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Allowable Costs guidance
Consultation Response
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1. Introduction

- 1.1 Section 20(1) 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 (QDCs) and qualifying sub-contracts (QSCs). The current statutory guidance on Allowable Costs (Single Source Cost Standards) 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 agreeing QDCs and QSCs.
- 1.2 As part of the current review, which commenced in April 2017, the SSRO has:
- a. held an initial discussion on three Allowable Costs topic areas at an Operational Working Group workshop on 25 April 2017;
 - b. 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 represent the Ministry of Defence (MOD), the ADS Group and individual defence contractors) and to other organisations who had indicated an interest in this review;¹
 - c. 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;
 - d. received written responses to working papers from 13 stakeholders, including 9 contractors to the MOD;
 - e. issued a working paper response document and draft guidance for consultation on 2 October 2017; and
 - f. held a third Operational Working Group workshop on 16 October to gather early feedback from stakeholders on the proposed changes.
- 1.3 This consultation response document sets out the scope of the review (Section 2). Section 3 sets out comments received on the principles of Allowable Costs. Section 4 explains the changes to the Allowable Costs guidance which the SSRO has decided to make in response to comments on draft proposals. Stakeholders provided helpful views on areas of the guidance where changes had not been proposed and these are set out in Section 5. Section 6 explains changes between draft and final guidance.

¹ The scope of these working papers is summarised in section 2. The working papers were not published on the SSRO's website.

2. Scope of the review

- 2.1 The three working papers which the SSRO issued on 19 June 2017 define the scope of the 2017 review of statutory guidance on Allowable Costs. They covered the following topics:
- a. Cost accounting and financial reporting issues
 - b. Tangible and intangible assets
 - c. Individual cost types:
 - i. Sales and marketing costs
 - ii. Bid costs
 - iii. Entertainment costs
 - iv. Faulty workmanship and reworks costs
- 2.2 On 2 October 2017, the SSRO published a response document summarising the input received on the working papers and the changes which the SSRO proposed to make to the existing statutory guidance. The draft guidance for consultation was also issued to stakeholders on 2 October.
- 2.3 The consultation closed on 24 November and the SSRO received 12 written responses (Table 1). The SSRO received a diversity of views, many individual comments and is grateful to all those who took the time to send us a written submission. The aim of this document is to make it clear how these views have been considered or logged for future reviews.

Table 1 – Summary of consultation responses

	Ministry of Defence	Industry (individual contractors or their representatives)	Other organisations	Total
Number invited to comment	1	38	9	48
Number of responses received	1	10	1	12
%	100	26	11	25

- 2.4 The SSRO asked the following five questions in the guidance consultation:
- 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?
 - 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?
- 2.5 Most respondents chose to reference their comments to particular sections or paragraphs within the draft guidance. Table 2 provides a brief summary of views on the questions posed.

Table 2 – Summary response to consultation questions

Question	Summary comments
a)	A number of respondents indicated that they thought the proposed changes made the guidance clearer.
b)	There were some observations about where proposed changes to guidance could be further improved to aid understanding. These are explained in Section 4.
c)	A number of respondents confirmed that the structural changes made the guidance easier to navigate. The Institute of Chartered Accountants in England and Wales (ICAEW) commented that they found the layout of the guidance much improved.
d)	Some contractors had concerns about the impact of new guidance on contracts currently being negotiated. The SSRO is of the view that the proposed familiarisation period of two months is sufficient. This is explored further in Section 4 in the part relating to application.
e)	One respondent identified topics which they considered high priority for future review. Section 5 describes how the SSRO will approach future reviews.

3. Principles of Allowable Costs

- 3.1 The current guidance describes a number of principles to be considered by the contracting parties in assessing whether a cost incurred in the delivery of a QDC or QSC is an Allowable Cost for the purpose of contract pricing. These principles can be used to establish whether a cost is Appropriate, Attributable to the contract and Reasonable in the circumstances (the AAR test). The stated principles are non-exhaustive and indicative.
- 3.2 Principles that underpin the AAR test are fundamental to all of the SSRO's statutory guidance on Allowable Costs. We had not proposed any changes to the guidance on the application of the AAR test, but respondents provided a number of comments. While we recognise the desire for change, we do not propose any revisions as a result of this consultation and therefore do not offer our views on the points raised. Nonetheless, it is helpful to present these overarching comments to frame the remainder of the document. We believe that more extensive engagement with the MOD, industry and other stakeholders on the principles of Allowability should be undertaken before changes are proposed, consulted on and implemented.
- 3.3 The sections below provide a summary of the views expressed by consultation respondents.

General points

- 3.4 The MOD suggested that this section of the guidance could benefit from additional commentary on how the principles should be used, for example, whether every condition should be met.
- 3.5 One industry respondent commented that the assessment of certain indirect costs as not Allowable created a risk for the MOD that the price of QDCs or QSCs would be higher than might otherwise be the case if these costs were Allowable. This might occur where the contractor created distinct cost structures within its organisation for QDC/QSC work and non-QDC/QSC work. The effect of such separation may be to reduce or remove the benefit to the MOD of economies of scale that may arise where indirect costs are spread across the entirety of the contracts undertaken by the contractor.

Appropriate

- 3.6 The MOD noted there was no materiality threshold when considering if a cost was Appropriate. Some types of expenditure were never Appropriate, it said, regardless of the extent of the cost. Examples included certain types of entertainment, political donations, and speeding fines incurred by a contractor's staff during the course of business activities.
- 3.7 A number of industry respondents commented on the inclusion of 'public scrutiny' as a way of assessing whether a cost is Appropriate. One respondent from industry noted that the current process, which includes scrutiny by the MOD's project team, the MOD's Cost Analysis and Assurance Service and, at times, the SSRO, was sufficient. Another suggested that the reference to public scrutiny be deleted, or further qualified with guidance or instruction on how this test could be applied.

3.8 The MOD provided clarification on how a public scrutiny test should be applied. In its view, the test is whether the public and Parliament would spend money on these items as an Appropriate use of public funds. Consequently, the MOD suggested that the only assessment needed to check for Appropriateness is “Whether the cost would meet the relevant standards of ethical behaviour and probity” with a qualified statement on public scrutiny.

