

**From:** [REDACTED]  
**To:** [REDACTED]  
**Cc:** [REDACTED]  
**Subject:** FOI - reference RFI 015  
**Date:** 09 October 2017 09:46:28  
**Attachments:** [20170619 WP1 - Allowable Costs Working Paper - Cost Accounting and Financial Reporting .pdf](#)  
[20170619 WP2 - Allowable Costs Working Paper - Tangible and Intangible assets.pdf](#)  
[20170619 WP3 - Allowable Costs Working Paper - Individual Cost Types.pdf](#)

---

Dear [REDACTED]

Thank you for your enquiry received on 2 October 2017, which we are treating as a request under the Freedom of Information Act. This has been allocated reference RFI 015.

We confirm that the SSRO holds three working papers on Allowable Costs, which relate to its current consultation. Copies of the working papers are attached.

If you are dissatisfied with the handling of your request, you have the right to ask for an internal review. Internal review requests should be submitted within two months of the date of receipt of the response to your original request and should be addressed to: Neil Swift, c/o Enquiries, [enquiries@ssro.gov.uk](mailto:enquiries@ssro.gov.uk).

If you are not content with the outcome of the internal review, you have the right to apply directly to the Information Commissioner for a decision. The Information Commissioner can be contacted at: Information Commissioner's Office, Wycliffe House, Water Lane, Wilmslow, Cheshire, SK9 5AF.

Yours sincerely,

[REDACTED]

[REDACTED]

[REDACTED]

Single Source Regulations Office  
*Assuring value, building confidence*

3<sup>rd</sup> floor, Finlaison House | 15-17 Furnival Street | London EC4A 1AB

☎: [REDACTED]

✉: [REDACTED]

# SSRO

Single Source  
Regulations Office

*Assuring value, building confidence*

## **Allowable Costs Working Paper – 2017/18 review**

Cost Accounting and Financial Reporting  
Issues

June 2017

**Contents**

1.	Introduction	3
2.	Current Guidance	4
3.	Stakeholder views	6
4.	Regulation in other countries and sectors	7
5.	Discussion of issues	9
6.	Questions for stakeholders	14
7.	Conclusion	15

## 1. Introduction

- 1.1 This working paper reflects the outcome of an initial review of the SSRO's current statutory guidance on Single Source Cost Standards (Allowable Costs Guidance). The Guidance was last updated on 1 July 2016. The SSRO has prioritised a number of areas where guidance may be developed during 2017. These are:
- a) Cost Accounting and Financial Reporting;
  - b) Allowable Costs associated with Tangible Assets and Intangible Assets; and
  - c) Specific Cost Types – Sales, Marketing and Bid costs, Entertainment costs and Faulty Workmanship and Reworks costs.
- 1.2 This working paper focuses on the topic of **Cost Accounting and Financial Reporting** and reviews sections 7 and 11 of the **current guidance**. The SSRO notes that the *Allowable Costs* guidance is used by accountants and non-accountants alike, and therefore seeks to ensure that the use of technical accounting terms is minimised where possible. The paper focuses on the following areas where the SSRO considers greater clarity would be beneficial:
- a) To distinguish between cost accounting principles that apply to management accounting and generally accepted accounting principles (GAAP) or accepted reporting standards that apply to financial reporting;
  - b) To improve definition and consistency of terms used;
  - c) To describe between the treatment of direct and indirect costs; and
  - d) To explain roles and responsibilities in relation to ensuring the costs of a contract are *Allowable*;
  - e) The need to distinguish clearly between the information reported in a company's financial statements and reports on individual contracts.
- 1.3 The issue of working papers in advance of a public consultation on guidance is a new approach which the SSRO is adopting. This is to ensure that we understand the issues fully before proposing any changes to the guidance and to capture feedback and examples from stakeholders that will help ensure the appropriate changes are made, if any is required. As well as comments on the specific contents of this working paper we also welcome any comments on the approach.
- 1.4 Section 20 of the Defence Reform Act 2014 ('the Act') states that the SSRO must issue guidance about determining whether costs are *Allowable Costs* under qualifying defence contracts and qualifying sub-contracts. The SSRO aims to review its *Allowable Costs* guidance on an annual basis and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.5 This working paper has been issued to stakeholders on Monday 19 June 2017. Stakeholder views on these working papers are welcomed and should be sent to **Simon.McCullough@ssro.gov.uk** by Friday 21 July 2017. Comments on the working paper will inform the development of a public consultation document on statutory guidance changes in October and November 2017. The SSRO aims to publish the final guidance on 1 January 2018 and it would apply to new contracts from that date although we will consider applicability of the guidance in the consultation in the autumn.

## 2. Current Guidance

- 2.1 Section 7 of the current Guidance sets out some principles of *Allowable Costs* which are related to costing. The current Guidance is set out in Table 1 below.

**Table 1 – Current Allowable Costs Guidance on Principles of Allowable Costs**

Current paragraph reference	Guidance
7.1	To be <i>Allowable</i> , a cost <b>must</b> meet all three criteria of <i>Appropriate</i> , <i>Attributable</i> and <i>Reasonable</i> . The following principles support the <i>Appropriate</i> , <i>Attributable</i> and <i>Reasonable</i> criteria and must be adhered to: a. costs should be supported by adequate and sufficient evidence; b. costs should be assigned to contracts only once; and c. actual costs are to be fully recorded and reflected in the books of account.
7.2	Section 20(4) of the Act places the onus upon the primary contractor of a qualifying defence contract to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance as being <i>Allowable</i> . The burden of proof rests with the contractor and it is essential that the MOD operates as an intelligent client and has the ability to verify, challenge and agree the costings that are submitted as being <i>Allowable</i> .
7.3	When a qualifying sub-contract is awarded the burden of proof shifts from the prime contractor to the sub-contractor.
7.4	It is essential to the establishment of <i>Allowable Costs</i> , both at pricing and contract delivery stages, that they are evidenced and demonstrably linked to the delivery of the qualifying defence contract or qualifying sub-contract.
7.5	Any costing system and costing methodology employed by contractors should allow the identification of costs allocated to qualifying defence contracts or qualifying sub-contracts. This should enable the testing and evidencing of those costs to ensure that they meet the criteria for <i>Allowable Costs</i> .
7.6	All <i>Allowable Costs</i> are to be reported to the SSRO to reflect the maximum potential cost of a contract. This is the sum of the direct and overhead/indirect costs to deliver the contract. This includes the costs that are or will be incurred as well as the value of all options or variations that may apply.
7.7	The allocation of costs to the contract should be based on a contractor's normal accounting system and policies and in line with generally accepted accounting principles.
7.8	Regardless of the type of cost, Section 20(2) of the Act requires the parties to be satisfied that it is <i>Appropriate</i> , <i>Attributable</i> and <i>Reasonable</i> in the circumstances in order to be an <i>Allowable Cost</i> .
7.9	If costs have already been incurred, referred to here as 'sunk' costs when the amended contract becomes a qualifying defence contract or qualifying sub-contract, the SSRO expects that the parties would make appropriate

