SSRO

Single Source Regulations Office

Assuring value, building confidence

Consultation Response Form

Allowable Costs Guidance

Your details

Name:

Paul Everitt

Organisation:

ADS Group

Position:

Chief Executive

Consultation questions

When answering the consultation questions, it would be helpful if you could support your responses with references to paragraph numbers and to make suggested wording changes where you consider this appropriate. This will help us to understand the basis for your answer and inform the finalisation of the guidance.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view. If you have just general comments to make then please just answer question 6.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes ✓ **No**

Consultation Questions

The following questions were included in the stakeholder response document issued with the revised Allowable Costs guidance:

Question	ADS Response
Do the proposed revisions make the guidance more or less clear?	The revised draft Allowable Costs Guidance is an improvement on the current issue. It is seen as being clearer and generally more user friendly.
Are there any material areas that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.	The MOD/SSRO/Industry workshops held as part of the Three Year Review of the Act and Regulations identified a number of issues where it was agreed it would be better to deal with them in guidance rather than via changes to the Act or Regulations. These need to be revisited and incorporated in the work plan for the forthcoming period.
Do the structural changes make navigation of the guidance more or less clear?	ADS believes there should be greater distinction between general guidance which is present for information and that which is Statutory Guidance to which suppliers must 'comply or explain'. Whilst recognising that the former provides useful context and background, it is suggested that it should be presented in a separate section or document.
Do stakeholders have any concerns regarding the proposed publication and implementation date of the guidance?	ADS is content with the proposal to publish the revised guidance at the same time as the new Baseline Profit Rate is announced.
Which guidance areas are high priority for the next review (in order of priority)?	ADS notes that a number of the areas recommended for review under the Three Year of the DRA and SSCRs may require amendments to the Statutory Guidance for Allowable Costs. These should be given a high priority to ensure the regulatory framework and statutory guidance are coherent.

Please add your comments:

General: ADS makes the following observations and comments against the Revised Allowable Costs Guidance, October 2017:

Paragraphs 2.2 and 2.3: Suppliers are required to evidence each cost element as being Appropriate, Attributable and Reasonable in order for it to become an Allowable Cost. During this process each cost element will be scrutinised by the MOD Project Team, CAAS and in some circumstances, the SSRO. It seems perverse that having passed through detailed professional scrutiny, 'Appropriateness' and 'Reasonableness' could then be subject to public opinion and 'Allowability' overturned. ADS suggests that references to public scrutiny are deleted or if retained guidance or instructions or both should be included to help a supplier determine whether or not a cost element would '*withstand public scrutiny'.*

Paragraph 2.5, Bullet 5: ADS believes the guidance should recognise that costs may be incurred in the operation of the business that '*enables the performance of the QDC or QSC*' and that these should be Allowable. This should be added to the end of the criterion. It is a feature of the Regulations (Reg 58(3) and (4), where a QSC can apply to subcontracts that '*enable'* performance of a regulated contract.

Paragraph 2.5, Bullet 6: This requires the supplier to prove a negative i.e. that a cost has

not been recovered elsewhere. ADS suggests it should be reformulated into a positive requirement for the contractor to evidence that its cost collection and allocation processes and procedures only allow a cost to be recovered once. The same approach should be taken as in Paragraph C1.5.

Paragraph 2.7, Bullet 2: as per 2.2 above.

Paragraph 2.7, Bullet 6: ADS believes that value for money can only be assessed on the whole price that MoD pays not on elements of cost, and the only person who can make that assessment is the end user. Whilst the UK tax payer may have an opinion, it is unlikely to be able to assess whether or not the military effect that could be delivered as a result of the expenditure represents value for money. ADS suggests this bullet is deleted.

Paragraph 3.2: As per comment in Paragraph 2.5 bullet 5. This requires the addition of '*to enable' the performance of the QDC or QSC*'.

Paragraph 3.3: Whilst it is common practice for a supplier and MOD to agree a QMAC on an annual basis it is not a requirement of the Act or Regulations. It is suggested that the first sentence is amended to read, '*Single source contractors declare their cost accounting and cost allocation approaches to MOD via the Questionnaire on the Method of Allocation of Costs*'.

Paragraph 3.5: DRA §20(3) requires that '*the Secretary of State or an authorised person, and the primary contractor, must have regard to guidance issued under subsection (1)'* rather than '*determine whether a cost is, or is not, Allowable in line with this statutory guidance.* ADS suggests this paragraph is amended to read *'The parties must be able to demonstrate that they have had regard to this guidance when making an assessment as to whether a cost is an Allowable Cost.'*

Paragraph 3.6: The contractor only has to show that a particular cost is 'Appropriate' 'Attributable' and 'Reasonable' when required to do so by the Secretary of State or an authorised person. ADS suggests the paragraph is amended to read '*When required to do so by the Secretary of State or an authorised person, which may be at any time up to completion of the contract, the contractor shall show that a particular cost is 'Appropriate', Attributable to the contract' and 'Reasonable in the circumstances'.*

Paragraphs 3.7-3.8: ADS is aware that Regulation 14 – Redetermination of Contract Price, is likely to be revised as part of the Three Year Review of the regulatory framework and feels it is premature to offer thoughts on the Statutory Guidance dealing with this issue before the revised form of Regulation is known. However, ADS believes the following principles should be reflected in the Regulation and the Statutory Guidance:

1. A distinction should be made between amendments that are a result of changes to the requirement e.g. the technical specification, quantities etc., and amendments that stem from other reasons e.g. changes of pricing methodology.
2. The costs, prices and profit of those parts of the original bargain that are not affected by the amendment should be preserved post amendment.
3. The treatment of further amendments once the contract has been converted to a QDC/QSC, 'changes-on-changes', and reporting need further consideration. The integrity of the costs, prices and profit of the original bargain should be preserved.

Paragraph A1.1: Shares will be part of an employee's '*contracted'* not 'normal' remuneration.

Paragraph A3.1: Redundancy payments are a matter for the company and the employees being made redundant. If payments are made in excess of statutory rates then it is for the company to demonstrate that this was 'Appropriate', '[Attributable]' and 'Reasonable' in order to recover the difference as a cost against on one or more single source contracts.

Paragraph A.4.1: inflation should have '*regard to*' an appropriate benchmark or index '*and justified in excess of that*' to be an Allowable Cost.

Paragraph B.1.1: as per A.4.1

Paragraph C.1.1: Requires the following adjustment: '….if they meet the AAR principles and '*would have a realistic opportunity, if successful*,' deliver demonstrable '*prospective'* financial benefit to the MOD.

Paragraph C.1.2 a. requires at the end of the sentence that costs being claimed *(or proportionately for QSCs).*

Paragraph C.1.2 b. requires the word '*likely'* before the word benefit.

Paragraph C.1.2. c. The evidence base should be '*notified'* to the MoD, instead of agreed.

Paragraph C.1.4: requires the word '*likely'* before the word benefit.

Paragraph C.2.1: The MoD/Contractor dialogue and engagement on a potential single source contract can start months or even years before the Request for Proposals (RFP) or ITT is issued, and contractors start incurring costs from this point. The following sentence should be added at the end of the paragraph: '*Expenditure incurred during early discussions with MoD/contracting authority on the prospective requirement prior to the issue of an RFP or ITT may be Allowable.'*

Paragraph C.2.2: Contractors will recover bid costs in accordance with the QMAC agreed with MOD. Where a contract is awarded as a result of the bid activity it is usual for the bid costs to be recovered as part of the contract price. Where a contractor has incurred costs preparing a bid or supporting MOD in pre contract activity in expectation that the resultant contract would be awarded to him on a single source basis, and MOD then abandons the procurement, the contractor should be able to recover the costs incurred as indirect costs on future QDCs or QSCs.

Paragraph E2.2: Rework above a 'reasonable level' should be allowable if '*special circumstances exist such that it can be justified.'*

Paragraph E.5.3: Replace 'compensate' with '*penalise'*.