Attributable

3.9 One respondent noted that the United States Federal Acquisition Regulations (section 31.204-4) sets out its criteria for allocability and includes, ‘Is necessary to the overall operation of the business, although a direct relationship to a particular cost objective cannot be shown’. In this stakeholders’ view, by not taking account of such costs, the SSRO’s definition risked being restrictive.

3.10 One of the conditions for Attribution included in the guidance is: ‘Whether the cost is incurred while fulfilling the requirements of the QDC and the QSC’. Two industry respondents suggested that costs incurred in the operation of the business that ‘enable the performance’ of the QDC or QSC should be Allowable. In support of this proposal, the respondents referred to Regulations 58(3) and 58(4), which use this form of words in describing the requirements for a contract to be a QSC.

3.11 The guidance currently states that a cost may be Attributable, and therefore Allowable, when ‘it can be evidenced that the cost has not already been recovered’. Two industry respondents noted that this requires the supplier to prove a negative. They suggested this condition could be restated to require the contractor to supply evidence that cost collection and allocation processes only allow a cost to be recovered once. This would mirror the requirement set out for marketing and sales costs, that a contractor ensures that costs claimed have not or will not be recovered through other means.

3.12 The guidance states that a cost is Attributable ‘if it is 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’. In response, one industry respondent stated that the requirement should be that actual costs are demonstrated to have been incurred, with reference to accounting records, and that there is no requirement that they are borne by the contractor. In addition, the respondent noted that estimates will not, by definition, have been incurred. The respondent goes on to note that arriving at estimates and producing the evidence is difficult and protracted. This is compounded by what they view as the MOD’s limited resources to undertake rate reviews. Costs are recovered once through hours charged to the MOD. The respondent’s other work is not charged to the MOD, who will only pay a proportion of the total cost against hours charged to non-competitive work.

3.13 The revised guidance states that in assessing whether a cost is Attributable, consideration should be given to whether the cost has a causal relationship with the contract. One industry respondent suggested that the guidance should be more flexible to account for the general cost of doing business. The respondent states, ‘Every contractor will have a specific cost that cannot be directly allocated to a single contract in regard to the overall business expense’.

- 3.14 One industry respondent pointed out that the Questionnaire on the Method of Allocation of Costs (QMAC) will define the relationship between the Contractor's accounting practices and systems and their application to rates and qualifying contracts. They are discussed with CAAS and Commercial as part of the supplier rates programme.
- 3.15 The MOD suggested the following minor edits:
- a. Re-word second paragraph (2.4²) to make clearer.
 - b. In paragraph 2.5, remove word 'generally' from the first bullet and re-word the final bullet as it is not possible to prove a negative state, and only relates to having been recovered but not 'is' or 'will be'.

Reasonable

- 3.16 The current guidance opens with the statement, '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'. The MOD expand this point to suggest that the guidance should also prevent costs being set too low and therefore suggest the statement reads: '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'. The MOD also suggest an explicit reference to materiality, which is discussed later in this document. The MOD also suggest removal of the final clause.
- 3.17 Sound pricing requires cost estimates to be based on empirical evidence where possible. One industry respondent suggests that this should be given more prominence.
- 3.18 One industry respondent commented on the statement, '...whether the costs deliver value for money for the UK taxpayer', suggesting that it should encompass the benefit of allowing the broader cost base, to take account of the economies of scale when associated with costs which are spread over the whole business base. This would avoid distinguishing between the QDC/QSC and the business cost base on the basis that certain costs would not be Allowable. The broader consideration of value for money would take into account the impact of standalone cost structures for a QDC/QSC. One example provided for one QDC is an increase of costs by approximately 14 per cent.
- 3.19 Two respondents also referred to value for money stating that it should only be assessed on the whole price that the MOD pays not on elements of cost. The respondents questioned whether the UK tax payer would have sight of, and therefore be able to assess, whether the military effect represents value for money and that the only person who can make that assessment is the end user. They also note that the Act makes no reference to such a person. As a result, one industry respondent concluded that the final bullet in paragraph 2.7 should be deleted.
- 3.20 One industry respondent stated that the focus in the guidance for cost review could be taken out of context if considered as individual elements of the price, some practical application may sometimes be required to consider costs in the wider context of delivering value and benefit to the MOD.

² All references to paragraph numbers in this section relate to the draft guidance. These paragraphs are now in Section 3 of the final guidance. For example, paragraph 2.4 is now paragraph 3.4.

- 3.21 One industry respondent suggested that in determining Reasonableness, consideration should be given to the source of the product and market pricing, whether it is specific to the QDC or QSC and if a product is available through other routes or markets.
- 3.22 The MOD suggested removal of the word ‘empirical’ in the following sentence: ‘... whether cost estimates are based on empirical evidence, where this is possible’ and add an additional bullet to state, ‘Whether assumptions made about improvements in efficiency and/or cost pressures are realistic’.
- 3.23 The MOD posed the following questions for clarification:
- a. Is there a difference in the assessment of an ‘indicator’ (2.6, second paragraph) and a ‘consideration’ (paragraph 2.7)?
 - b. Does the ‘uncertainty’ stated at 2.6 (second paragraph) relate to the Oxford English Dictionary definition of uncertainty (that is, things which are unknown) or the understood risk definition of a range of possible outcomes but having a basis?

4. Comments on proposed guidance changes

Cross cutting themes

Evidence

- 4.1 Industry respondents sought further clarity on the evidence required to demonstrate that costs were Allowable. This was particularly an issue in respect of the estimation of future costs. These respondents were concerned that the absence of guidance about evidential standards resulted in an unacceptable degree of subjectivity in the MOD's decision making on Allowability of costs.

To provide further clarity on the evidential standards required to demonstrate Allowability, the SSRO would need sight of examples from the MOD or contractors of the evidence currently provided by contractors for this purpose. As a point of principle, the SSRO believes it is for the contracting authority and the contractor to agree the evidence that is needed to demonstrate that costs are Allowable within the context of a specific QDC or QSC.