Current paragraph reference	Guidance
	arrangements such that it should be unnecessary for any question to be raised with the SSRO in relation to the sunk costs.
7.10	Such arrangements may include stating in the amended contract that: <ul style="list-style-type: none"> <li>• the parties agree that the sunk costs are <i>Allowable Costs</i>; and</li> <li>• the parties will not seek to reclaim costs or to claim additional costs in respect of the period prior to the amended contract becoming a qualifying contract or qualifying subcontract.</li> </ul>
7.11	The following cost definitions are provided to inform the different characteristics of costs.
7.12	<p><b>Direct costs</b></p> <p>A direct cost is a cost that can be attributed to the production or delivery of specific goods, works or services required to fulfil the qualifying defence contract or qualifying sub-contract. Direct costs may consist of materials, labour or other costs. The parties must always be satisfied that the cost is <i>Appropriate, Attributable and Reasonable</i>.</p>
7.13	<p><b>Overhead/indirect costs</b></p> <p>Overhead and indirect costs are defined as those costs which have necessarily been incurred for the performance of the qualifying defence contract or qualifying sub-contract 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. These costs may be apportioned to individual contracts if both the costs and the proposed apportionment satisfy the test of being <i>Appropriate, Attributable and Reasonable</i>.</p>

2.2 Section 11 of the current Guidance describes cost allocation practices which are related to single source defence contracts. The current Guidance is set out in Table 2 below.

**Table 2 – Current Allowable Costs Guidance on Cost Allocation Practices**

Current paragraph reference	Guidance
11.1	Single Source contractors are required annually to declare to the MOD, through the Questionnaire on the Method of Allocation of Costs (QMAC), their cost accounting and cost allocation approach. This declaration does not pre-determine whether costs are <i>Allowable</i> . The contractor must make information available on an open book basis.
11.2	A contractor will follow its own normal accounting systems, and in advance must declare material changes to the SSRO and the Secretary of State, together with a clear statement explaining the reasons behind the change.

Current paragraph reference	Guidance
11.3	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.
11.4	In making an assessment of <i>Allowable Costs</i> , the parties must arrive at a determination on whether a cost is, or is not, <i>Allowable</i> in line with this statutory guidance.
11.5	The contractor is required to demonstrate to the Secretary of State and evidence any claim for a cost to be <i>Allowable</i> . Any unresolved disputes between the contractor and the Secretary of State can be referred to the SSRO.

2.3 The SSRO considers that the current sections 7 and 11 should be amalgamated into a new section on Cost Accounting and Financial Reporting to highlight the importance of these issues. The SSRO considers that these topics need to be clearly explained and should help the contractor and the MOD with their assessment of whether costs are *Allowable*. The resulting new Guidance whilst retaining a vast majority of current content will be re-formatted and expanded in places to provide greater clarity and explanation.

### 3. Stakeholder views

#### *Industry*

3.1 To assist in this review the SSRO asked defence industry stakeholders, as part of a survey on the *Allowable Costs* Guidance, the following question:

- How specific does the guidance need to be about accounting or financial reporting standards and issues?

3.2 Stakeholders made the following responses:

- As a non-accountant, the guidance doesn’t need to be specific as long as acceptable national standards (or standards widely accepted within a given country) are used.
- The expectation is that the SSRO should not be prescriptive. In most cases prime contractors will have been using systems developed over considerable time to satisfy client, company internal and statutory accounting and reporting.
- Guidance should be specific enough to prevent differences of interpretation between SSRO, MOD and contractors. Such differences are costly in time and damaging to cooperative working relationships. Guidance must be fair and well researched with all constituents before publication so that all parties understand and (to the extent possible) agree to the guidance and implementation dates.
- One area that has caused issues is the principle that the contractor’s existing accounting structure will be used, yet the changes around allowable costs has the effect of changing the standard accounting structure with regards to the way costs are spread across the business to provide a balanced competitive business that remains sustainable.

- The longer term, macro-economics of the cost base needs to be considered. Contractors need to consider the impact of moving disallowed costs to other areas of their business and what this would do for their competitiveness and sustainability.
- Suppliers should always follow appropriate accounting standards and therefore guidelines should not be at odds with these standards otherwise reconciliation to accounts will be problematic, e.g. disallowing bid costs.
- Principles need to be clear for the many different types of contractor, contracts and circumstances, so as to produce a comprehensive set of guidance material for each.
- Data used by the contractor to meet financial reporting standards has to remain consistent. Therefore, guidance needs to be generic to allow for this, unless, agreed by contracted parties (prior to commencement) that a differing approach is more applicable.
- Our preference is to keep the guidance principles based and therefore should be consistent with financial reporting standards, but not detailed by reference to specific standards.

3.3 In addition, from the 2016 consultation on the *Allowable Costs* Guidance the following responses were received which are relevant to this topic:

- What is meant by the “costing system”? Is costing methodology the correct term? Distinction needs to be made between the core accounting system and the MOD costing system that draws upon the accounting system data.
- Part of the QMAC disclosure is for contractors to advise how the financial accounting rates differ from the rates used to develop MoD rates. This issue is fully understood by the MoD and Industry and should be acknowledged in the guidance.

#### ***MOD views***

3.4 The MOD have shared the following views with the SSRO on this topic:

- Contractors must assure themselves that costs produced by their accounting systems (estimates or actuals) are *Allowable*.
- The use of a supplier’s standard system for allocating or recovering overheads does not override the requirement to prove that costs are AAR.
- Costs should be sufficiently broken down to be transparent without creating unnecessary work for the contractor and should be traceable back to the company’s financial statements.

## **4. Regulation in other countries and sectors**

4.1 As part of this review the SSRO has looked at costing principles and guidance produced and applied in other international jurisdictions. These are summarised in Table 3 below. There is consistency in some areas but also differences of approach. For example, most guidance outside of the United Kingdom is more rules based than principles based. The United States have public procurement regulations which are cross government and are supplemented by defence specific regulations and guidance. In Canada, **legislation and Government Contract Regulations** apply to procurement activities. Public Services and Procurement Canada (PSPC) are currently reviewing their costing and pricing approach and guidance as



they recognise it is different from other countries they have looked at and requires updating in some areas. In Australia, there are Commonwealth procurement rules that are supplemented with defence specific guidance.