Paragraph F.2.1: Amend as follows: Exceptional costs will not be allowed where they relate to normal commercial business risk and '*any'* discussions around closure, rationalisation or restructuring must '*have minimising costs as its primary aim*.' Contractors '*must have regard'* to innovation and efficiency in the proposals they submit for reducing the costs associated with the closure, rationalisation or restructuring. '*The AAR test is reduced to "reasonable" costs.'*

The reference to value for money is inappropriate in these circumstances. The objective should be to arrive at the best solution for both parties at the least realisable cost within the timescale provided. If this is achieved it may represent value for money, however, it is not a matter for statutory guidance.

Paragraph F.2.2: The statement is incoherent: site closures are made on commercial terms and not under the Framework. The Guidance should only deal with the one-off costs associated with the site closure.

Paragraph F.3.1: ADS suggests removing the criterion '*but which were designed for that purpose*' as it is inappropriate. The idle facilities only have to have enabled a regulated contract at some time, however, they may have been originally designed for other purposes.

Paragraph F.3.2: ADS suggests deleting '*for the delivery of a QDC or QSC'.*

Paragraph F.3.3: ADS suggests deleting the criterion '*which could not have been predicted by the contractor'* as it requires the contractor to second guess government or defence policy. The AAR criteria will control whether the contractor has behaved responsibly in the light of information available. Alternatively, guidance should be provided on how to predict '*….government or defence policy …'.*

Paragraph F.3.4: ADS suggests deleting this paragraph. Costs associated with idle or under used facilities are not dealt with specifically in the DRA or Regulations. It is unclear why any agreement between the contractor and the Authority on these matters must be reported to the SSRO or what its role is in this situation.

Paragraph G.1.6: Replace '*is attributable to*' with '***enables****'* in the penultimate line.

Part H: ADS suggests consideration of this section is held in abeyance pending the outcome of the consultation on risk.

Table of Comments from Babcock International – SSRO Allowable Costs Consultation

Item	Issue	Reference	Comment
	Wording in guidance	**Section**	
1.	Overhead / indirect costs	3.2	The wording still has too strong a link to the performance of a QDC / QSC whereas overhead / indirect costs, by definition, are either not possible to link in this way or not possible to estimate, and will therefore cover the general costs of running a business. Making a minor change to the wording would assist with this:- ……costs which have necessarily been incurred for the performance of a QDC or QSC **OR** as part of the conduct of the contractor's business in general……..
2.	..to be considered allowable… a. Any retrospective of prospective benefit to the MOD through cost savings on QDC's is greater than the costs being claimed.	C.1.a	The guidance on marketing and sales costs suggests that the ability to include these costs as allowable is binary. There is no consideration of a proportion of costs being allowable. Alternatively it could be read as the value of marketing and sales costs which would be allowable is equal to, or less than the cost benefit to the MoD which can be demonstrated as a result of successful competitive orders. Furthermore, when agreeing pricing, the basis of the estimated rates will often include an assessment of future success on winning competitive work, and therefore MoD will receive the benefit of this in pricing, regardless of whether the work is won or not. If the expectation is that the marketing and sales costs will only be allowable in the actual costs in the event that the Contractor is successful in winning the competitive work (to the degree that the benefit to MoD is greater than or equal to the marketing and sales costs), is this not potentially a double impact to the contractor ? i.e. the contractor carries all the risk of winning the work as the MoD have already had the benefit through pricing regardless of success ? This cannot be an equitable arrangement and needs further consideration

Item	Issue	Reference	Comment
3.	If insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable.	E.6.3.	We are content that insurance premiums related to loss of profit are disallowed. All other premiums should be allowable as an appropriate cost of running a business or a project noting that some are legal requirements, others are contractual requirements that also provide for certain client rights. It should also be noted that insurance often covers the impact or effect of the insured item failing and not the failure itself. Again this is a complicated area of business, is the normal practice for all companies in the comparator group and wider industry and rule of thumb statements should be avoided.
4.	Non-cash costs	G.1.	Whilst we accept the general principle that items of a capital nature should be recovered through depreciation / amortisation, we would challenge this guidance where an asset is bought specifically for one contract or for a class of contracts. Companies have to plan capital investment programmes in advance to understand the cash impact on the business of providing facilities fit for purpose for delivering future workload. There are clearly limits to cash availability within any business due to the requirement to satisfy a number of stakeholders. Plant and equipment required to support specific projects, or classes of projects (known as Refit Support Equipment in the Submarines and Ships world) clearly meets the requirement of the AAR test and it is therefore logical that these items should be treated as direct charge against the specific contract (or first of class for a class requirement). For example, this is the agreement that has existed for 30 years within Devonport and is captured within our QMAC. These items can be large value at times and to treat as capital items for recovery over a long period may lead to other important capital investment projects being deferred or cancelled by Contractors due to the lack of limitless available cash within the Company. This approach was proposed by Industry (see the first item on Industry stakeholder feedback in para 3.1 of the Working Paper, Allowable

Item	Issue	Reference	Comment
			Costs related to tangible and intangible assets) and is mentioned in para 2.6, first bullet point in the same paper. We would encourage the continuation of this thinking to reach a pragmatic solution to the funding of items required for specific Qualifying Defence Contracts (or classes of QDC's).
5.	Evidence	N/A	One of the main concerns highlighted by Industry on Allowable Costs relates to the difficulty with the provision of evidence i.e. what constitutes evidence ? (referred to para 5.1 and elsewhere throughout the guidance). It was considered by Industry that there were no clear guidelines on what was expected of Contractors in providing evidence in support of estimation of future costs. Whilst it is relatively easy to provide evidence for costs incurred, it is far more difficult and subjective to evidence something which will happen in the future due to the uncertainty and volatility of future assumptions. Indeed the biggest challenge for ourselves and MoD in agreeing QDC's has been on the perceived requirement to evidence future estimates. For example, in labour rates calculations, one of the significant inputs is the volume of labour hours (the denominator in the rates), so some stability in this is key to drive a set of future pricing rates if the labour rates estimating model is set up to be sensitive to changes in volume. This is particularly challenging in our environment where our workload in Devonport is almost entirely dependent on an MoD issued programme of work which is inherently volatile For example, the Submarines programme SSMP 144 was used as the basis for pricing our MSDF contract less than 3 years ago, and we are now working to SSMP 193 – that is 49 programme changes in 33 months. This makes it extremely difficult to evidence the basis of an estimated labour rate as any assumption used is quickly out of date. In our opinion, it is far more logical for estimating labour rates / costs to be underpinned by a sensible level of granularity given the uncertain and volatile landscape in which we, and many other Contractors

Item	Issue	Reference	Comment
			operate, and that it is the actual cost baseline which is used as the start point for estimating which should be evidenced. For future estimating, the reasonableness of the methodology is what should dominate discussions rather than an expectation of 'evidencing' every individual assumption which could impact future costs, which is not possible.

SSRO

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Regulations Office

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Consultation Response Form

Allowable Costs Guidance

Your details

Name:

Michael Hayes

Organisation:

The Boeing Company

Position:

Commercial Director, Boeing Defence UK Ltd

Consultation questions

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Yes ☑ **No** ☐

Consultation Questions

The following questions were included in the stakeholder response document issued with the revised Allowable Costs guidance:

- Do the proposed revisions make the guidance more or less clear?
- Are there any material areas that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.
- Do the structural changes make navigation of the guidance more or less clear?
- Do stakeholders have any concerns regarding the proposed publication and implementation date of the guidance?
- Which guidance areas are high priority for the next review (in order of priority)?

Please add your comments:

General: The revised draft Allowable Costs Guidance is an improvement on the current version. Boeing has pleasure in providing the following comments, with references to the section numbers in the draft document.

Paragraphs 2.2 and 2.3: Suppliers are required to evidence each cost element as being Appropriate, Attributable and Reasonable in order for it to become an Allowable Cost. During this process each cost element will be scrutinised by the MOD Project Team, CAAS and in some circumstances, the SSRO. It seems perverse that having passed through detailed professional scrutiny, 'Appropriateness' and 'Reasonableness' could then be subject to public opinion and 'Allowability' overturned. Boeing suggests that references to public scrutiny are deleted or, if retained, guidance or instructions or both should be included to help a supplier determine whether or not a cost element would '*withstand public scrutiny'.*

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Paragraph 2.7, Bullet 2: as per 2.2 above.