Materiality

- 4.2 Industry respondents favoured the idea that the assessment of Allowability should consider the materiality of the costs involved within the wider context of the QDC or QSC. This would ensure that the application of the AAR test and the evidence required to demonstrate Allowability would be proportionate to the costs under examination.

The SSRO considers that the contracting parties should have regard to the principles and practice for assessing materiality in the context of financial reporting when assessing the Allowability of costs in a QDC or QSC. If the SSRO were to separately define materiality it could lead to confusion.

Introduction

- 4.3 One industry respondent stated that a general statement should be included in the guidance confirming that it allows timely and reasonable agreement of principles to ensure that this is clear and widely understood. Another industry respondent stated that the guidance should only be applied to QDCs and QSCs as governed by the Act and cautioned against more general application of the guidance by the MOD. This is for the MOD to consider.
- 4.4 The MOD made a few helpful suggestions. Firstly, the removal of the list of sections in the guidance, as this duplicates the contents page. Secondly, the current footnote identifies the Financial Reporting Council as a recommended source of accounting standards, and the suggestion is to provide other accountancy bodies and preface them by stating that they are examples. The first reference to Section 20(4) of the Act which sets out that the onus of proof lies with the primary contractor to demonstrate to the Secretary of State that costs are Allowable is currently in section 4 (Application of the guidance). The MOD suggests that this principle is presented in the introduction.

The SSRO has now made reference to Section 20(4) in the introduction to the guidance and clarified that the guidance applies to all defence contractors with a QDC or QSC.

Application

- 4.5 One respondent suggested that other than the implementation date there was no statutory guidance in the section on application.
- 4.6 The SSRO proposed to issue its final guidance for a period of two months (February and March 2018) so that the MOD and contractors could become familiar with it and communicate it within their organisations. One contractor stated that contract negotiations can take a long time before a contract is awarded and felt introducing new guidance during the final stages of a negotiation could be problematic. Throughout the review process the SSRO has made clear the areas of guidance which it was considering changing and has consulted on its proposals. We do not consider that the changes which are being made would have a significant impact on contract negotiations. Where there was a significant impact, the contracting parties could choose to deviate from the statutory guidance, provided that any deviation was reported, as necessary, in the contractor's statutory reports.
- 4.7 The MOD suggested that a sentence which had been removed from the current guidance about the MOD needing to act as an intelligent client should be re-instated.
- 4.8 Industry respondents indicated that it is not always possible for prime contractors to have access to the information which would allow them to ensure that costs within QSCs are Allowable. For this reason the MOD will reach agreement with the sub-contractor directly on whether costs are Allowable. The SSRO recognises that the draft guidance provided on how prime contractors was not sufficiently clear.

The SSRO in its final guidance on application has:

- a. moved this guidance earlier in the document (now section 2);
- b. clarified that there may be issues where new guidance is introduced during contract negotiations and that the parties may deviate from the statutory guidance, provided that any deviation was agreed and reported, as necessary, in the contractor's statutory reports;
- c. re-instated wording relating to the MOD's role in verifying and challenging costs; and
- d. clarified how the MOD or prime contractors can ensure that costs in sub-contracts or qualifying sub-contracts are Allowable.

This section now includes further statutory guidance. The SSRO does not consider the lack of statutory guidance in the application section to be an issue but does recognise the need to more clearly distinguish between contextual information and statutory guidance in the document. It will seek to provide this clarity in future revisions.

Cost accounting and financial reporting

Direct and indirect costs

- 4.9 The MOD questioned whether the SSRO's definitions of 'direct' and 'indirect' costs were sufficiently helpful. It suggested that use of existing definitions might be preferable to something created by the SSRO. Other respondents noted that contractors may have different approaches to the classification of costs as direct or indirect. How costs were classified was considered less important than the need for the classification system to be agreed with the MOD and applied consistently by the contractor.
- 4.10 Respondents noted that 'overheads' and 'indirect costs' were merely different terms for costs that could not be directly attributed to a contract. Industry respondents felt there was too great an expectation in the guidance that contractors could demonstrate that indirect costs (described by one respondent as 'the general costs of running a business') were linked to the performance of a QDC or QSC. It was proposed that the guidance on indirect costs be amended to refer to costs incurred 'to enable the performance of a QDC or QSC' or incurred 'during the conduct of the contractor's business'.
- 4.11 One industry respondent suggested that a contractor might be able to demonstrate that the apportionment of indirect costs was Allowable where the cost through the proposed method of apportionment was lower than would be the case if the contractor had established a stand-alone cost allocation mechanism for the contract; as it might otherwise do to separate out costs that were otherwise not Allowable.
- 4.12 Respondents again questioned whether the SSRO's guidance on who was responsible for ensuring that costs were Allowable in the case of a QSC was consistent with the Regulations, which states that 'the Secretary of State or an authorised person, and the primary contractor, must be satisfied'. They contended that, in the case of a QSC, the contracting authority has no rights of access to information, with the contractor only obliged to provide this to the Secretary of State. This issue has been addressed in the section on Application.

Cost allocation practices and accounting systems (now Cost accounting)

- 4.13 Respondents noted that there was no requirement in the Act or Regulations for contractors to declare their cost accounting or allocation approach each year, nor for all contractors to complete a Questionnaire on the Method of Allocation of Costs (QMAC). It was considered that the guidance required amendment on these points.
- 4.14 The MOD noted the need for greater precision in this section of the guidance, questioning use of the term 'single source contractors' when referring to contractors with QDCs or QSCs. It also suggested that the requirement for the contractor to use the same costing system for all its work to ensure a fair and transparent allocation of costs might be amended. It suggested, rather, that where a different costing system was used for the Secretary of State's work, the contractor must be able to demonstrate how costs were allocated and that indirect costs were not over-recovered.
- 4.15 One industry respondent suggested that the guidance be amended to note that the demonstration by the contractor that costs are Allowable should only be required up to completion of the contract. The SSRO considers that Section 20(4) of the Act is clear that this demonstration can be at any time.