**Table 3 – Summary of costing principles and guidance applied in other countries**

Country	Key aspects of principles and costing/pricing guidance
United States	<ul style="list-style-type: none"> <li>• Federal Acquisition Regulation System (FARS) set out regulations for all executive agencies. FAR – Part 31 in particular provides guidance on – <b>Contract Cost Principles and Procedures</b>. These regulations also include <b>Cost Accounting Standards</b>.</li> <li>• Defense FARS (DFARS) set out supplementary regulations for defense acquisition and Procedures, Guidance and Information. DFARS Part 231 provides supplementary guidance on - <b>Contract Cost Principles and Procedures</b></li> </ul>
Canada	<ul style="list-style-type: none"> <li>• Public Services Procurement Canada - <b>Contract Cost Principles</b></li> <li>• Public Services Procurement Canada - <b>Supply Manual</b></li> </ul>
Australia	<ul style="list-style-type: none"> <li>• Australian Department of Defence - <b>Cost Principles</b></li> <li>• Australian Department of Defence - <b>Defence Procurement Policy Manual</b></li> </ul>

- 4.2 The AAR principles share similarities with approaches to procurement in other jurisdictions. For example, in the United States the principles of allowability, reasonableness and applicability apply. There is also a relative degree of consistency in terms of those costs that are Allowable and those that are not. The SSRO asks stakeholders to comment on any aspects of the regulations in other international countries (including the cost principles or cost accounting standards in Table 3) and whether they would improve the current statutory guidance if they were incorporated.
- 4.3 Prior to the Defence Reform Act 2014, the review board for government contracts made references to ‘Government Accounting Conventions’ and it published reviews spanning both profit and costs in a single publication. The SSRO’s has published a number of separate documents to set out its statutory guidance and methodologies. The SSRO is not minded to merge these publications, but it welcomes views as to how best to maintain consistency across all relevant publications, and other relevant observations.
- 4.4 Regulatory reporting requirements that provide a link between statutory accounts exist in various sectors of the UK economy. For example, Appendix 2 contains a summary of the regulatory reporting arrangements for the water sector. The SSRO welcomes views about the relevance to the single source contract regulations of the approach outline in Appendix 2 and other similar arrangements in other industries.

## 5. Discussion of issues

5.1 This section of the working paper discusses the following themes:

- Accounting terminology;
- Accounting systems;
- Financial reporting;
- Cost accounting and pricing of contracts under the Single Source Contract Regulations;
- Open book access and provision of information;
- Statutory reporting requirements;
- Efficient costs; and
- Relationship between Allowable Costs and Contract Profit Rate methodology.

### ***Accounting terminology***

5.2 Appendix 1 to this working paper contains a list of terms and phrases used throughout the *Allowable Costs* Guidance ('Guidance') that may risk misinterpretation in the context of financial reporting and cost accounting terminology. The appendix contains cross references to their position in the current guidance.

5.3 The SSRO considers that it is appropriate to review the usage and definitions of these terms, with the aim of improving the clarity of the guidance, with a particular objective of ensuring that the guidance can be used by accountants and non-accountants alike. Some suggestions are made in Appendix 1 but this will be addressed in the consultation draft. The SSRO welcomes any comments on Appendix 1.

### ***Accounting systems***

5.4 References to accounting/costing systems occur at paragraphs 7.5, 9.11 and 11.3 of the Guidance.

5.5 Companies require accounting systems for financial reporting and cost accounting purposes. Company directors are responsible for keeping adequate accounting records that are sufficient to show and explain a company's transactions. Accounting systems are needed to ensure that companies charge their customers in accordance with contractually agreed terms. In the case of the MOD, this involves only charging for costs that satisfy the AAR principles in single source contracting. Accounting systems must also be capable of providing access to the MOD through open book access arrangements and allow traceability of contract costs to financial statements and vice versa.

5.6 The SSRO is not prescriptive about the choice of accounting system used by a contractor but welcomes any views on this.

### ***Financial reporting***

5.7 The Guidance makes several references to *Generally Accepted Accounting Principles* (GAAP) in relation to specific cost items (including intangible assets, research and development, and pensions).

- 5.8 Financial reporting requires the application of GAAP. At an elementary level, most financial statements are prepared on an accruals basis (matching principle) and contain several financial statements, e.g. a profit and loss account, balance sheet and cash flow statement, along with supporting notes and disclosures. The SSRO notes the existence of several sets of practices that may apply to the preparation of financial statements. These include US Generally Accepted Accounting Principles (US GAAP), International Financial Reporting Standards (IFRS), and UK Generally Accepted Accounting Practices (UK GAAP). The prevailing UK GAAP is set out in Financial Reporting Standard 102 (FRS 102) published by the Financial Reporting Council.
- 5.9 In September 2016, the SSRO published a statistical bulletin which showed that 30 of the 33 QDCs were contracted to companies registered in the UK.<sup>1</sup> A number of these companies were UK subsidiaries of companies with global operations. These companies are able to report their results in the GAAP that prevails in multiple jurisdictions.
- 5.10 In the UK, the Companies Act 2006 sets out the requirement to prepare and file accounts, and the requirements for an audit. Directors of companies may adopt a variety of accounting policies in the preparation of their accounts. Accounting policies provide additional information about the assumptions and judgements that are applied (e.g. the useful life over which an asset is depreciated). The auditor's report will contain an opinion as to whether financial statements give a true and fair view of the state of a company's profit or loss; have been properly prepared in accordance with *Generally Accepted Accounting Practice* (GAAP); and have been prepared in accordance with the requirements of the Companies Act 2006. Additional disclosure requirements apply to companies with shares listed on a stock exchange, or operate in particular sectors.
- 5.11 The SSRO's view is that the Guidance should remain non-prescriptive as to the selection of which accounting standards or principles should apply to the financial statements of a contractor, that is a decision for the directors of each company. However, in so doing, it is assumed that the same standards and principles will be applied to all qualifying defence contracts entered into with the MOD unless they result in costs charged which would not satisfy the AAR principles.
- 5.12 The SSRO is keen to hear from stakeholders as to whether particular aspects of the *Allowable Costs* Guidance, such as the application of the AAR principles to specific categories of cost which may have complex accounting treatments – gives rise to anomalies that might undermine the balance between value for money for taxpayers and fair and reasonable return for contractors. In addition, the SSRO would like to know if particular aspects of GAAP would suggest there was not a level playing field between contractors involved in QDCs. Such contributions should be accompanied with examples and quantitative analysis, where practical.

***Cost accounting and pricing of contracts under the Single Source Contract Regulations***

- 5.13 The pricing of contracts subject to the Single Source Contract Regulations involves the addition of a profit rate to the estimated costs of a contract, comprising direct costs and indirect costs. The profit rate is determined by the Secretary of State following a recommendation by the SSRO.

---

1

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/551293/International\\_aspects\\_of\\_qualifying\\_defence\\_contracts\\_2015\\_16.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/551293/International_aspects_of_qualifying_defence_contracts_2015_16.pdf)

- 5.14 In management accounting terminology, this approach may be described as a form of Activity Based Costing (see paragraph 5.22), modified for the application of the AAR principles to both direct and indirect costs.

*Direct costs*

- 5.15 As stated at paragraph 7.12 of the Guidance, a direct cost is a cost that can be attributed to the production or delivery of specific goods, works or services required to fulfil the qualifying defence contract or qualifying sub-contract. Direct costs may consist of materials, labour or other costs.
- 5.16 The SSRO considers that this definition is clear.

*Overhead/Indirect costs*

- 5.17 Paragraph 7.13 describes overhead and indirect costs as those costs which have necessarily been incurred for the performance of the contract 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.
- 5.18 The SSRO considers that it is for each contractor to consider the classification of indirect costs and it is the responsibility of the contractor to demonstrate to the MOD how costs meet the AAR principles.