Paragraph 2.7, Bullet 6: Boeing believes that value for money can only be assessed on the whole price that MoD pays not on elements of cost, and the only person who can make that assessment is the end user. Whilst the UK tax payer may have an opinion, even though the DRA makes no reference to such a Person, it is unlikely to be able to assess whether or not the military effect that could be delivered as a result of the expenditure represents value for money. Boeing strongly suggests that this bullet is deleted.

Paragraph 3.2: As per comment in Paragraph 2.5 bullet 5. This requires the addition of '*to enable' the performance of the QDC or QSC*'.

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Paragraphs 3.7-3.8: Regulation 14 – Redetermination of Contract Price, is likely to be revised as part of the Three Year Review of the regulatory framework and Boeing feels that it is premature to offer thoughts on the Statutory Guidance dealing with this issue before the revised form of Regulation is known. However, Boeing believes the following principles should be reflected in the Regulation and the Statutory Guidance:

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Paragraph C.1.2. c. The evidence base should be '*notified'* to MoD, instead of agreed.

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Paragraph C.2.2: Contractors will recover bid costs in accordance with the QMAC agreed with MOD. Where a contract is awarded as a result of the bid activity it is usual for the bid costs to be recovered as part of the contract price. Where a contractor has incurred costs preparing a bid or supporting MOD in pre-contract activity in expectation that the resultant

contract would be awarded to him on a single source basis, and MOD then abandons the procurement, the contractor *should* be able to recover the costs incurred as indirect costs on future QDCs or QSCs.

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Paragraph G.1.6: Replace in the penultimate line '*is attributable to*' with '*enables'*.

Part H: Boeing suggests consideration of this section is held in abeyance pending the outcome of the consultation on risk.

24 November 2017

Mr Matthew Rees
SSRO
3rd floor, Finlaison House
15-17 Furnival Street
London EC4A 1AB

Dear Matthew,

Revised Allowable Costs guidance for consultation

We are pleased that our comments on the consultation on *Allowable Costs Working Papers - 2017/18 Review* were well received. We hope that our contribution brought some different perspectives to the discussion.

We are now writing to you in connection with the follow-up consultation on the Allowable Cost guidance itself. We have borne in mind that in paragraph 6.2 of the accompanying paper entitled *Allowable Costs Working Papers: Stakeholder Response,* the expectation is made clear that any additional new comments or responses at this stage will be minimal and only relate to items of a significant nature.

We find the layout of the new guidance is much improved. In particular, the index on page 10 is very useful. Since we do not have any other specific comments on the guidance, we would like to share some more general observations.

We assume that the objective of the guidance on allowable costs is to ensure that Government (and ultimately the public) does not bear:

- The consequences of poor cost controls/inefficiency within the company bidding for contracts, which is a risk with costs plus contracts;
- Amounts that represent a cross-subsidy for costs that were incurred on another contract or for other customers; and
- The cost of items that should be paid for out of profits ie borne by the company.

While discussing the draft guidance, we considered whether it was clear and robust enough to leave its users in no doubt what is expected of them and what is allowable and what is not. For example, we noted that while it has been necessary for the SSRO to provide a fair amount of explanation and additional guidance to underpin the AAR principle, this principle

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will always be open to interpretation, including of course over what is ‘reasonable’; such broad and relatively loose terms tend to be a recipe for disagreement and even litigation. We considered in this context, and by contrast, the strict criteria under tax law for costs to be ‘wholly and exclusively’ for business purposes in order to be allowable for tax purposes. This is a difficult issue. We support a principles-based approach to providing guidance; but if there are any doubts that the objective set out above is being met, it might be worth reflecting on whether the SSRO guidance could be more strongly worded in places, and tax law is a good place to look for similarities or analogies.

You will appreciate that much of the content of this consultation lies outside our area of expertise and together with a lack of practical experience, this makes it difficult to respond to the SSRO’s formal questions. We hope that our observations may be of use nevertheless.

Yours sincerely,

Dr Nigel Sleigh-Johnson
Head of Financial Reporting Faculty

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Single Source
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Consultation Response Form

Allowable Costs Guidance

Your details

Name:

James Schofield

Organisation:

Leonardo MW Limited

Position:

Financial Controller

Consultation questions

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Yes	X	**No**	

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- Are there any material areas that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.
- Do the structural changes make navigation of the guidance more or less clear?
- Do stakeholders have any concerns regarding the proposed publication and implementation date of the guidance?
- Which guidance areas are high priority for the next review (in order of priority)?

Please add your comments:

- ADS are providing a detail response to the consultation that LMWL is in support of. Complementing the ADS reply LMWL would add the following:

- **The propose revisions in most respects make the guidance clearer**

- **Material areas where we would suggest changes are made:**

    - **4.3 (application of the guidance – QSC's)**
      We believe the wording of the previous July 2016 guidance (7.3) to be correct and would recommend the wording is not amended.
        - The prime contractor has the obligation to flow down relevant terms and conditions where the subcontract is non-competitive and it is a QSC, but it is the Secretary of State under the DRA 2014 and associated regulations who has rights of "examination of relevant records", be it bid or cost certification purposes.
        - At a practical level, due to issues of commercial confidentiality, suppliers typically only share price level information with the Prime Contractors. The demonstration that QSC costs are Allowable requires a level of cost and price breakdown beyond this, which the supplier will uniquely only provide to the MoD. In addition, in the case of major foreign subcontractors, at times, the MoD have negotiated directly with the subcontractor, then advising the prime contractor the value of the subcontract to be included in the prime contract.

    - **A3.1 Redundancy costs**
      We believe redundancy costs agreed between the Company and the employee would need to be evidenced as AAR but should not require approval of the Secretary of State.

    - **A4.1/B1.1 Inflation of labour costs/rates and material**
      We believe inflation should have regard to an appropriate benchmark and any increase in excess of that benchmark be justified in order to be an allowable cost.

    - **C.1 Marketing and sales costs**
      Demonstrated benefit to the MoD should be where the rates calculated including sales and marketing costs and associated non-

MoD throughput of activity are lower than those rates calculated excluding sales and marketing costs and the relevant non MoD throughput.
That may or may not mean a “maintenance or reduction in the rates charged”, it could equally mean a lower increase in the rates, depending on the movement in overall business volumes.

Recommended wording for C.1
Paragraph C.1.1 remains as written, C 1.2 to 1.5 substituted by:
Benefit to the MoD may be demonstrated by showing the inclusion of sales and marketing costs and associated non-MoD throughput yields a lower rate or unit costs, charged to the MoD QDC and QSC, than if sales and marketing costs and associated non-MoD throughput was excluded.
Marketing and sales costs may include such items as salary costs, related staff expenses (travel and subsistence), marketing and sales campaigns, relationship/account management activities, sponsorship and other related commercial activities.
A contractor should ensure that any costs claimed are not or will not be recovered through other means. For example, where there is Government financial support for sales and marketing campaigns already in place these costs should not be claimed.

- **C 2 Bid costs**
  Bid costs are a normal “part of the conduct of the contractor’s business in general” (3.2) and are often incurred in periods prior to a contract being let. To that end the cost, as with sales and marketing, ought to be an allowable cost within the operating costs of the business and be included in that periods rates. If and when the contract is won and if the customer agrees to pay for the bid costs (the MoD have not always agreed to include bid cost as a direct cost in the pricing of their contract), then the bid costs should be directly allocated to the relevant contract and any prior year bid cost for that contract be credited to the current periods operating costs rate calculation.
  Recommended wording for C.2
  Bid costs wherever possible should be charged directly to a contract rather than being apportioned as indirect costs. However, often bid costs are incurred in accounting periods prior to a contract being awarded. In such cases, bid costs, being a normal “part of the conduct of the contractor’s business in general” are an allowable cost within the operating costs of the business and may be included in the rates. If and when the contract is won and if the customer agrees to pay for the bid costs, then the bid costs should be directly allocated to the relevant contract and any prior year bid cost for that contract be credited to the current periods operating costs and rate calculation.