- 4.16 The MOD suggested that use of the term ‘accounting systems’ was inappropriate in this section of the guidance.
- 4.17 Industry respondents noted that it was for the contractors to determine what systems they use to record costs. Systems should support the allocation of costs in a way that was consistent with any approach agreed with the MOD. One indicated that the requirement to identify costs which were Allowable and those which were not, had necessitated changes to its accounting system. Another indicated that the analysis of Allowable Costs for QDCs took place outside its accounting system, given the need to exclude certain costs that were not considered dis-Allowable by other customers.

Sunk costs

- 4.18 Industry respondents commented on the importance of guidance related to sunk costs. However, some felt it was premature to comment on the guidance until the completion of the Secretary of State’s review of legislation or until the SSRO had concluded its consideration of a related matter that had been referred to it.
- 4.19 Respondents made a number of suggestions for improving the guidance. Notably, respondents felt the guidance should relate not just to costs already incurred but also to costs which were already committed when the contract was agreed. It was also suggested it needed to address the case of QDCs or QSCs whose price is re-determined following amendment (as provided for under Regulation 14).

Financial reporting

- 4.20 The MOD questioned the usefulness of this section as the SSRO was not providing guidance on this matter.

DefCARS

- 4.21 The MOD felt this section was irrelevant to the assessment of Allowable Costs and questioned its inclusion in statutory guidance.

The SSRO has made clear that it is for contractors to decide whether Allowable Costs are categorised as direct or indirect costs. All cost accounting issues are now dealt with together in this section of the guidance. The MOD will want to be satisfied with how the costs have been categorised and the method of allocation and/or apportionment. Some amendments have been made to the section on cost accounting to reflect comments made by contractors and the title now more accurately reflects its content. The SSRO still considers the paragraphs on financial reporting and DefCARS helpful and, therefore, they are retained.

Part C.1 – Marketing and sales costs

- 4.22 The SSRO received a significant number of comments about the proposed guidance on marketing and sales costs. One industry respondent considered that the section read like it only applied to UK prime contractors and only those with QDCs rather than QSCs. The SSRO recognises this point but cannot develop guidance which is specific to different types of contractor. We have tried to address this issue with a general reference in the introduction (final guidance, paragraph 1.4).

- 4.23 The MOD welcomed the proposed guidance but questioned the relevance of the first sentence in paragraph C.1.1 (draft guidance reference). One industry respondent also commented that it was not clear how the MOD could award a single source contract without marketing and sales activity and suggested that a cross reference was made to guidance on bid costs. The MOD also considered that it was important that marketing and sales activity was targeted and not unfocussed and resulted in market impact. The SSRO recognises that marketing and sales activity will not always be successful.
- 4.24 One industry respondent suggested that demonstrable benefit to the MOD should be where the rates calculated including marketing and sales costs and associated non-MOD throughput of activity are lower than those rates calculated excluding marketing and sales costs and the relevant non-MOD throughput. The SSRO considers this to be a clear approach which contractors should be able to demonstrate through provision of evidence. Another industry respondent thought it was unreasonable for these costs to only be recovered where the benefit to the MOD exceeded the costs incurred. Another suggested that if the MOD did not contribute to a contractor's overall cost base, which would include marketing and sales costs, it should not benefit from any cost savings that resulted from increased sales volumes.
- 4.25 The SSRO recognises that it may be difficult to demonstrate how these types of costs are Attributable to a particular QDC or QSC. However, Attributability can be demonstrated through the application of rates to a contract that provides the benefit to the MOD, as described in paragraph C.1.2 (draft guidance reference).
- 4.26 One industry respondent said that the guidance suggested that the ability to include these costs as Allowable is binary. They thought the guidance could be clearer that a portion of costs might be Allowable. They also suggested that when pricing a contract, the estimated rates often include an assessment of likely future success in winning competitive work and, therefore, the MOD would receive benefit in this way.
- 4.27 Industry respondents suggested some minor wording changes to this guidance, some of which have been accepted.

The SSRO in its final guidance on marketing and sales costs has:

- a. recognised that that a proportion of marketing and sales costs may be Allowable;
- b. redrafted C1.3 to provide more clarity on the evidence that would be required to meet the AAR test for these types of cost;
- c. retained the definition of marketing and sales costs as it is considered helpful;
and
- d. made minor amendments to paragraphs C.1.4 and C.1.5 (draft guidance reference).

Part C.2 – Bid costs

- 4.28 The MOD suggested that a definition of bid costs might be useful to include in this section of guidance and provided a proposal. The SSRO found the proposed definition helpful. One industry respondent commented that contractors could incur bid costs as a result of a failed competition or if the MOD decided not to award a contract after the contractor had put in considerable effort to develop a proposal.
- 4.29 In its proposed guidance, the SSRO tried to identify when bid costs would be likely to be incurred. Stakeholders commented that bid costs can be incurred much earlier than the date of issue of a request for expression of interest, Preliminary Qualifying Questionnaire or Invitation to Tender.
- 4.30 The MOD's view is that bid costs should be charged directly to a contract. However, contractors have indicated that bid costs will be incurred in periods prior to a contract award and may therefore be included in rates rather than shown as a direct charge to the contract. The SSRO's view is that if the costs meet the AAR test then the method of cost allocation is a secondary issue, although where possible bid costs should be shown as a direct cost. We would expect the cost allocation method to be agreed during contract negotiations or as part of the process when agreeing a Questionnaire on the Method of Cost Allocation.
- 4.31 Industry respondents were strongly of the view that where the MOD has chosen to not award a contract, the contractor should not be penalised for this by not being able to claim back these costs. In cases where these costs were not Allowable, they could act as a discouragement for contractors wishing to bid for future contracts. The SSRO recognises this point but considered that its draft proposals set out that costs in this type of scenario could be Allowable if the MOD agree that they meet the AAR test. We now have clarified that this is not an Allowable Costs issue as no QDC would exist and that any discussion of these costs between the MOD and a contractor would be a separate arrangement.

The SSRO in its final guidance on bid costs has:

- a. provided a clearer definition of bid costs;
- b. not sought to put a time-frame around when bid costs might be incurred: it being for the MOD and the contractor to determine whether costs are Allowable;
- c. clarified the allocation of bid costs to a contract; and
- d. confirmed that costs associated with proposals where the MOD decides not to award a contract are not an Allowable Costs issue.