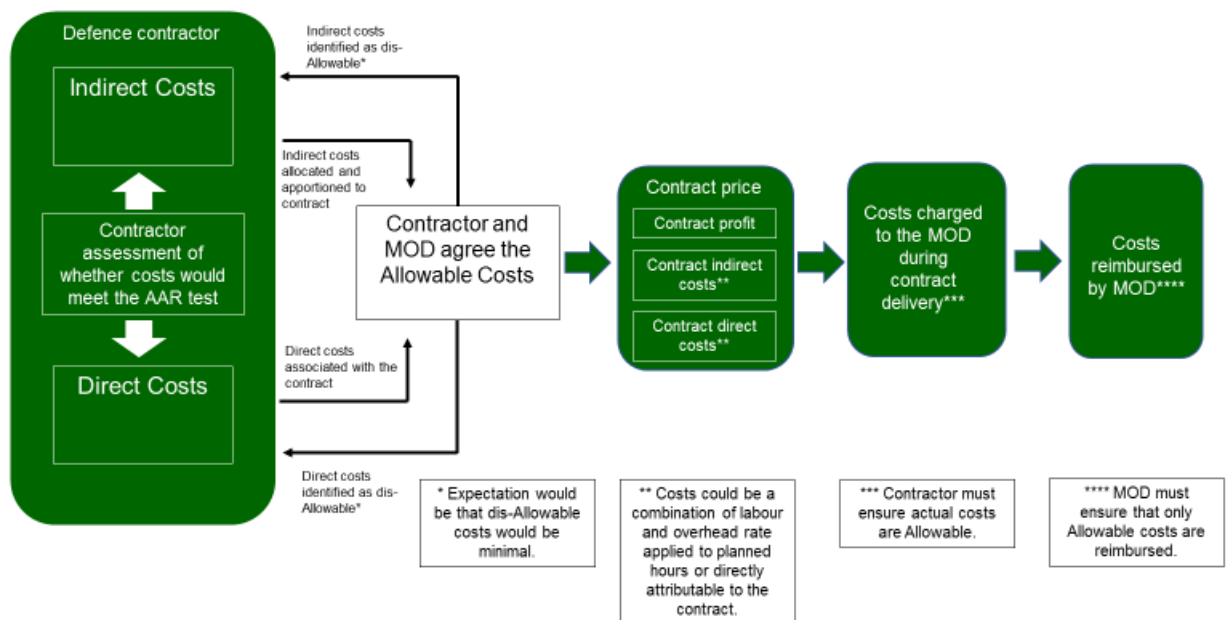
*Allocation, apportionment and recovery of indirect costs*

- 5.19 As stated in paragraphs 11.1-11.5 of the *Allowable Costs* Guidance, contractors are required to declare the method of allocation or apportionment through the 'Questionnaire on the Method of Allocation of Costs' (QMAC). This provides a form of assurance to the MOD about how a contractor treats their costs and attributes them to contracts. The MOD have other arrangements in addition to the QMAC process (e.g. system audits, full access to accounting systems in some situations) which are not reflected in the Guidance.
- 5.20 The allocation of indirect costs to an individual contract is straightforward if a company is engaged exclusively in the delivery of one contract. In more complex scenarios, such as a company with multiple contracts, of which some are QDCs, it is necessary to apportion indirect costs to contracts using an appropriate basis of apportionment.
- 5.21 The SSRO is not prescriptive about what basis of apportionment is appropriate because there are several methodologies that companies could use and a wide range of contracts, therefore this will be determined on a case by case basis.
- 5.22 Activity based costing is a technique used in management accounting that identifies the activities within an organisation and assigns both direct and indirect costs of the activity to the products and services according to the actual amount consumed. A business may use this technique to derive the price at which it should sell a product in order to ensure that it fully recovers the direct and indirect costs.
- 5.23 For example, if the number of hours incurred by a workforce to manufacture a product is the principal cost driver, then activity-based costing would involve dividing indirect costs by planned production hours to calculate an indirect cost per hour. This would be combined with direct labour costs per hour and other direct costs. Under these circumstances, indirect costs will be fully absorbed in the price of a contract if planned and actual hours are the same. The use of 'labour hourly recovery rates' (includes direct and indirect costs) is commonplace in single source contracting.

## Allowable Costs – Working Paper (Cost Accounting and Financial Reporting Issues)

- 5.24 The SSRO's view is that the under or over recovery of overheads resulting from a variation of the planned versus the actual number of production hours is a matter for the individual defence contractor to address with the MOD. We would expect contractors to continually monitor their recovery of overheads and raise any concerns or variances at the earliest opportunity with the MOD. We would also expect the MOD to consider reviewing outturn with the contractor depending on the size of the contract.
- 5.25 The MOD will approve the estimated rates that are to be used to derive the costs of the contract. In some cases, contractors have told the SSRO that there can be a significant time delay between rates being submitted to the MOD for approval and those rates being approved. Contractors are required in their contract reports submitted to the SSRO to confirm the status of the rates used to cost the contract.
- 5.26 Diagram 1 below illustrates the process flow from the defence contractors costing through to the approved contract and ultimate payment by the MOD.

**Diagram 1 – Process for agreeing, charging and payment of Allowable Costs**



### **Open book access and provision of information**

- 5.27 It is for the contractor to demonstrate to the MOD through provision of reasonable evidence that its costing system and supporting methodology results in estimated and charged costs which are *Allowable*. The Ministry of Defence in their guidance<sup>2</sup> states:

*Section 20(4) of the Defence Reform Act enables the MOD to require a contractor to show that their proposed costs are allowable, when requested to do so by the MOD. You*

<sup>2</sup> MOD Single Source Contract Regulations 2014 Guidance – Chapter 3 Pricing a Qualifying Defence Contract: The Cost Element (paragraph 17)

*(commercial teams) should always ask a contractor to show that their costs are allowable, through submission to the MOD of sufficient supporting evidence. It is not your responsibility to specify what constitutes adequate supporting evidence – while you may provide broad clarification it is for the contractor to make their own judgement about the level of evidence required to show that their costs are allowable.*

5.28 Section 20 of the Act states that in the case of a qualifying defence contract the MOD and the primary contractor must be satisfied that costs are *Allowable*. In the case of a qualifying sub-contract, the same principle applies between the prime contractor and the sub-contractor. However, the SSRO are aware of cases where sub-contractors did not wish to share information with the prime contractor due to them being potential competitors for other business. This may inhibit the ability of both parties to be satisfied that the AAR principles apply and the SSRO considers that it should be possible for this to happen without the release of commercially sensitive information. The prime contractor should provide evidence as to what steps have been taken to ensure that the AAR principles have been satisfied. In some cases, the MOD may be assist in the agreement of whether the costs of a qualifying sub-contract are *Allowable*.

5.29 The current Guidance (paragraph 7.3) states that:

*When a qualifying sub-contract is awarded the burden of proof shifts from the prime contractor to the sub-contractor.*

5.30 The SSRO considers that this sentence may be replaced with the following wording to reflect the need for the both parties to ensure that all costs are *Allowable*:

*When a qualifying sub-contract is awarded the burden of proof is extended to the sub-contractor, however the ultimate responsibility for ensuring all costs are appropriate, attributable and reasonable in the circumstances remains with the prime contractor.*

### **Statutory reporting requirements**

5.31 The SSRO has developed the DefCARS system to enable contractors to submit contract and supplier returns including estimates, approved rates and forecast and actual costs in accordance with the Single Source Contract Regulations and Defence Reform Act. Contractors must ensure their accounting systems can produce the relevant information for submitting statutory reports. This contract information must be provided in accordance with the Single Source Contract Regulations.