- **C3 Entertainment costs**
  Could there be alignment with the HMRC rules rather than a blanket disallowance?

- **G.1.6, 1.7 Goodwill**
  Proposed alternate words:
  Goodwill created upon business combination is generally an intangible asset on a company’s balance sheet. A case by case review would be required to determine the reason for the business combination and whether the goodwill arising is a contract cost and if

any subsequent, revaluation, impairment or amortisation is an allowable cost.

- **The structural changes do improve the navigation of the document**

- **Publication and implementation date**
  - This will depend on the final draft and our ability to change any processes in time and also implications on bids or rate submissions already in process under existing rules but not contracted/agreed at the cutover date.

- Highest priority areas for the next review will in part be dependent on the conclusion to this review and especially that of marketing, sales and bidding costs.

SSRO

Single Source
Regulations Office

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Consultation Response Form

Allowable Costs Guidance

Your details

Name:

ADRIAN DOE

Organisation:

MBDA UK Ltd

Position:

Head of Programmes Commercial Operations UK

Consultation questions

When answering the consultation questions, it would be helpful if you could support your responses with references to paragraph numbers and to make suggested wording changes where you consider this appropriate. This will help us to understand the basis for your answer and inform the finalisation of the guidance.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view. If you have just general comments to make then please just answer question 6.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes [X] **No** [ ]

Consultation Questions

The following questions were included in the stakeholder response document issued with the revised Allowable Costs guidance:

- Do the proposed revisions make the guidance more or less clear?
- Are there any material areas that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.
- Do the structural changes make navigation of the guidance more or less clear?
- Do stakeholders have any concerns regarding the proposed publication and implementation date of the guidance?
- Which guidance areas are high priority for the next review (in order of priority)?

Please add your comments:

Overall, this version of the guidance represents an improvement, in terms of clarity, from previous versions.

We do, however, have two observations upon the content of Section C:

In relation to Sales and Marketing Costs – as written, these costs may be recovered where the benefit to MoD exceeds the costs incurred – this seems unreasonable and we would suggest that this section requires amendment to allow any such costs to be recovered, provided such recovery does not exceed the benefit to MoD.

Entertainment – we would not take issue with what we believe is intended here, however the lack of definition of "entertainment" does mean that any costs which may appear to fall into that classification would be disallowed. It might be helpful for some definition to be applied, still as guidance where, for example invitations to sporting events would be inadmissible whilst expenditure incurred in the course of normal, business related, activity (for example lunch/dinner), and naturally within the bounds of "AAR", would be recoverable.

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Consultation Response Form

Allowable Costs Guidance

Your details

Name:

Terry Hersey

Organisation:

Metasums Ltd

Position:

Director

Consultation questions

When answering the consultation questions, it would be helpful if you could support your responses with references to paragraph numbers and to make suggested wording changes where you consider this appropriate. This will help us to understand the basis for your answer and inform the finalisation of the guidance.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view. If you have just general comments to make then please just answer question 6.

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Yes Consent **No**

Consultation Questions

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- Are there any material areas that stakeholders consider have not been fully addressed, in the areas covered in this review? Any issues should be supported with evidence, where practical.
- Do the structural changes make navigation of the guidance more or less clear?
- Do stakeholders have any concerns regarding the proposed publication and implementation date of the guidance?
- Which guidance areas are high priority for the next review (in order of priority)?

Please add your comments:

General comment

I was aware of your engagement with stakeholders on the 19th June. I had hoped that my contributions to previous consultations would have given reason for SSRO to include Metasums Ltd within its selection of stakeholders. Metasums Ltd provides training and ongoing support to contractors wanting to undertake UK and US defence contracts. Since the Defence Reform Act and regulations came into force in the 17th December 2014 over 1,000 persons have undertaken training by Metasums on the revised pricing frameworks applicable to single source contracts. Business that Metasums has supported have included; many located overseas (including USA), some that become exposed as a result of failed competition, commercial rather than typical 'defence (sub)contractors', smaller contractors. These contractors are outside of the group of largest suppliers with which SSRO typically consults. Similarly, many of these contractors are not engaged through ADS.

Metasums is ready to engage further as SSRO wishes.

Specific comments

Section 2 Attributable. The US FAR 31.204-4 sets out its criteria for 'allocability'. Not a word I would ever use in the UK but it covers the same ground as 'attributable'. I believe that the US definition is far better.

…. A cost is allocable to a Government contract if it-

(a) Is incurred specifically for the contract;

(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

(c) Is necessary to the overall operation of the business, although a direct relationship to a particular cost objective cannot be shown

The SSRO's version is too restrictive to be generally applied *'…. Incurred directly or indirectly for the fulfilment of the QDC or QSC in question and it is necessary to fulfil the requirements of that contract.'* The SSRO's definition in excluding (c) above is unreasonably restrictive e.g. redundancy costs.

Section 2 Reasonable. The 5th bullet included within 2.7 is lost in the noise. A key feature of the regulated framework sought by the Secretary of State was to enable MoD to undertake effective post award pricing audits and secure price reductions where facts known at the time of pricing were not disclosed. Post award audits are only effective if MoD is supplied with sound facts at the time of pricing that can be subsequently verified. It is for this reason that the US framework requires (1) cost and pricing data to be certified as complete current and accurate, and (2) estimates to be based upon verifiable facts. Lost in the noise is *'cost estimates are based on*

empirical evidence where this is possible'. This is key to the effective working of the system to deliver sound pricing. Little else has anywhere near this power. Give it the prominence it deserves.

Section 3. This section does not look to comprise statutory Guidance. It either provides background or talks to elements of the regulatory framework itself e.g. 3.11 which talks to reporting process

3.1 Section 20(2) states it is the Secretary of State and the contractor that must be satisfied that the cost is allowable. For a QSC this is still the Secretary of State as the contracting authority has no rights to information and the contractor only has an obligation to provide it to the Secretary of State (not the contracting authority).

3.3 Single source contractors are not required, annually or at all, to submit a QMAC. Many do submit a QMAC as a matter of good practice and MoD may often request the same.

3.6 I agree that this is between the contractor and the Secretary of state and not the contractor and the contracting authority in the case of rates or a QSC.

3.7 and 3.8 This is far too glib. Segregation between sunk costs and later costs becomes key for any contract where (1) the final price is dependent on agreement of actual costs incurred, or (2) the price for the period consistent with the sunk costs needs to be agreed and what costs are to be included. This is a moral hazard waiting to bite the ill-considered.

Section 4 Other than the implementation date included at 4.1 this section does not look to comprise statutory Guidance. It either provides background or talks to elements of the regulatory framework itself.

4**.3** As discussed above. For a QSC this is still the Secretary of State as the contracting authority has no rights to information and the contractor only has an obligation to provide it to the Secretary of State (not the contracting authority).

Section 5.

A.1.1 "normal" suggests normally received and this may not be the case. Suggest use of 'contracted', this would cover infrequent circumstances such as SAYE share options.

A.1.3 When would distributions of profit ever be allowable. Why include 'generally'?

A.2.1 SSRO does not look to have given adequate consideration to FRS102 and reporting dispensation to individual legal entities who share a group defined benefit schemes. I may be out of date but I suspect not.

A.2.2 I believe that inducements for early retirement as part of a redundancy programme should be considered for inclusion as allowable costs. For defined benefit schemes these costs will appear as past service costs as should be considered for reasonableness along with redundancy.

A.3 In 2017 it is unreasonable to restrict redundancy costs to the statutory minimum. The Government itself pays far larger values to those staff that it makes redundant and often deservedly so. The Secretary of State has to be satisfied with the reasonableness of all costs (rate, cost estimates, actual contract costs) so why does SSRO require this to have a specific

requirement. Failure to agree should lead to an opinion or a reference by the SSRO. It should not be that 'only if approved by the 'Secretary of State'.

C.1 This section reads as if the only supplier type considered were UK prime contractors who sell a significant proportion of their business to MoD on a single source basis. Many contractors within the framework are not typical defence contractors, some are based overseas, some become exposed as a result of failed competitions or follow on requirements from competitive contracts.