Part C.3 – Entertainment costs

- 4.32 The SSRO only received three comments on this section of the guidance. One contractor raised the issue of whether there should be alignment between statutory guidance on the allowability of entertainment costs with HMRC rules. This alignment point was also raised in the responses to working papers. The SSRO considers that these are two separate issues. HMRC determine tax rules in relation to these costs whereas the SSRO's guidance is about whether costs are Appropriate, Attributable and Reasonable in the circumstances.
- 4.33 One industry respondent indicated in response to the consultation that they did not disagree with the SSRO's proposed guidance. However, they felt that entertainment costs should be more tightly defined as some may be more Appropriate than others.
- 4.34 The MOD suggested that entertainment costs are not Allowable as indicated in the proposed guidance because they would never be considered Appropriate as public money should not be used to reimburse entertainment activities.

The SSRO in its final guidance on entertainment costs has decided to make no changes. The SSRO has not sought to define entertainment costs at this stage but recognises the need to develop a tighter definition through engagement with stakeholders. Costs which are not entertainment, (for example, sales and marketing, launch of a ship) are likely to be included in other cost categories and meet the AAR test.

Part E.2 – Reworks and wastage

- 4.35 The SSRO received four specific comments on the proposed guidance. One industry respondent stated that the guidance should recognise that on occasions there are trade-offs between the additional cost to increase quality and the potential for rework and wastage. The contractor and the contracting authority would be expected to explore this during contract negotiations and arrive at a value for money judgement.
- 4.36 One industry respondent identified the difficulties with identifying and obtaining suitable benchmark information. This is largely because other potential competitors would be unwilling to share this information. However, the SSRO would expect the MOD as a customer to understand expected levels of rework and wastage across like contracts. Two respondents suggested that rework above a reasonable level should be Allowable if special circumstances existed which could be justified. The respondents did not identify what these special circumstances might be.
- 4.37 The MOD suggested some minor wording changes to the proposed guidance. In paragraph E.2.1 it was proposed that the second sentence could be shortened without losing any meaning. In E.2.2, it was considered that contractors might only be able to identify causes of rework or wastage where they are material.

The SSRO in its final guidance on reworks and wastage costs has:

- a. made amendments to reflect that attempts to achieve zero rework or wastage may be uneconomical and this would need to be understood in reaching a value for money judgement;
- b. confirmed that it may not be possible for individual contractors to obtain benchmark information, but that this may be something which the contracting authority is able to provide;
- c. amended the guidance to reflect that special circumstances might exist; and
- d. made amendments to E.2.1 and E.2.2 to reflect the suggestions received from the MOD.

Part E.3 – Faulty workmanship (now incorporated in Part E.2)

4.38 There was broad support for the changes which the SSRO proposed on faulty workmanship, although the MOD proposed removing this guidance as it was covered by that on reworks and wastage. The SSRO considers that the distinction between these two different types of cost needs to remain. One industry respondent repeated the point made under reworks and wastage that there might be a trade-off between achieving standards of quality and these costs.

The SSRO in its final guidance on faulty workmanship has made no changes to its proposals as it considers it important to retain separate guidance on reworks and wastage and faulty workmanship. However, it has decided to merge this guidance on reworks, wastage and faulty workmanship into one part as they are closely related.

Part G – Non-cash and financing costs (formerly ‘non-cash costs’)

- 4.39 One respondent queried why the SSRO was using the term non-cash costs. This is a term which is used and defined in accounting standards and therefore the SSRO does not propose changing it. We do however agree that the title of this section needed to be changed to ensure it captured all the guidance included in Part G.
- 4.40 An industry respondent stated that they accepted the general principle that items of a capital nature should be recovered through depreciation/amortisation, but challenged whether the guidance was clear enough that assets could be a direct charge to a contract. The SSRO considers that paragraph G.1.4 makes clear that the MOD may fund an asset up front which means that the contractor does not need to charge depreciation or amortisation.
- 4.41 One respondent stated that there can be depreciation and amortisation charges made to the income statement for which there were cash payments in the period. In most cases we would expect these to be non-cash transactions. Each time a company prepares its financial statements, it records a depreciation & amortisation expense to allocate the loss in value of the purchase. However, unlike other expenses, depreciation and amortisation expenses are “non-cash” charges. This simply means that no money is actually paid at the time in which the expense is incurred.

- 4.42 One respondent stated that the valuation and recognition of assets and the allocation or apportionment of non-cash costs are accounting estimates and not accounting policy but each company will have their own policies regarding recognition of assets which is audited against accounting standards. These companies will then develop their estimates based on the policies in place.
- 4.43 The MOD suggested removing section G.1.5 but after consideration the SSRO has decided that this paragraph is still applicable as there may be scenarios in which the MOD retains ownership of assets but which contractors have access to.
- 4.44 One respondent stated that intangible assets recognised as a consequence of a business combination would never be Allowable. The SSRO has considered this point and has decided to make it clear that if the circumstances arose there might be cases where this would be Allowable but this would be determined following a review of the circumstances.
- 4.45 An industry respondent requested that the wording in section G.1.6 'is Attributable to' should be replaced with the word 'enables'. The SSRO believes that 'is Attributable to' in this context is the most appropriate expression for describing the relationship between the contract and the acquired asset.
- 4.46 The MOD suggested removing the explanation of goodwill in paragraph G.1.6 but the SSRO felt that this should be left as this might be useful to readers of the document who are from a non-financial background. The MOD suggested that the wording is changed in the second sentence to read 'Amortisation or write down of Goodwill will only be allowable under exceptional circumstances'. The SSRO took this recommendation into consideration and has edited the wording to 'will require a case-by-case review' as this would confirm any exceptional circumstances. The last suggestion by the MOD within this paragraph was to replace 'acquired asset' with 'acquired business' which the SSRO agreed was more appropriate.
- 4.47 The MOD suggested that there should be no need to explain the consequences of asset valuation in paragraph G.1.7. They also considered that increased depreciation resulting from revaluation should only be seen as Appropriate if there is a balancing credit. The SSRO reviewed this suggestion but felt that the wording of this paragraph is appropriate for readers from a non-financial background and explains that when the value has changed that it would come under review to explain the circumstances and that there may be circumstances where a credit to the MOD may be necessary.
- 4.48 One respondent thought that the first sentence was adequate in paragraph G.1.8 (paragraph G.2.1 in final guidance). The SSRO feels that the rest of this paragraph is important to make the link to the profit rate guidance.
- 4.49 The MOD suggested that it would be helpful to include a few examples such as bank interest, lease interest, and broker/intermediary/bank fees relating to the costs of finance.