### **Efficient costs**

5.32 In the current Guidance, paragraph 10.5 refers to 'efficiency' solely in relation to costs associated with closure, rationalisation or restructuring.

5.33 In line with the SSRO's duty to ensure that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons who are parties to qualifying defence contracts are paid a fair and reasonable price, the SSRO is interested to hear views in relation to whether, and if so how, the guidance may introduce reference to the efficiency of costs in relation to the application of the AAR principles. For example, this may introduce an expectation that contractors should provide to the MOD evidence of the on-going delivery of efficiency savings and continuous improvements in order to demonstrate value for money for the taxpayer. Examples of how this may be achieved include:

- demonstration of how increased throughput will reduce indirect costs charged to contracts;

## Allowable Costs – Working Paper (Cost Accounting and Financial Reporting Issues)

- transparency of continuous improvement programmes both across the whole organisation and specifically against single source contracts and the associated benefits;
- visible reductions in levels of wastage, faulty workmanship and reworks;
- greater use of specialized sub-contracting organisations; and
- use of benchmarking information from DefCARS (see paragraph 5.31) and other sources to identify priorities for improvement.

### ***Relationship between Allowable Costs and Contract Profit Rate methodology***

- 5.34 As stated in the Baseline Profit Rate methodology, the SSRO considers that financial statements provide sufficient financial information to use benchmarking of comparator companies to calculate a baseline profit margins that can be combined in conjunction with other stages of the 'six steps' to produce a Contract Profit Rate that achieves a balance between value for money in government expenditure and a fair and reasonable return for contractors.
- 5.35 The SSRO considers that financial statements prepared for statutory reporting purposes alone are not likely to provide sufficient disclosure for a contractor to demonstrate to the MOD that its costs satisfy the AAR principles.
- 5.36 Some contractors have stated that there should be a symmetrical relationship between the Allowable Costs principles and the approach to benchmarking. In other words, the reported results that the SSRO uses in its benchmarking should be adjusted to remove categories of costs that a contractor is not able to recover from the MOD through the Allowable Costs category. This process may result in an increase in the profit margin derived from the benchmarking exercise, which would depart from the financial performance of the companies that are included in the benchmarking.
- 5.37 The SSRO is minded to proceed on the basis that contractors should not recover through an uplift to the profit rate benchmarking such costs that do not meet the AAR principles set out in the Allowable Costs guidance because to do so would introduce an imbalance between value for money and fair and reasonable returns.
- 5.38 The SSRO is also of the view that it is not practical to adjust benchmark companies for costs that do not meet AAR principles because the level of disclosure in financial statements is generally not sufficient.
- 5.39 The SSRO welcomes quantitative evidence in this regard.

## **6. Questions for stakeholders**

- 6.1 This paper explains how concepts including cost accounting and financial reporting relevant to the *Allowable Costs* Guidance. The SSRO requests stakeholder views on the following aspects of this paper:
- Should the *Allowable Costs* Guidance more clearly distinguish between cost accounting principles that apply to management accounting and *Generally Accepted Accounting Principles* (GAAP) or accepted reporting standards that apply to financial reporting?
  - Are the suggested improvements to definition and consistency of terms helpful?
  - Should the guidance provide more information to describe the treatment of direct and indirect costs and demonstrate their efficiency?

- Should the guidance provide better explanation of the roles and responsibilities in relation to ensuring the costs of a contract are *Allowable*?
- Should the guidance distinguish more clearly between the information reported in a company's financial statements and reports on individual contracts?

## **7. Conclusion**

- 7.1 The SSRO welcomes views from stakeholders on the questions in section 6 and on any other aspect of this working paper. While there is a programme of engagement with defence contractors and the MOD through the Operational Working Group and separate workshops, the SSRO also invites stakeholders to discuss any of the issues raised in this working paper with the SSRO on an individual basis.
- 7.2 Once the SSRO has reflected on the comments received on this, and the other two working papers being published at the same time, draft changes to guidance will be included in a public consultation document which will be issued at the beginning of October, giving stakeholders the opportunity for further comment and engagement over a six week period. The publication of the final guidance is scheduled for January 2018 but the SSRO will consult on the implications of releasing the new guidance at this time.



Appendix 1: Accounting-related terminology used in the current guidance

Term used in guidance	Reference to 2016 SSCRs	Suggested revised term	Suggested definition
Costing system	7.5, 9.11, 11.3		A costing system is designed to monitor the costs incurred by a business.
Costing methodology	7.5		Approach to determining and calculating costs. No one single methodology is appropriate for every situation so a variety are often used.
Direct cost	7.6, 7.12		See paragraph 5.14.
Overhead	7.6, 7.13	Remove term and use indirect costs throughout for consistency.	
Indirect cost	7.6, 7.13		See paragraph 5.16.
Normal accounting system	7.7, 11.2	Remove use of the normal as accounting systems are contractor specific.	An accounting system is the system used to manage the income, expenses, and other financial activities of a business. A costing system is a sub-system within an accounting system.
Generally accepted accounting principles	7.7, 8.5, 9.7, 9.18, 9.25		A collection of commonly-followed accounting rules and international standards for financial reporting.
Sunk costs	7.9		Prior costs which have been incurred or committed normally before a defence contract has become a QDC or QSC.
Apportion	7.13, 9.27	Define cost apportionment.	The assignment of common indirect costs among various cost centres or projects.
Cost accounting practices	8.4, 11.1	Delete this term and replace with generally accepted accounting principles.	
Recovered / recovery	8.4, 9.6, 9.10, 9.19, 9.20		Full cost recovery means ensuring an organisation recovers the full cost of delivering a service or project. Costs can be over or under recovered.
Contractor's own rates	9.6	Delete this reference as it is incorrectly being used to describe the contractor's internal	

**Allowable Costs – Working Paper (Cost Accounting and Financial Reporting Issues)**

<b>Term used in guidance</b>	<b>Reference to 2016 SSCRs</b>	<b>Suggested revised term</b>	<b>Suggested definition</b>
		accounting policy.	
Indirect overhead	9.11	This should be amended to say indirect cost.	
Rates	9.14	Should be replaced with terms.	
Exceptional	9.16, 10.2, 10.3, 10.4	Replace with definition of abnormal cost.	
Allocated	9.18, 11.1	The term cost allocation should be defined.	Cost allocation is the process of identifying, aggregating, and assigning costs to cost objects. A cost object is any activity or item for which a company wants to separately identifiable measure costs.
Accounting standard	9.20	Change to generally accepted accounting principles.	See definition above.
Statutory accounts	9.25		Mandatory financial statements used to report the financial activity and performance of a business or company during its most recent financial year.
Abnormal cost	10.2		Abnormal Cost is an unusual or a typical cost whose occurrence is usually irregular and unexpected and due to some abnormal situation of the production.

## **Appendix 2: Ofwat Regulatory Reporting**

Water companies are required to produce, for each financial year, a set of Regulatory Accounts and supporting Accounting Separation - methodology statement.