C.1.1 This suffers from SSRO's restricted definition of 'attributable'. It should be that the contractor should show '*The cost is necessary to the overall operation of the business, although a direct relationship to a particular cost objective cannot be shown'.*

C1.2 The drafting assumes that MoD is the immediate customer. For QSC the test is just 50% is expected to be for qualifying contract use.

C.1.2.c It should not be that the SSRO sits outside of obligation to opine if the parties fail to agree. This paragraph should be removed such that there is scope for the matter to be referred.

C.2.1 May result from a failed competition. MoD may decide not to award the contract. Costs may have been incurred on unsuccessful competitions and tenders.

C.4.2 Why is this here? What is it seeking to avoid? Could equally say that VAT on goods and services that is recoverable from HMT is not an allowable cost.

D.1 Slowly improving. Research is not permitted to be included in the balance sheet, the cost must be immediately expensed to the income statement. The charge to the income statement of development expenditure can be deferred and expensed to the income statement as amortisation. The value included in the income statement (net of accumulated amortisation is restricted to the lower of net book value or the sum of the anticipated future cash flows (fair value). Where the future cash flows are lower than the book value then the asset is impaired and the difference is immediately expensed to the income statement. No choice. Research and development is not akin the Marks and Spencer's they differ in what they seek to achieve and how they are accounted.

Inclusion within D.1 that costs are considered when they are incurred and not when they are subsequently amortised or impaired would greatly assist.

D.1.b This talks to development only

D.1.c This talks to development only

D.1.d This mainly talks to research

D.1.6 does not belong in this section as the credit also applies to contract costs

E.1.2 When would losses on other contracts ever be allowable?

E. 3 I assume that the both parties are MoD and the contractor for both QDC and QSC. What is the position where the parties fail to agree. Will SSRO take a reference or give an expert opinion.

E.4.1 This is unclear. Does the term 'compensation or loss of profit for poor performance' mean liquidated damages. If so why repeat damages; if not I have no idea what this is trying to say. Needs a good tidy up to be understandable.

E.5.2 When are notional transactions ever allowable?

E.5.3 Fines and penalties are not there to provide compensation they are there to penalise.

E.6.2 Are there insurance companies who will provide a policy that protects a contractor from its own poor performance? Can I test what SSRO means: causes of flight crashes are always investigated and often fall to be an error within the system of design, build, maintenance etc. Is the SSRO test one of gross negligence or one of the only insurable risks that are allowable are acts of God?

F.1.3 This paragraph is ambiguous. Who should inform the SSRO. Why is the SSRO to be informed?

F.2.1 Split first sentence into two to make understandable. Normal commercial business risk is very fluffy (lacks any substance). 'Must' is far too strong a word; it can't be a requirement to demonstrate innovation as there may not be any to be called upon.

F.2.2 I believe that 'recovered' should be replaced by the word 'offset' else SSRO is telling contractors to swallow the full cost.

F.3.4 Reported by whom and for what purpose and how does that purpose relate to guidance on allowable costs?

G.1. Where did the tile 'Non-cash costs' come from? It displays no meaning. Do you mean long term assets?

G.1.2 There are many costs that appear on the income statement for which there is no related cash payment during the period. There are can be depreciation and amortisation charges made to the income statement for which there were cash payments in the period. Find a qualified chartered accountant and listen to what they say. This is torrid.

G.1.3 These are accounting estimates and not accounting policy. Depreciation is required to be in accordance with estimates of life of the asset and tested against for impairment by comparison with its future cash flow generation.

G.1.6 Intangible assets recognised as a consequence of a business combination are a sub-set of what used to be included many years ago within goodwill. If you talk with Steve Smith or John Ashley they will explain why MoD will not allow amortisation or impairment of intangible assets recognised as a consequence of a business combination into allowable costs (ever).

G.1.7 Impairment is a consequence of a diminution in the carrying value of the asset by assessment of future cash flows generated by the same asset. I don't know of anyone that still revalue land and building on a routine basis. The only area that the SSRO has cause to address is revaluation of the balance sheet on a business combination.

G.1.8 Why say anything beyond the first sentence?

H.1.1 Estimates need to be developed from and supported empirical evidence. This evidence needs to be complete current and accurate else the price could be materially flawed. Cost estimates should amount to the mean expected outturn of costs. Compensation for taking risk and using scarce resource is profit. Profit should not be included in the agreed estimated costs and profit should not include costs that are, on average, expected to be incurred. SSRO's approach looks from these 3 paragraphs to be fundamentally muddled and undermining of an effective framework for post award audits.

The style of drafting is much improved. I love the plain English approach; it's so much easier.

Happy to dialog further if it is considered I could assist.

I care that the framework succeeds for all parties.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
Introduction			
1.1	6.1, 4.2, 4.3	Last sentence of existing paragraph 6.1 has been deleted	Agreed
1.2	2.5	First sentence of existing paragraph 2.5 removed.	Agreed
1.3	6.2	New sentences added to new paragraph 1.3 to cover purpose of Section 20 of the Act and introduce the AAR test much earlier in the guidance	Agreed, however the onus of proof S.20(4) is not mentioned until para 4.2, as this is a key principle we would like to see this 'front and centre' i.e. within this introductory section Observation: 1.4 details the sub-sections in the Act but 1.3 relies on a footnote. Suggest consistency in style as 1.4.
1.4	1.1, 2.6	Paragraph dealing with key provisions within Section 20.	Agreed. See above observation. Suggest consistent referencing of QDC/QSC. Sentence, as proposed, could be taken as not applying to QSCs.
1.5	1.1	Second sentence of existing paragraph 1.1 retained. New sentence added about definition of accountancy terms	Agreed, although footnote should be prefaced by ‘e.g.’
1.6	N/A	New paragraph to explain individual sections of the guidance	As there is a Contents page, is this needed?
1.7	Bold text in italics after paragraph 5.3	N/A	Agreed

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
AAR principles			
2.1 – 2.7	8.1 - 8.7	Current guidance on AAR principles remains unchanged	2.1 Would this benefit from additional commentary on 'how' the non-exhaustive lists might be used e.g. are these a checklist where every consideration must be fully met? Query why definitions of AAR (2.2, 2.4 & 2.6) are italicised. 2.2 Comment - we believe that this test is specifically about whether the public and Parliament would expenditure on these items as an appropriate use of public funds. So, for example, if it's for employing intermediaries to ease negotiations with other overseas sub-contractors, it's non-allowable whether it's incurred in the conduct of delivering a QDC or not. Reasonableness and attributability are dealt with by the other two criteria. It may also be worth pointing out that there is no materiality threshold for this type of expenditure. Charging for alcohol, certain types of entertainment, political donations, staff's speeding fines, etc., is never allowable, even if the amounts involved are small. Suggest delete bullets 1, 2, and 4. Add bullet: "Whether the cost would meet the relevant standards of ethical behaviour and probity". 2.4 Suggest re-wording second para to make clearer. 2.5 Suggest that additional commentary in respect of 'identifiable' would underpin improved adherence to the consideration. 2.5 First bullet: remove the word 'generally'. Final bullet: suggest re-word as it is not possible to prove a negative state, and only relates to having been recovered but not 'is' or 'will be'. 2.6 Sentence 1: The guidance should also prevent costs being set too low. We therefore suggest replacing first sentence with: 'A cost is reasonable if it is of a scale that might be expected for the normal delivery of the QDC or QSC in question'. Suggest removal of final clause. Suggest some explicit reference to materiality here.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
			Is there a difference in the assessment of an 'indicator (2.6 b) and a 'consideration' (2.7)? Does the 'uncertainty' stated at 2.6 b relate to the OED definition of uncertainty (i.e. don't know) or the understood risk definition of a range of possible outcomes but having a basis? 2.7 Bullet 3 – Suggest removal of the word 'empirical'. Add additional bullet: • Whether assumptions made about improvements in efficiency and/ or cost pressures are realistic.
Cost Accounting and Financial Reporting			
3.1	7.12	No change.	FRC does not provide fulsome definitions. FRS 102 refers to "indirect costs" once and then refers to such costs as "overheads". However, these terms have accepted meanings and reference should be made to a respected source rather than creating something. Alternatively, do not define.
3.2	7.13	No change.	Overheads and indirect cost are effectively the same thing. Otherwise, as above.
3.3	11.1	No change.	Sentence 1: should this be 'Contractors with single source contracts'. Which is different from 'Single source contractors'? Replace the word 'are' with 'may be'. Sentence 3: i) what is the relevance of this to 'Cost allocation practices'? Last sentence should read" The contractor must make information concerning its cost allocation practices available" to make sense.
3.4	11.3	No change.	Replace with: "Where the contractor's costing system for Secretary of State's work is different from that used for other work, the contractor must be able to demonstrate that indirect costs are not over recovered".
3.5	11.4	No change.	Is there any benefit in including this tautology?