The SSRO in its final guidance on non-cash and financing costs has:

- a. amended the title of this section to reflect all the guidance contained;
- b. adapted the references to accounting policies to make clearer how they relate to identifying non-cash costs for depreciation and amortisation;
- c. in response to comments from the MOD, clarified guidance relating to goodwill resulting from business combinations; and
- d. where non-cash costs change following a re-valuation, the guidance indicates that consideration should be given to whether the MOD are due any credit.

5. Comments on guidance where no change was proposed

- 5.1 Consultation respondents provided comments on aspects of the existing Allowable Costs guidance where no changes were proposed. This suggests there are a number of areas where stakeholders believe further review of Allowable Costs guidance may be beneficial. The SSRO acknowledges that there may be scope to improve the guidance further, subject to engagement with stakeholders, and bearing in mind the need to achieve a balance between frequent changes and certainty for the contracting parties.
- 5.2 The SSRO proposes to undertake an annual cycle of guidance review. Our 2017 review of particular elements of the Allowable Costs guidance has shown that it can take 10-12 months to review guidance, engage with stakeholders and consult on proposed changes prior to determining how guidance should change. Depending on the scale of the topic, it is likely that only two or three topics could be reviewed in detail in any year. To review all the aspects of the guidance on which stakeholders have provided comments, to refresh areas of the guidance reviewed this year where further evidence indicates a need for change, and to provide additional guidance on any new cost types would, therefore, represent a long-term programme of activity.
- 5.3 The SSRO will hold a workshop with stakeholders in April 2018 to discuss any immediate issues arising from implementing the new guidance and to help the SSRO select the topics for review in 2018/19. We propose that the following criteria should be considered in identifying the priorities for future review:
- a. the extent of comment from stakeholders that current guidance requires revision;
 - b. the volume of contract costs to which the guidance relates (the SSRO would seek the MOD's views on this);
 - c. the time it will take to ensure that the guidance can be reviewed in the appropriate level of detail and with an appropriate level of stakeholder engagement; and
 - d. the availability of evidence that would enable the SSRO to make an informed change in its guidance.
- 5.4 To inform the discussion about future priorities, we provide below a summary of the comments made by respondents on specific sections of the Allowable Costs guidance where no changes were proposed this year.

Part A.1 – Employee benefits

- 5.5 Respondents suggested that the guidance should refer to 'contracted' rather than 'normal' remuneration, as some employee benefits, such as shares, may be provided infrequently.
- 5.6 The MOD noted that the guidance did not distinguish between shares acquired through Save As You Earn (SAYE) schemes (which were not Allowable) and other employee/executive share schemes (which may be Allowable).

- 5.7 Industry respondents queried how the AAR test should be applied and the supporting evidence requirements. It was suggested that employee benefit costs which were in line with a contractor's policy and which were a contractual obligation should be deemed to be Allowable without the need to evidence the performance of individual employees receiving the benefits. Contractors, it was suggested, would only incur the employee benefit costs necessary to attract and retain staff with the skills required.
- 5.8 Respondents questioned whether the distribution of profit would ever be Allowable. If not, the guidance should state this.

The SSRO made one change to paragraph A.1.3 to aid clarity.

Part A.2 – Pension costs

- 5.9 One respondent suggested that this guidance should be reviewed in the light of the most recently applicable accounting standards pertaining to the reporting of group defined benefit pension schemes.
- 5.10 The MOD identified the treatment of one-off lump sum payments as an issue that may require further guidance.

Part A.3 – Redundancy costs

- 5.11 Respondents challenged the suggestion in the guidance that redundancy costs exceeding those required by statute would be considered not Allowable without express approval of the Secretary of State, even if they satisfied the AAR test. Industry respondents noted that the level of redundancy payments would be defined in policies that formed part of a contractual obligation to employees. Payments made in accordance with company policies should be considered Allowable.
- 5.12 The MOD suggested it would be useful for guidance to be provided on how redundancy costs in excess of the statutory rates might be assessed. It proposed a number of factors that should be taken into account such as: employee terms and conditions; the universality of the contractor's redundancy policy; existing agreements between the contractor and Secretary of State; and the inclusion of other costs such as payment in lieu of notice, which would need to be assessed separately.
- 5.13 The MOD also questioned whether there was a need for specific guidance on determining whether redundancy costs were wholly or partially Attributable to an MOD contract.
- 5.14 One other respondent suggested that inducements for early retirement as part of a redundancy programme should also satisfy the AAR test.

Part A.4 and B.1 – Labour and material costs

- 5.15 The MOD suggested that the separation of guidance on the inflation of labour and material costs and rates was unnecessary as the guidance for both was the same.
- 5.16 Industry respondents felt the requirement to benchmark labour or material cost inflation 'against an appropriate benchmark or index' for costs to be Allowable was too restrictive. They wanted the guidance to give scope for inflation costs that exceeded benchmarks or indices to be Allowable, where these could be justified and evidenced, for example, by reference to specific labour market pressures.
- 5.17 It was noted that labour rates may change from one year to the next due to changes in the mix of staff, rather than the level of their pay. It was also noted that labour rates may include non-labour overhead costs which may require inflation at a different rate to the labour element.

Part C.4 – Third party costs

- 5.18 The MOD noted that the guidance might be more specific in noting that donations of a political or charitable nature were 'not Appropriate', rather than being simply 'not Allowable'. It suggested that the guidance might be more specific in other sections also as to costs that would not be Allowable due to not being Appropriate.
- 5.19 Another respondent questioned why the SSRO felt it necessary to provide guidance specifically on the Allowability of discounts on sales to third parties, when other costs might be similarly identified, for example recoverable VAT on goods and services.