The Regulatory Accounts consist of 4 sections:

1. Regulatory Reporting
  - Analyses the statutory accounts into the regulated business and non-regulated business
    - i. P&L, Balance Sheet, Cashflow and Net Debt
2. Price review and other segmental reporting
  - As per section 1 but analysed into Retail and Wholesale activities
    - i. Retail sub analysed into household and non-household
    - ii. Wholesale sub analysed into Water and Wastewater
  - Analysis of Grants and Contributions
  - Additional analysis of revenue
  - Reconciliation of revenues to the price control
3. Outcome performance table
  - Data relating to performance indicators, actual vs target and supporting narrative, e.g.
    - i. Leakage
    - ii. Interruptions to supply
    - iii. Sewer flooding
4. Additional regulatory information
  - Combination of financial and non-financial data
  - Financial data analyses Water and Wastewater into sub activities and includes unit cost data.

Detailed information for section 4 can be traced back to the Statutory Accounts and vice versa. The accounts also include:

- Independent Auditors Report
- Statement of Directors' responsibilities
- Regulatory Disclosures, e.g.
  - Accounting policies
  - Revenue recognition
  - Bad debt policy
- Disclosure of transactions with associates

### **Accounting separation – methodology statement**

The purpose of the methodology statement is to assist the reader of the Regulatory Accounts (Annual Performance Report), in particular to give information on how the company has met the requirements of the **Regulated Accounting Guidelines** (RAGs) for the attribution of costs between price control units and further subdivisions of costs by activity. It includes any material changes to the methodology from previous years.

## Allowable Costs – Working Paper (Cost Accounting and Financial Reporting Issues)

The statement explains the basis on which the accounts have been prepared and confirms that they have followed the general principles as set out in RAG2, being:

- Transparency
- Causality
- Non-discrimination
- No cross subsidy between price controls
- Objectivity
- Consistency
- Principal Use

# SSRO

Single Source  
Regulations Office

*Assuring value, building confidence*

## **Allowable Costs Working Paper – 2017/18 review**

Allowable Costs related to tangible and  
intangible assets

June 2017

## Contents

1.	Introduction	3
2.	Current guidance	3
3.	Stakeholder views	6
4.	Discussion of issues	7
5.	Relationship with the contract profit rate methodology	10
6.	Questions for stakeholders	10
7.	Conclusion	11

## **1. Introduction**

- 1.1 This working paper reflects the outcome of an initial review of the SSRO's current statutory guidance on Single Source Cost Standards (*Allowable Costs* Guidance). The Guidance was last updated on 1 July 2016. The SSRO has prioritised several areas where guidance can be improved during 2017. These are:
- a) Cost Accounting and Financial Reporting;
  - b) *Allowable Costs* associated with Tangible Assets and Intangible Assets; and
  - c) Specific Cost Types – Sales, Marketing and Bid costs, Entertainment costs and Faulty Workmanship and Reworks costs.
- 1.2 This working paper focuses on the topic of **Allowable Costs related to tangible and intangible assets** and reviews parts of sections 9 and 10 of the **current guidance**. In particular, the paper focuses on the following areas where the SSRO considers greater clarity would be beneficial:
- a) the distinction between the treatment of depreciation, amortisation, impairment and revaluation as they relate to tangible, and intangible assets and subsets thereof, such as goodwill;
  - b) the considerations relevant to the application of the AAR principles of the aforementioned cost items; and
  - c) improvements to definitions and the consistency of terms used.
- 1.3 The issue of working papers in advance of a public consultation on guidance changes is a new approach which the SSRO is adopting. This is to ensure that we understand the issues fully before proposing any changes to the guidance and to capture information and examples from stakeholders that will help ensure the right change is made, if any is required. As well as comments on the specific contents of this working paper we also welcome any comments on the approach.
- 1.4 Section 20 of the Defence Reform Act 2014 ('the Act') states that the SSRO must issue guidance about determining whether costs are *Allowable Costs* under qualifying defence contracts and qualifying sub-contracts. The SSRO aims to review its *Allowable Costs* guidance on an annual basis and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.5 This working paper has been issued to stakeholders on Monday 19 June 2017. Stakeholder views on these working papers are welcomed and should be sent to **Simon.McCullough@ssro.gov.uk** by Friday 21 July 2017. Comments on the working paper will inform the development of a public consultation document on statutory guidance changes in October and November 2017. The SSRO aims to publish the final guidance on 1 January 2018 and it would apply to new contracts from that date although we will consider applicability of the guidance in the consultation in the autumn.

## **2. Current guidance**

- 2.1 A defence contractor may incur costs related to investment in assets which they may use to deliver one or more single source defence contracts and seek to recover through contract prices. In the context of the single source regime, such expenses may be recovered as *Allowable Costs*, subject to the AAR principles and the return delivered through the contract profit rate. The scope as it relates to *Allowable Costs* is set out in Figure One.

Figure 1: Scope of discussion paper

		Within scope of Allowable Cost guidance
Asset class	Balance sheet item	Income statement expense
Non – current assets	Tangible fixed assets	Depreciation
		Impairment
		Revaluation
	Intangible assets	Amortisation
		Impairment
		Revaluation

2.2 This paper does not address matters in relation to leases, foreign exchange, financial instruments or other assets. The SSRO may look at these issues in future reviews of the guidance.

2.3 The SSRO has identified the sections of its current statutory guidance on *Allowable Costs* covering asset related expenses which it believes require review, with the aim of providing greater clarity in the practical application of the AAR principles in this area. In undertaking its review the SSRO has also taken into account previous stakeholder feedback on this topic.

2.4 There are several areas in the existing *Allowable Costs* Guidance which reference capital related items and their associated expenses.

### Depreciation, amortisation and impairment

Paragraph reference	Guidance
9.5	Any expenditure of a capital nature, including the raising of that capital, is generally not Allowable. However, depreciation, amortisation or impairment may be an Allowable Cost.
9.6	Depreciation and amortisation charges are to be calculated at the contractor's own rates, provided they are consistent, equitable and relate to the non-current assets. Re-valuations of assets have to be agreed by the Secretary of State if they are to be Allowable. There should be no recovery of depreciation charges where the costs have been recovered through other means.
9.7	The treatment of intangible assets, such as 'Goodwill', may be an Allowable Cost if the impairment action has been taken in accordance with generally accepted accounting principles and should be approved by the Secretary of State. Any increase in value of an intangible asset will not reduce Allowable Costs under the contract.