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
3.6	11.5	No change.	Suggest removing, as not really guidance on allowable costs
3.7	7.9	No change.	There is a missing ',' after costs on the first line. May need to be revised in the light of ingoing referral. Re-word footnote to remove 'not subject to the regime'.
3.8	7.1	No change.	Agreed.
3.9 & 3.10	N/A	New paragraphs cover accounting records and financial reporting issues raised in working paper.	3.9 This would be beneficial but would require the inclusion of codings, and would likely generate additional costs. Is this simply a matter of identification? Suggest removal of the words 'accounting systems'. 3.10 Not sure of the benefit that this paragraph adds, in its current format, to provide insightful guidance to the user.
3.11	N/A	New paragraph covering statutory reporting of Allowable Costs.	This paragraph bears no relation the providing statutory guidance on Allowable Costs. It may be true but is not relevant to the determination of allowable costs.
Application of the guidance			
4.1	1.2, 6.5 & 4.1	First sentence of existing paragraph 6.5 retained.	Agreed
4.2	7.2	First sentence of existing paragraph 7.2 retained, second sentence deleted	Second sentence to be reinstalled: first sentence describes the onus on the Contractor, but needs to be balanced with the responsibilities placed on MOD, i.e. second sentence.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
4.3	7.3	New guidance clarifies current paragraph 7.3.	Suggest replacing with: “The prime contractor needs to be able to satisfy itself and, if requested, the MOD that the cost of any sub-contract is allowable in accordance with this guidance. In the case of QSCs, the MOD has access to information that the prime does not, and also has to satisfy itself that the component costs of those contracts are allowable.”
4.4	5.1	No change.	No comment.
4.5	5.2	No change.	No comment.
4.6	5.3	No change.	No comment.
Guidance on specific cost types			
5.1	9.1 - 9.2	Part of existing paragraph 9.2 retained and the remainder is new. New table added to clarify the cost types which are covered.	The third sentence states that the sections states 'how' the AAR test is applied but aspects such as Entertainment are ‘Not Allowable’ so there is no test to be applied - the outcome is binary. No Comment is made on the table but its introduction is welcome for ease of locating the relevant material.
5.1 - table	N/A	None	Suggest Part B be re-titled 'Escalation', and cover A4 and B1. The use of an index to project costs and Rates, as opposed to any other approach, must be evidenced. The index itself must prove its validity in relation to the cost category to which it is applied.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
A1 (1.1 - 1.3)	9.15 - 9.17	No change.	A1.1 Cost of shares issued at favourable prices does not distinguish between SAYE schemes (not allowable) and employee/executive share schemes (allowable). A1.3 Are there any examples of where these costs are Allowable? Usually dividends or occasionally payments to a Director where they also control and own the company.
A2	9.24 - 9.25	No change.	Agreed. One off lump sum payments which may distort annual rates may be phased over several (say 2 or 3 years).

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
A3	9.14	No change.	***A.3 Redundancy costs*** *A.3.1 Redundancy payments made in the normal course of business, and which are in accordance with the rates laid down by statute, may be included in Allowable Costs. If payments are made in excess of such rates then these may also be included as agreed between the contractor and employees, but only if approved by the Secretary of State.* This is not particularly helpful. Since the government's own employees are given greater sums than the statutory minimum, it must be recognised that it would be extremely difficult for MOD to justify limiting payments to the statutory figure. Therefore the SGAC would achieve usefulness only if it could provide guidance on how to assess the validity of sums above the statutory minimum. One might therefore suggest that the following could be added to the draft: *When considering the allowability of redundancy payments above the statutory rates, consideration should be given to the following: Does the payment conform to employee terms and conditions? Has the policy of redundancy payment been universally applied? Are there any existing agreements in place between the contractor and the Secretary of State? To what extent does the "redundancy package" include elements in addition to the sum calculated for redundancy e.g. payment in lieu of notice, incentives to remain in post - items which should be assessed separately.* There is also an issue concerning the agreement of contracts specifically designed to recompense a contractor for costs incurred as a result of a major redundancy or restructuring programme. This concerned the determination of the proportion of the total cost which is Attributable to MOD (as opposed to other customers). We need to decide whether it would be beneficial to suggest that guidelines for determining the Attributable element of these costs.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
A4	9.37 - 9.38	A4 has been simplified	Agreed
B1		Material costs split from labour costs	Agreed but unconvinced of the benefits of segregation from labour as guidance is the same for both categories.
C1	9.26 - 9.27	Revised guidance on sales and marketing costs	The additional guidance is welcome and progressive. However: i) the inclusion of a Sales & Marketing category/definition in respect of targeted, but possibly unfocussed activity, which improves market impact/recognition, ii) the first sentence of C.1.1 is considered redundant. The word 'financial' should also be deleted from the final sentence iii) C1.2 Preface first sentence with 'Financial' and it would be clearer to say "....expected to result in increased throughput so as to maintain or reduce the rates charged to MOD....." iv) C1.3 should be removed as it provides a 'checklist' for costs which may be included, but may themselves contain costs that are Not Allowable e.g. relationship management activities includes entertainment costs, v) C.1.4, in its current format does not assist. It would be better to include "Where possible, a Contractor should provide a breakdown of their costs. For example....a. and b. as described, vi) C.1.5. Suggest 'Government' be removed from the second sentence.
C2	9.28 - 9.29	Revised guidance on bid costs	This Section should start with a definition that Bid Costs are those costs incurred in pursuit of the expected positive award of a specific contractual outcome, and that this also includes the term 'Proposal'. The current text states that 'only' costs incurred for a QDC/QSC are classified as 'Bid Costs'.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
C3	9.3	No change to guidance on entertainment costs but warrant separation from third party costs	C3.1The separation is welcome but instead of the assignment of 'Not Allowable', this should be 'Not Appropriate'. The same comment applies in all subsequent sections were classed as 'Not Allowable'. And that this be replaced with a precise assessment.
C4	9.31 - 9.32	No change	C4.1 & C4.2 See Comment for C3
D1	9.18 - 9.23	No change	Would benefit from a significant revision as simply recast from Yellow Book. Unclear terminology and little/no assistance in assessing Allowability. Should commence with definitions of "Research" and "Development" with reference to relevant SSAPs and FRS, etc. The "discernible benefit provided to the QDC" clause (D.1.2b) would rule out allowing almost all R&D cost (whereas Development costs can be allowed as they are usually Direct). R&D is generally recovered in overheads subject to the contractor showing a benefit or potential benefit to MOD. If benefit must be directed to a QDC/QSC there will be similar difficulties in linking S&M to QDC/QSCs. This renders nugatory much of what follows e.g. D.1.5 - for example, how can abortive R&D spend be of benefit to any QDC/QSC?