Part D – Research and development costs

- 5.20 There were extensive comments on this section of the guidance, which respondents felt would benefit from significant further discussion and redrafting. The MOD believed the guidance did not go far enough in assisting the parties to assess the Allowability of costs.
- 5.21 Respondents indicated a desire for clearer definitions of 'research' and 'development', drawing on the definitions used for accounting and financial reporting purposes, and clarity on how the guidance related to costs in each of these areas. One respondent noted that the accounting treatments of research expenditure and development expenditure differed, with the former being immediately charged to the income statement and the latter potentially deferred and charged to the income statement as amortisation (or an impairment where expected future cash flows from the asset were lower than the net book value). Consequently, it was suggested that guidance needed to identify when research and development costs would be considered.
- 5.22 The current guidance that costs should be not Allowable where there was 'no discernible benefit provided to the QDC or QSC' (D.1.2 b) was thought likely, by the MOD, to prevent 'almost all' research and development costs being assessed as Allowable. The MOD reported that such costs were usually recovered through overheads subject to the contractor demonstrating a benefit or potential benefit to the MOD. This approach was supported by industry respondents, who believed that there were financial benefits to the MOD from pooling research and development expenditure across the business. If the MOD did not allow such expenditure in rates claims, it could not, they said, subsequently enjoy the benefit of technological advances which flowed from it without paying proportionally for this in a later contract.

- 5.23 The MOD queried how costs related to ‘abortive research and development’ (D1.5) could ever demonstrate benefit to a QDC or QSC.
- 5.24 There were several comments about the expectation that 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. Industry respondents requested clarification that the guidance related only to benefits or credits arising from costs that were deemed Allowable for delivery of a QDC or QSC. A number of these queried whether the requirement to offset benefits or credits arising from such expenditure was appropriate. They noted that research and development tax credits were intended to provide an incentive to companies to invest in innovation. Offsetting these against Allowable Costs effectively negated the benefit and consequently the incentive. The result was, they said, that defence spending was being funded, inappropriately, by another government department or, effectively, contractors.

Part E.1 – Losses, obsolescence and bad debt

- 5.25 The MOD proposed refinements to the guidance on whether costs associated with stock losses and obsolescence were Allowable, and their treatment as direct or indirect costs in specific QDCs or QSCs.
- 5.26 Respondents suggested that losses on other contracts would not be Allowable in relation to a QDC or QSC and the guidance should reflect this. Similarly, the MOD indicated that bad debts and provision for these would not be Allowable unless related to a QDC or QSC and the guidance should reflect this.

Part E.4 – Damages and compensation

- 5.27 One respondent felt this section required clarification, particularly in relation to the types of damages or compensation to which it relates.
- 5.28 The MOD noted that some proportion of costs arising from damages or compensation might be considered Allowable where the expected cost of delivering a QDC or QSC included a probabilistic assessment of such costs being incurred.

Part E.5 – Refunds, penalties and notional transactions

- 5.29 The MOD expressed a preference for stating specifically that these costs were ‘not Appropriate’ rather than just ‘not Allowable’.
- 5.30 Industry respondents noted that the purpose of fines and penalties (E5.3) was ‘to penalise’ not ‘compensate’ a third party ‘for harm done’.
- 5.31 One other respondent questioned whether notional transactions (E5.2) would ever be Allowable.

Part E.6 – Insurance

- 5.32 Respondents sought greater specificity concerning the types of insurance that may or may not be Allowable. They noted that the types of insurance mentioned in the guidance as being those for which costs may be Allowable (covering buildings and equipment, employer’s liability or vehicles and plants) was not exhaustive. They pointed out that some insurances are a legal requirement, and others are required by contracts.

- 5.33 Respondents questioned the assertion in the guidance that the cost of insurance to cover the contractor's 'own poor performance' should not be Allowable, or, indeed, what the SSRO intends by this. It was suggested that many types of insurance would provide cover for losses arising from the performance of the contractor or its employees and that the beneficiary of such cover would, in some cases, be the MOD.
- 5.34 One industry respondent agreed that the cost of insurance related to loss of profit should not be Allowable. Another noted that contractors would purchase some forms of insurance to cover all their business activities, not just QDCs or QSCs, and there might be financial benefits to the MOD from so doing. It was suggested that the costs of these insurances should be considered Allowable as business risk management overheads even if they could not be directly attributed to a QDC or QSC.

Part F.1 – Exceptional and abnormal costs

- 5.35 The MOD proposed changes to the structure of the guidance in this section and questioned whether the section heading was appropriate to the types of costs noted in the guidance.
- 5.36 One other respondent questioned why the guidance required the SSRO to be informed of negotiations concerning costs that were exceptional in nature. They noted that it was unclear from the guidance who was responsible for informing the SSRO.

Part F.2 – Costs associated with closure, rationalisation and restructuring

- 5.37 Respondents thought that the requirement to demonstrate innovation in proposals for reducing costs associated with closure, rationalisation and restructuring was too onerous as innovation may be neither possible nor preferable to 'tried and tested' approaches. It was suggested, rather, that contractors might 'have regard to innovation'.
- 5.38 Industry respondents suggested that 'cost minimisation' rather than 'value for money' should be the primary aim when discussing proposals for closure, rationalisation and restructuring. Account needed to be taken of other factors that may influence the activity and associated costs. It was proposed that the AAR test might be replaced in such cases by a simpler test of Reasonableness.
- 5.39 Respondents felt that the guidance on assessing the net costs associated with closure, rationalisation or restructuring (offsetting benefits to other sites operated by the contractor or within a joint venture) was confusing and unnecessary. It was suggested that the guidance should only be concerned with one-off costs associated with the closure, rationalisation or restructuring.
- 5.40 One respondent sought further clarity on the meaning of 'normal commercial business risk', as the guidance indicates that costs of closure, rationalisation or restructuring associated with this would be deemed dis-Allowable.
- 5.41 One respondent noted that it may only be possible to estimate profits and losses at the time that closure, rationalisation or restructuring takes place and that it should be permissible to recoup all costs where this was 'fair and reasonable'.