## Allowable Costs – Allowable Costs related to tangible and intangible assets

Paragraph reference	Guidance
9.20	Development expenditure that gives rise to an intangible asset should be attributed to the relevant product or products of the contractor. The intangible asset generated should fulfil the criteria set out in the relevant accounting standard and such expenditure will be charged direct to the products being developed. The costs of this research expenditure would be recovered through the costs of the relevant products when they are sold.
10.10	The costs of idle facilities or capacity is not generally Allowable unless after application of the Appropriate, Attributable and Reasonable criteria it is confirmed that those unused facilities: <ol style="list-style-type: none"> <li>a. are determined by the Secretary of State as necessary to meet uncertain defence demands;</li> <li>b. are of a strategic nature that the Secretary of State has determined may be called upon to enable, or support, urgent deployments; or</li> <li>c. are unused due to a change in government or defence policy which could not have been predicted by the contractor.</li> </ol>

- 2.5 The SSRO considers that the paragraphs listed above would be improved by creating a new section comprising paragraphs 9.5, 9.6, 9.7 on costs related to tangible and intangible assets. To the extent that the consideration of such costs are covered in paragraphs 9.20 and 10.10 this material would be included in this new section as necessary and cross referenced accordingly.
- 2.6 The aim of this new section would be to provide clearer guidance on the considerations which will be relevant to contractors in demonstrating that *Allowable Costs* related to tangible and intangible assets satisfy the AAR principles. In relation to the current guidance we would envisage updating the Guidance to:
- Better define ‘expenditure of a capital nature’ and reconcile the treatment of the cost of an asset at the time of acquisition and or production compared with the subsequent recognition of this as an expense for accounting purposes (paragraph 9.5);
  - Provide clearer guidance on the basis upon which depreciation and amortisation charges should be calculated to the extent these may be *Allowable Costs* and the relevance of ‘consistency’ and ‘equity’ in this context (paragraph 9.6);
  - Expand the guidance on revaluation and impairment to differentiate between asset classes (for example acquired intangibles on business combination and goodwill) in order to assist the contractor in providing evidence to the Secretary of State to demonstrate whether an accounting estimate associated with downward asset revaluation may be regarded as an *Allowable Cost* (paragraph 9.7).
  - Where relevant, delineate more clearly issues relevant to accounting treatments, cost recovery and the application of the AAR principles (paragraphs 9.20 and 10.10).
- 2.7 A set of more detailed proposals are outlined in section 4.

### 3. Stakeholder views

3.1 This section sets out comments made by the MOD in previous SSRO consultations.

#### Industry

Stakeholder feedback
There are occasions when assets are purchased for the exclusive use of a single contract. It is our understanding (defence contractor) that in these special circumstances, provided the assets fulfil the AAR criteria, they could be included as an <i>Allowable Cost</i> . It would be helpful for the <i>Allowable Costs</i> guidance to highlight that there are cases where capital expenditure may be <i>Allowable</i> as a direct contract charge.
The reference included in paragraph 9.6 to ‘There should be no recovery of depreciation charges where the costs have been recovered through other means’ should be limited to no recovery where recovered from the MOD through other means.
Depreciation of individual buildings to an overhead recovery rate used in the pricing or reporting of a qualifying contract should not be restricted to those buildings used to fulfil the requirements of that contract else there will be an impossibly high number of rate numerators and denominators. It matters that the basis of indirect cost apportionment is reasonable, equitable and consistently applied; not that each indirect cost is necessary to fulfil the requirement of that contract.
The section of the guidance on depreciation, amortisation and impairment does not clearly distinguish between these very different accounting treatments.
The SSRO needs to give consideration within the statutory guidance on <i>Allowable Costs</i> to those types of costs that only appear in consolidated financial statements, (e.g. Goodwill impairment and impairment/amortisation of those intangible assets that arose as a consequence of initial recognition on business combination), and those costs that are only required to be computed and disclosed for the group or intermediate holding company (e.g. IAS 19 for group schemes). Consideration also needs to be given by the SSRO within the statutory guidance as to the extent to which costs and credits arising as a consequence of (1) IAS 39 and the treatment of fair value hedging, and (2) IAS 21 should be recognized as costs.
The SSRO needs to separately consider 3 types of intangible assets - assets acquired in the day to day execution of an ongoing business; intangible fair value assets recognised by the acquirer on business combination; and goodwill.

#### Ministry of Defence

Stakeholder feedback
Where an asset has been paid for by the MOD in advance of or at the start of a contract then there should be no associated depreciation charges as <i>Allowable Costs</i> .
The treatment of intangibles requires greater attention in guidance than that of tangible assets.
The principles of attribution should apply to intangibles.

### Stakeholder feedback

The consideration of costs in relation to idle facilities needs to take into account the circumstances which mean that the asset is being retained.

## 4. Discussion of issues

4.1 This section of the working paper discusses the following themes and invites stakeholder comments:

- Accounting terminology;
- Recognition of an asset;
- Depreciation;
- Amortisation and Impairment;
- Revaluation; and
- Application of the AAR principles to balance sheet-related expenditure.

### Accounting terminology

4.2 Appendix 1 to this working paper contains a list of terms and phrases used throughout the Section 9 of the *Allowable Costs* Guidance ('Guidance') that could be subject to misinterpretation in the context of financial reporting and cost accounting terminology. Appendix 1 contains cross references to their position in the current guidance.

4.3 The SSRO considers that it is appropriate to review the usage and definitions of these terms, with the aim of improving the clarity of the guidance, with a particular objective of ensuring that the guidance can be used by accountants and non-accountants alike. Some suggestions are made in Appendix 1 but this will be addressed in the consultation draft. The SSRO welcomes any comments on Appendix 1.

### Recognition of an asset

4.4 A contractor may be able to claim the expenses of generating/acquiring an asset from the MOD, either expensed over the life of a contract or in total at the time the expense was incurred, depending on the accounting treatment or the contract terms agreed. Where there has been no expense to the contractor, or the contractor did not fund the generation or acquisition of the asset, the contractor may not be able to demonstrate how the expense satisfies the AAR principles.

4.5 The contractor, in order to determine whether a capital related expense is attributable, should consider what role existing or newly acquired assets will play in the delivery of a contract. In some cases, assets can be attributable to the contract but have been provided by someone else e.g. the MOD.

4.6 There are two categories for a company's fixed assets, tangible and intangible. These assets are reflected on a company's balance sheet but there are different issues associated with them. Paragraphs 9.5 – 9.7 may benefit from a clearer distinction between various matters, including asset and depreciation, amortisation and impairment charges.

## **Allowable Costs – Allowable Costs related to tangible and intangible assets**

4.7 The current guidance (paragraph 9.5) states that:

*Any expenditure of a capital nature, including the raising of that capital, is generally not Allowable. However, depreciation, amortisation or impairment may be an Allowable Cost.*

4.8 The SSRO considers that these sentences could be replaced to improve clarity and reflect that some of the points set out in the paragraphs below.

4.9 In some circumstances a contractor may utilise or provide access to existing assets in the delivery of a contract. In other circumstances the creation of a new balance sheet asset may be necessary. Examples include:

- Construction of a new asset;
- Purchase of property, plant or equipment;
- Internally generated intangible assets, such as development of intellectual property; and
- Acquisition of a business.

4.10 The contractor and MOD will have to consider the circumstances which led to the recognition of an asset in determining whether the costs of acquiring or generating it support the AAR principles. This is both to ensure contractors are able to recover the costs of assets whose purpose (in whole or in part and subject to the AAR principles) is to deliver MOD single source contracts, but also to avoid double counting.

4.11 For the purposes of the AAR principles, it should be possible to demonstrate that the cost of an asset has been financed by the contractor's equity or debt and not already been recovered. Those elements of cost which relate to the asset and have been financed directly or indirectly by the MOD should not be subject to further recovery. Examples of circumstances in which there may be a potential risk of over recovery of costs by a contractor may include a facility constructed and paid for directly by the MOD under a previous contract or intellectual property arising from MOD funded development activity. Financial returns and financing costs related to the ongoing usage of an asset employed in the delivery of MOD contracts are provided through the capital servicing adjustment in the contract profit rate.