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
E1	9.11 - 9.13	No change	E1.1 Last sentence should be the first sentence. Then - where such losses can be identified to contract then Direct. If not then treated as an Overhead. - *Contractors will be requested to provide evidence to support any claimed obsolescent stock write-offs.. Stock losses and obsolescence should be charged directly to the contracts to which they relate as Allowable Costs. In circumstances where it is not possible to identify stock losses or obsolescence costs that specifically apply to contracts then they may still be Allowable and will only apply when the contractor is able to isolate these stock losses as an overhead.* E1.2 Re-word: Losses on other contracts are not allowable. E1.3 i) Re-word: Bad debts and any provision for bad debts is not allowable unless they specifically relate to MOD qualifying contracts.
E2	9.33 - 9.35	Revised guidance on reworks and wastage	E2.1 Suggest the statement concludes after effective on line 2. E2.2. Sentence 3: Replace with “Contractors should be able to identify the level and, where material, causes of re-work and wastage.
E3	N/A	New guidance on faulty workmanship	Remove. Covered by E2.2 above
E4	9.36	No change	Remove, pending outcome of risk work. These form part of the expected costs of delivering the contract, and therefore probability adjusted amount should be included in the price (except loss of profit).
E5	9.39 - 9.41	No change	E5.2 and 5.3 - delete "generally" from 5.2 and can we say that the costs are "Not Appropriate".

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
E6	9.42 - 9.44	No change	E6.1 implies that only the insurance types mentioned are allowable but the list is not exhaustive. The argument continues about the ability to buy insurance to cover own poor performance. E6.2 and E6.3 - Delete – See E4 above.
Part F			The Part F heading does not fully reflect the subject matter described in paragraphs 1.1 - 3.4. Idle facilities?
F1	10.1 - 10.4	No change	F.1.1 is more akin to an introduction to Part F rather than contributing to the guidance of 'Exceptional & Abnormal costs' addressed in 1.2 - 1.4. In fact it looks more like part of the introduction to the whole of Section 5. F1.3 Should insert comma after "negotiations". Why should the SSRO be informed?
F2	10.5 - 10.7	No change	F.2.1 If a Contractor adopts 'tried and tested' approach to site closure, are these then not allowable as they do not demonstrated innovation and efficiency? Why is "innovation" so important here?

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
F3	10.8 - 10.11	No change	F.3.1 starts with a definition. Why is this not duplicated elsewhere? Everything after "completely unused" is entirely unnecessary, and is somewhat confusing. F.3.2 - "for the delivery of a QDC or QCS" makes no sense in this context. The cost of spare labour should be included in the definition of "idle capacity". What about idle facilities that are not for QDC/QDC work but for another part of the business, presumably they would also be disallowed. F.3.3.c. The stated criteria is overly restrictive and does not allow for other circumstances that would give rise to idle facilities/capacity e.g. deferred programme on contract resulting in revised spend profile. F.3.4 - Why a "separate agreement"? Separate from what? Why should such agreement be reported to the SSRO? It may not be a QDC/QSC ?

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
G1	9.5 - 9.7	Revised guidance on depreciation, amortisation and impairment.	Is the Part G heading fully reflective of the following guidance? G.1.5 - Can be removed. G.1.6 - Remove first sentence as there should be no need to explain Goodwill - a well-understood accounting concept. Second sentence replace with "Amortisation or write down of Goodwill will only be allowable under exceptional circumstances". Final sentence: replace 'acquired asset' with 'acquired business'. G.1.7 - There should be no need to explain the consequences of asset revaluation. Increased depreciation resulting from revaluation should only be seen as Appropriate if there is a balancing credit. Costs resulting from impairment reviews of tangible and intangible assets but NOT Goodwill, may be allowable because the cost represent previous cash outflows. G1.8 The costs of raising capital may be allowable. The costs of Servicing it should not be. It would be helpful to include a few examples such as bank interest, lease interest, and broker/intermediary/band fees relating to the costs of obtaining finance.
H1	9.8 - 9.10	No changes.	Put on hold pending outcome Current risk work.

New guidance paragraph reference	Existing guidance paragraph reference	Comment	Ministry of Defence
Deleted paragraphs from existing guidance			
N/A	N/A 2.1, 2.2, 2.3, 2.4, 3.1, 3.2, 3.3, 4.4, 4.5, 4.6, 6.3, 6.4, 7.1, 7.4, 7.5, 7.6, 7.7, 7.8, 7.11, 9.3, 9.4, 11.2	These paragraphs are considered to either duplicate existing guidance or were no longer relevant.	
			GENERAL POINTS
			1. Review required of references to Qualifying Contracts - they are sometimes referred to as "QDC or QCS", and other just as "QDC".
			2. The frequent and unnecessary use of the word "generally" creates vagueness - should be avoided where possible.
			3. The use of definition of terms is inconsistent, and should be present in more instances.
			4. There is no guidance provided re cost recovery bases.
			5. Interest payment costs are not specifically disallowed.

Thales UK Ltd – Responses to Allowable Costs November 2017:

Thales has reviewed the consultations on allowable costs and welcomes a consistent approach across Contractors. The fact that Industry does account for cost in different ways , for example if a cost is treated as indirect or direct does mean the total costs of acquisition should be the key and not just the cost of say a labour hour which may not be comparable. The guidance considers allowable costs but application results in total costs which are a function of the labour hours executed on a contract times the appropriate recovery per hour plus non- labour costs. Value for money can only be assessed on the whole price that MoD pays not on elements of cost, and the only person who can make that assessment is the end user.

The methods of labour and material recovery and types of rates do make comparison across Contractors difficult. Where Contractors have several types of Customer and mix of products then what must be clear is the MOD only recovers a proportion of the costs dependent on the hours executed on MOD work.

We have made comments against sections that we feel still would benefit from more precise examples and have noted against each section the alpha character which references to your request for responses (a to e)

Rather than be too prescriptive we should recognise in general Industry will incur cost where future value is perceived and if a cost is allowable for HMRC purposes, perhaps more use should have been made of existing tax legislation regarding allow ability of certain types of cost which is already well understood.

Thales welcomes discussions on our responses whether individually or as part of a group with SSRO

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 is high priority for the next review?

Thales has provided partial responses against each section where we have an opinion. The revised draft Allowable Costs Guidance is an improvement on the current version. Thales makes the following comments, with references to the alpha numbers above.

Sec	Ref	Comment	Question ref
1.1	The Defence Reform Act 2014 (the Act) requires that qualifying defence contracts (QDC) and qualifying sub-contracts (QSC) are priced on the basis of Allowable Costs. A contract is a QDC if it meets the definition laid down in Section 14(2) of the Act.	Guidance is relevant to the Defence Reform Act 2014 (the Act) and should be applied to those qualifying contracts and subcontracts under the Act. The MOD Internal policy appears to be a attempting to extend the application of the guidance which in our opinion is not in the spirit of the legislations	b
1.2	The Act also states that, in carrying out its functions, the SSRO must aim to ensure that:• good value for money is obtained in government expenditure on QDCs; and• persons (other than the Secretary of State) who are parties to QDCs, and QSCs are paid a fair and reasonable price under those contracts.	Timely and reasonable agreement on these principles will reduce the Total Cost of Acquisition. Industry does require a fair and reasonable return. Nugatory effort whether directly or indirectly deflects from the delivery of contracts and projects and the guidance should be therefore easily understandable with examples. Value for money can only be assessed by an end user.	b
2.4	Costs should be incurred by the contractor and applied to the QDC or QSC on a basis that is consistent with the contracting company's overarching cost accounting practices. The costs should be costs not recovered in any way from another contract, whether past, existing or proposed.	Costs are applied to QDC's and QSC's using a method as declared in the QMAC. Although the QMAC is not covered in the Regs, it will define the relationship between the Contractor's accounting practices and systems and the application to rates and qualifying contracts. QMACS will be discussed with CAAS and Commercial as part of the supplier rates programme.	d
2.5	In order to assess whether a cost is Attributable, consideration should be given to the following: • whether the treatment is consistent with generally accepted accounting principles;• whether the cost is borne by the contractor;• whether the cost has a causal relationship with the contract, in the sense of being required for its delivery; • whether the cost is identifiable;• whether the cost is incurred in fulfilling the requirements of the QDC or QSC; and • Whether it can be evidenced that the cost has not already been recovered.	Actual costs have to be demonstrated to have been incurred by reference to the accounting records, not that it is *borne* by the Contractor. The cost **can** be identifiable in the case of actuals by reference to the books of account but for an estimate this is **not possible** and by definition cannot have yet been incurred only forecasted. We agree actuals and estimates for a particular year; by definition that there is a degree of estimation for the estimates and due to the requirement to produce evidence for these means the whole process is elongated and 'difficult'. We almost think we need to consider the use of inflated actuals for estimates and prevent the lengthy discussions as an estimate or budget will definitely change depending on factual circumstances during the	d/e