Part F.3 – Idle facilities and capacity

- 5.42 The MOD questioned why the guidance, in general, did not provide more definitions, as was the case in this section, for example, for ‘idle facilities’.
- 5.43 The requirement in the guidance’s definition of ‘idle facilities’ for these to have been ‘designed for’ the purpose of fulfilling the requirements of a QDC or QSC was deemed inappropriate by industry respondents. It was suggested that the idle facilities need only have enabled such a contract at some time, even if designed for another purpose.
- 5.44 The definition of ‘idle capacity’ as being the part of a facility or capital asset that was under-utilised ‘for the delivery of a QDC or QSC’ was also challenged by respondents. Firstly, as it took no account of utilisation for other purposes. Secondly, as it made no reference to costs associated with idle labour resources.
- 5.45 Industry respondents commented on the circumstances in which the costs of idle facilities might be considered Allowable. Some questioned the suggestion (in F3.3 c) that some changes in government or defence policy might be predicted by a contractor, and that failure to predict might render some costs dis-Allowable. The AAR test was deemed sufficient to ascertain whether contractors had acted reasonably in incurring costs in the light of available information. Others wished to explicitly include costs arising from idleness which was the result of the MOD’s delay in awarding a contract or deferring programme expenditure.
- 5.46 The requirement in the guidance for decisions on Allowability of such costs to be subject to a separate agreement between the MOD and contractor was questioned by respondents. They were unclear why a separate agreement was required and why any such agreement would need to be reported to the SSRO if not related to a QDC or QSC.

Part H – Risk

- 5.47 One organisation noted that cost estimates should be based on current and accurate empirical evidence. The cost estimate for pricing purposes should equal the mean expected outturn of costs. This respondent believes cost estimates should be distinct from estimates related to risk, for which compensation would be provided through profit. As a consequence, profit should not include expected costs. They believed that this could be more clearly stated in the guidance, providing a more effective framework for post-award audits.
- 5.48 One industry respondent distinguished between modelled costs that can be quantified and those risks that are unquantifiable, and therefore cannot be modelled. In their view, the latter risks should also be included in the cost risk adjustment assessment and should not be deemed to be not Allowable.
- 5.49 Reference was made to the work undertaken by the SSRO to consider the treatment of cost risks and incentives in pricing QDCs, to inform the Secretary of State’s first periodic review of the legislation, and the need to ensure the guidance was consistent with the findings of that work.

The SSRO undertook an extensive study during 2017 on the treatment of cost risk and incentives in QDCs, to inform the Secretary of State's first periodic review of the single source procurement framework. That work identified a number of areas where the SSRO's guidance on risk in Allowable Costs might benefit from revision, alongside changes to the SSRO's statutory guidance on adjustments to the baseline profit rate in determining the profit rate for a QDC. Following the outcome of the Secretary of State's review of the legislation, the SSRO will consider what changes to guidance would be desirable and will consult on those in due course.

6. Changes to draft guidance

6.1 The table below describes the changes made between the draft guidance which the SSRO issued for consultation and the final guidance published on 1 February 2018.

Draft guidance paragraph reference	Final guidance paragraph reference	Explanation of changes
1.3	1.3	Expanded to deal with all elements of Section 20(1) – 20(4) in one place.
1.4	1.3	
1.5	1.4	New sentence added to make clear that guidance applies to MOD and all defence contractors with QDCs or QSCs.
1.6	-	Paragraph removed as duplicates the contents page.
Section 2	Section 3	No change to content but moved to Section 3.
3.3, 3.4, 3.6 and 3.9	4.1, 4.2, 4.3	These paragraphs now deal with cost accounting matters earlier in this section and include amended text from draft guidance paragraphs 3.3, 3.4, 3.6 and 3.9.
3.1 & 3.2	4.5 & 4.6	Amended content retained in 4.5. New content covering recovery rates in 4.6.
3.3	4.4	Amended paragraph to recognise that the SSRO is not prescriptive about the categorisation of costs.
3.4	4.2	Improved wording based on input from stakeholders which the SSRO has accepted.
3.5 & 3.6	-	Deleted as covered in the introduction section.
3.9	-	Deleted as covered in paragraph 4.3.
4.1	2.1	Additional sentence to clarify when reporting deviations from guidance may have to be necessary.
4.2	2.2	Second sentence re-introduced from current guidance following response from the MOD.
4.3	2.3 & 2.4	Paragraph improved following stakeholder response.
4.4	2.5	Removed reference to SSRO Answers.
A.1.3	A.1.3	Minor amendment to improve clarity – no need to define distributions of profit.

Draft guidance paragraph reference	Final guidance paragraph reference	Explanation of changes
C.1.1	C.1.2	Amended paragraph to provide reference to bid costs.
C.1.2	C.1.3	Improved wording based on a suggestion from a stakeholder which the SSRO has accepted.
C.1.3	C.1.1	Definition retained but moved to beginning of section.
C.1.5	C.1.4	Incorporates guidance from previous paragraph C.1.4.
C.2.1	C.2.1	Incorporates a suggested definition of bid costs from a stakeholder. Removes suggested timeframe within which costs might be incurred.
C.2.2	C.2.2	Where the MOD abort a contract there should be a separate arrangement for assessing these costs.
E.2.1	E.2.1	Paragraph amended to reflect that attempts to achieve zero rework or wastage may be uneconomical.
E.2.2	E.2.2	Paragraph amended to reflect that it might not always be possible for contractors to have access to benchmark information and that the specific circumstances of the contract need to be considered.
E.3.1	E.2.3	Guidance included alongside that on reworks and wastage.
G.1.3	G.1.3	Minor amendment to improve clarity.
G.1.6	G.1.6	Minor amendment to improve clarity.
G.1.7	G.1.7	Minor amendment based on suggestion by the MOD which the SSRO has accepted.
G.1.8	G.2.1	Guidance on financing costs moved to new section.

