responsibility of the company's Board of Directors;
- c. contract costs should be reconcilable to the contractor's financial statements;
- d. contractors do not always have a 1:1 relationship between the statutory accounts of a legal entity and the management accounting of a Qualifying Business Unit;
- e. the guidance should follow International Financial Reporting Standards and UK Generally Accepted Accounting Practice, and the SSRO should not create anything new;
- f. the proposed guidance changes are seeking to extend beyond the SSRO's current remit;
- g. the justification for exploring the differences between a company's management accounts and its statutory accounts is not clear;
- h. there is no statutory requirement for a linkage between a company's statutory accounts and contract reporting requirements; and
- i. the notion of sunk costs is not covered by the legislation, in that a contract agreed to become a QDC currently has to be repriced in its entirety. Accordingly, the guidance should not refer to sunk costs.

Summary and Proposed Change:

- 3.12 The SSRO considers that a section on cost accounting and financial reporting issues in the proposed guidance is an improvement. It draws together principles that were in different places in the current guidance. The SSRO recognises the stakeholder comments made about accounting systems and financial reporting being the responsibility of the Directors of contractors and the amended guidance reflects this. The SSRO acknowledges that there are auditing/accounting standards which must be complied with and well-established processes undertaken by the auditors of companies and the MOD to review the approaches adopted.
- 3.13 In the working papers, the SSRO proposed a glossary of terms. The majority of stakeholders considered that these terms were already defined by accountancy bodies and alternative definitions could be confusing. The SSRO recognises this and as a result the proposed guidance does not include a glossary of terms.
- 3.14 The issue of sunk costs was considered during the SSRO's review of the legislation and the MOD is also considering this issue as part of its review. Recognising that a future change in the legislation will be required to clarify the treatment of sunk costs, the SSRO has decided that until such amendment the guidance should remain as currently drafted.

4. Other changes and future review

- 4.1 In general, stakeholders confirmed that the statutory guidance on Allowable Costs should remain principles based. The SSRO did not receive specific comments on the AAR test but on review is proposing that the AAR principles included in section 2 of the revised guidance should remain unchanged.
- 4.2 The SSRO set out at the beginning of its review that it intended to make incremental improvements rather than radical change. At the beginning of each section of the proposed guidance, the changes to that section are explained to aid understanding of the changes that have been made.
- 4.3 While not a specific issue raised by stakeholders, the SSRO is proposing a restructuring of the guidance to make navigation clearer and to 'future proof' the document so that further guidance on cost types not currently covered could be added if necessary.
- 4.4 In the working paper on Cost Accounting and Financial Reporting, the SSRO proposed some rewording of paragraph 7.3 of the current guidance, which deals with Allowable Costs and qualifying sub-contracts. The SSRO accepts that it did not clarify this issue sufficiently and some alternative wording is now suggested.
- 4.5 Stakeholders suggested that the SSRO should define the types of evidence that should be provided by either party to satisfy the AAR test. The SSRO gives examples of evidence where it can, but given the diversity of contracts it is not always possible to define examples that would fit every scenario.
- 4.6 The draft guidance includes the existing guidance on risk. The SSRO will consult on changes to this guidance as part of its consultation on profit rate adjustments guidance in December. This is to ensure that stakeholders can consider Allowable Costs guidance on risk and the guidance on the step 2 cost risk adjustment having been informed by the SSRO's study on risk which will be published in November.
- 4.7 Several comments were made by stakeholders with regard to topics that were not specifically covered by the working papers or part of this year's review. These included research and development expenditure, intellectual property rights, insurance and stock losses / obsolescence. As part of developing the SSRO's next Corporate Plan we will discuss with stakeholders the relative priority of these issues and the time needed to review these comprehensively.

5. Application of the guidance

- 5.1 The SSRO intends to publish the final guidance on 1 February 2018 following approval by the SSRO Board in January. Stakeholders confirmed that they would welcome a period of familiarisation before the guidance applies. This will allow stakeholders time to raise awareness and amend any relevant processes or procedures prior to its implementation.
- 5.2 The SSRO proposes that the revised guidance will be applicable to all new qualifying defence contracts or qualifying sub-contracts entered into or amended on or after 1 April 2018. The revised guidance would replace the previous version issued on 1 July 2016.
- 5.3 The SSRO welcomes views on the proposed publication and application date as part of the consultation.

6. Consultation questions

- 6.1 The SSRO would like to hear stakeholder views with regard to the following consultation questions:
- a. Do the proposed revisions make the guidance more or less clear?
 - b. Are there any material issues that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.
 - c. Do the structural changes make navigation of the guidance more or less clear?
 - d. Do stakeholders have any concerns regarding the proposed publication and implementation dates of the guidance?
 - e. Which guidance areas are high priority for the next review?
- 6.2 The SSRO's expectation is that given the stakeholder engagement that has already taken place any additional new comments or responses would be minimal and only relate to items of a significant nature, taking into account the prior opportunities that have been available to stakeholders to voice their concerns or comments.
- 6.3 Consultation responses should be emailed to simon.mccullough@ssro.gov.uk by Friday 24 November 2017. The SSRO is also willing to meet with any stakeholders, individually or collectively to discuss their responses during the consultation period.

7. Timetable

7.1 The indicative timetable for activities going forward are summarised in the following table.

Activity	Organisation	Date
Publication of consultation on Allowable Cost Guidance	SSRO	2 October 2017
Submission of responses to consultation	Stakeholders	24 November 2017
Compile the final version of the guidance	SSRO	December 2017
SSRO Board review and sign off	SSRO	23 January 2018
Publication of new Allowable Costs Guidance	SSRO	1 February 2018
Awareness raising	SSRO and Stakeholders	February and March 2018
Application of new Allowable Cost Guidance	SSRO	1 April 2018