		year of estimate and CAAS resource to review rates is stretched. The method of calculating the hourly rates and booking an hour of time to a project will mean costs are recovered only once and more importantly for people to understand, costs are only recovered from the MoD through hours charged to the MOD. Where a business has other work, MOD are only paying a proportion of the total cost against hours charged to non-competitive work.	
2.6	A cost is Reasonable if by its nature it does not exceed what might be expected to be incurred in the normal delivery of the QDC or QSC in question, whether under competitive tendering conditions or as a single source contract.	Consideration should be given to the source of the product and market pricing and the extent to which it is specific to the QDC or QSC or is the application of a product available through other routes or markets	e
3.2	Overhead and indirect costs are defined as those costs which have necessarily been incurred for the performance of the QDC or QSC as part of the conduct of the contractor's business in general, but cannot be measured as directly applicable to the performance of a single contract	A Contractor will define those costs allocated directly versus those allocated indirectly and the rationale. There may be differences across contractors and business units but the important point is that the agreed rationale is consistently applied and understood.	a
3,4	The contractor's costing system must be the same for the Secretary of State's work as it is for other work in which it is engaged thus ensuring that the allocation of costs can be relied upon as being both fair and transparent	Whilst the accounting system may be the same, the extraction and application has by necessity to be different. A contractor will seek to generally recover all its costs from fee paying customers and other customers (non-Mod) do not have the same level of disallowance so this analysis and allocation is undertaken external to the system. It is necessitated by the fact that all costs that are generally allowable in other contracts.	a
3.9	The contractor's accounting systems should be able to differentiate between costs that are Allowable and those which are incurred but where they are not Allowable. The SSRO does not otherwise provide guidance about the choice of accounting systems that a contractor uses to record accounting entries.	The accounting system will record **all** transactions and costs will not be differentiated in the system – it is the subsequent analysis outside of the system that determines whether the cost is allowable or not.	a

4.3	In the case of a QSC, the sub-contractor may have to satisfy the MOD that costs are Allowable. The prime contractor may also need to be satisfied that costs within the price of a QSC are Allowable if it forms part of the price of a QDC.	A subcontractor may not be able or willing to allow full transparency to a prime contractor and would resist any attempt to use the guidance in this way.	b
A 1.1 and 2	Where employee benefits payments are made for items such as profit sharing schemes, shares or benefits in kind, which are an element of employees 'normal remuneration, then these may be included in Allowable Costs. The cost of shares issued to employees at favourable prices, is to be arrived at in the manner prescribed by the relevant generally accepted accounting principles.A.1.2 Payments of staff bonuses must be in line with company policies. In order for these costs to be considered Reasonable, contractors must be able to provide supporting evidence.	Whilst there is no change to this guidance, It should be acceptable to demonstrate that a cost is Allowable and Reasonable by reference to the Contractor's policy and its application and the resulting cost. The performance assessment of the individuals is a matter for the Contractor and its business to determine. A Contractor will incur the necessary cost to retain and attract the skill set required and no more than this. If a cost is in accordance with the Contractor's policy and indeed a contracted obligation with the employee then there should be no cause for further debate with respect to AAR.	b
	Redundancy payments made in the normal course of business, and which are in accordance with the rates laid down by statute, may be included in Allowable Costs. If payments are made in excess of such rates then these may also be included as agreed between the contractor and employees, but only if approved by the S of State.	Again Companies will have a written and understood internal policy for redundancy and this is an obligation between the employee and Company and as such should be allowed. Contractors should be transparent with their policy as part of the SICR submission.	b
A4.1	Inflation of labour costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable C	Labour inflation typically consists of two elements, cost of living increases and retention or experience or qualification increases at an individual level. At a Rate level the mix of staff may change from year to year. Therefore whilst we'd agree with having regard to an index in part and explaining the delta this should not determine which a cost is Allowable – evidence against cost actually incurred is the key. Comparison could be more appropriate against the external cost of a similar resource , A labour rate does include an element of overhead inflation for the non-labour costs included in the labour rate.	b
B1.1	Inflation of material costs or rates should be evidenced against an appropriate benchmark or index in order to be an Allowable Cost.	Likewise a cost may be referenced, but the benchmark or index may not be wholly appropriate and be therefore able to demonstrate why should be sufficient for a cost being Allowable.	e
C 1.2	Marketing and sales costs may be considered	We agree with the pragmatic approach to include sales and	e

	Allowable in a single source contract if they meet the AAR principles and deliver demonstrable financial benefit to the MOD. C.1.2 Benefit to the MOD may be demonstrated where proven successful orders have resulted (retrospective test) or are expected to result (prospective test) in increased throughput of activity and maintenance or reduction in the rates charged to the	Marketing effort as this is the way a business will grow by expanding into new customer bases. Benefit to the MOD will be shown is a reduction in the rate per hour as a result of increased throughout. Marketing and sales effort is planned and implemented against business plans. It unfortunately cannot always be successful. It would seem illogical to only want to take the benefit of successful campaigns. We welcome a pragmatic discussion with the MoD on this subject and more definitive examples. We remain convinced that we do not incur unnecessary cost.	
C 2.2	2 If bid costs are Allowable they should be charged directly to a contract rather than being apportioned as indirect costs	Bid costs by definition are retrospective and a method of agreeing the value to be included needs to be agreed at bid stage as where a contract is awarded as a result of the bid activity it is usual for the bid costs to be recovered as part of the contract price. Where a contractor has incurred costs preparing a bid or supporting MOD in pre contract activity in expectation that the resultant contract would be awarded to him on a single source basis, and MOD then abandons the procurement, the contractor should be able to recover the 100% costs incurred as indirect costs on future QDCs or QSCs. as an adjustment to the rate submissions.	d
D 1.2	Research and development costs should not be allowed where there has been no discernible benefit provided to the QDC or QSC as a whole or where sufficient evidence is not available to	R&D needs to be fully discussed and if the MOD do not allow the claim in the rates and have subsequent benefit of the technology then a proportion of cost should be recovered on a future contract. The key is in communication and intent.	d
D1.6	Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims should generally be Allowable.	R&D incentives were Introduced into UK tax legislation with the aim of encouraging businesses to increase investment in innovative activities. R&D tax reliefs offer significant benefits for businesses advancing science and technology. Helping organisations to significantly reduce their corporation tax bill, or if loss-making, to generate tax credit repayments, the government established the incentive schemes in order to bring the UK into line with other countries offering similar rewards for innovation, and to boost a vital part of the UK economy. The mechanism	d

		therefore of SSRO as part of the statutory guidance of alluding to the fact that Industry would in a sense not receive this full benefit as it would be offset against allowable costs needs to be fully explained and understood. Secondary to this, the degree to which any credits are applicable should be related to and offset in the costs claimed but be compared only to the extent that the source costs were AAR and recovered from MOD. We would welcome examples as It is our belief that R&D tax credit regime was not introduced to be a funding mechanism between Government departments	
E.6.3	Accordingly, insurance against faulty workmanship (see E.3 above), defective parts, and breach of contract or loss of profit associated with poor performance should not be Allowable. If insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable. A part of the costs may be Allowable if the contractor demonstrates what the cost would be with any Inappropriate, Non-attributable or Unreasonable cover excluded.	Depending on the terms of a contract there may be times where an insurance policy may mitigate the effect of any penalties or liabilities that may be applied, whether correctly or not. Whilst the cost may not be allowed directly attributable to the contract, it should be considered as part of business risk management and therefore may be allowed through the overheads in the rate calculation and may be considered as part of Business Risk Management. It is sometimes not possible to precisely evaluate particular elements of any premium.	d

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Yes ☑ No ☐