4.12 The accounting expenses recognised in profit and loss may be *Allowable Costs* if they satisfy the AAR principles. The next sections deal with these expenses individually.

### **Depreciation**

4.13 Depreciation is a charge applied to fixed assets only. The useful life of such assets is more than one year and is determined by the individual company in accordance with general accepted accounting principles.

4.14 A contractor will have its own accounting policies which determine the value of an asset at initial recognition and measurement subsequent to this. The SSRO is not prescriptive in relation to the accounting policy that a contractor applies, such as the method of depreciation (e.g. straight line or reducing balance) or the useful economic life of an asset. Nevertheless, it is the responsibility of the contractor to demonstrate that where these policies inform the basis of a charge to the MOD for use of an asset, these are consistent with the AAR principles.

### **Amortisation and Impairment**

4.15 Paragraph 9.5 states that amortisation and impairment may be an *Allowable Cost*.

## **Allowable Costs – Allowable Costs related to tangible and intangible assets**

- 4.16 Business combinations, such as the acquisition of a company or business can result in the creation of goodwill. Goodwill is an intangible asset and may be recognised on a company's balance sheet. This goodwill will be initially measured when a merger or acquisition takes place and could be subsequently re-measured in accordance with the accounting standards which contractors will apply as part of their financial reporting arrangements.
- 4.17 In a typical scenario, the SSRO would not expect the payment of goodwill to be *Allowable* because it is not an expense; it is an intangible asset. The cost of inefficient or inappropriate acquisitions should be borne by the company's shareholders. There may also be unusual cases where decisions taken by the MOD (e.g. cancelling other contracts) may damage the goodwill of an acquired company and result in an adverse financial impact for the contractor which also need to be considered. The cost of acquired assets should be recovered through the cash generating assets of which the goodwill is part. Consequently, any amortisation and impairment which relates to goodwill (this will depend on the accounting practices of the firm) will also not typically be *Allowable*.
- 4.18 There may be circumstances however where the assets recognised on business combination to which the goodwill relates are primarily for the purpose of delivering an MOD single source contract. In such cases, consideration may need to be given to any benefits to the MOD of the contractor acquiring these assets above their book value and factor this into any AAR assessment.
- 4.19 Intellectual property may arise from work funded by the MOD. We are interested to hear views on how the AAR principles would be applied to products that exploit that intellectual property in such scenarios.
- 4.20 Generally accepted accounting principles require companies to keep under review the carrying values of fixed assets and intangible assets, including goodwill, on their balance sheet. The SSRO expects contractors to adhere to these principles. Where there is a significant change in the carrying value of an asset in the company's accounts versus the current market value, the associated treatment should be discussed and agreed with the MOD.
- 4.21 Contractors should be able to demonstrate that any accumulated depreciation of tangible assets, amortisation of intangible assets, revaluations and impairment losses to be recovered from the MOD are reflective of the cost of delivering the contract. Consideration should be given to the impact on the overall level of cost recovery arising from revaluation or impairment action that changes the depreciation or amortisation period. The audit trail associated with these items must therefore be sufficiently detailed to allow the MOD to satisfy itself any such items satisfy the AAR principles.

### **Revaluation**

- 4.22 The current Guidance (paragraph 9.6) states that:

*Revaluations of assets have to be agreed by the Secretary of State if they are to be Allowable.*

- 4.23 The SSRO considers that it is correct that revaluations of assets, either to increase or decrease their value, need to be fully understood by the MOD and any *Allowable Costs* associated with them agreed. We would be interested to hear from contractors who adopt a revaluation model to measurement after initial recognition (section 17 and 18 of FRS 102).

### **Application of the AAR principles to balance sheet-related expenditure**

- 4.24 The SSRO considers the aim in the application of the AAR principle in the context of capital related expenses is to be able to establish a monetary estimate, to be charged to the MOD,

## Allowable Costs – Allowable Costs related to tangible and intangible assets

which is commensurate with the consumption or usage of an asset paid for and employed by a contract in delivering a QDC or QSC. This may occur through direct costs to the contract or as indirect costs recovered. We are interested in understanding the approaches contractors typically adopt and their relative merits.

4.25 The SSRO's Guidance is principles-based and therefore does not prescribe the approach to making an assessment of whether costs relating to tangible and intangible assets satisfy the AAR principles. However, we consider it is appropriate that the guidance sets out considerations that may be relevant in the decision as to whether an expense may be *Allowable* or not.

4.26 The following questions should be considered in respect of the AAR principles related to expenditure of a capital nature:

- Is it **appropriate** to expect the MOD to reimburse the contractor for asset related costs?
- To what extent is the capital employed in the delivery of the contract and consequently the related expense **attributable** to the contract and the MOD?
- Do the policies relating to initial measurement and measurement after initial recognition give rise to a **reasonable** charge to the MOD in relation to the use of assets?
- Is there **certainty** that there has been no double recovery of costs?

## 5. Relationship with the contract profit rate methodology

5.1 Some stakeholders have previously put forward a proposal to change the measure of profit in the baseline profit rate from EBIT to EBITA or EBITDA. This would lead to a relative increase in contract profits, by in effect introducing a flat rate payment for depreciation and amortisation, through the baseline profit rate.

5.2 The SSRO has considered two issues in relation to such a change:

- It may result in double counting, since in addition to payments through the baseline profit rate, contractors may be paid their cost of investing in assets as *Allowable Costs* as they are incurred, or on a deferred basis through depreciation and amortisation; and
- the consistency of the capital base used to determine payments to contractors for their investment in assets as *Allowable Costs* and their return on those assets through the Capital Servicing Adjustment.

5.3 Given these issues, the SSRO considers that it is not appropriate to revise the profit methodology or the allowable costs guidance in isolation from each other because to do so risks unintended consequences that could result in an imbalance between value for money for the taxpayer and fair and reasonable returns for contractors.

5.4 The SSRO welcomes quantitative evidence on this matter.

## 6. Questions for stakeholders

6.1 The SSRO asks stakeholders for views on the following questions in regard to expenditure of a capital nature:

- What are the difficulties with applying the AAR principles and the existing guidance to costs associated with tangible and intangible assets?

## **Allowable Costs – Allowable Costs related to tangible and intangible assets**

- Are the principles set out in this paper appropriate in regard to the recovery of costs associated with tangible and intangible assets?

### **7. Conclusion**

- 7.1 The SSRO welcomes views from stakeholders on the questions in section 6 and on any other aspect of this working paper. While there is a programme of engagement through the SSRO's Operational Working Group and separate workshops, the SSRO also invites stakeholders to discuss any of the issues raised in this working paper with the SSRO on an individual basis.
- 7.2 Once the SSRO has reflected on the comments received on this, and the other two working papers being issued at the same time, draft changes to the guidance will be included in a public consultation document which will be published at the beginning of October, giving stakeholders the opportunity for further comment and engagement over a six week period. The publication of the final guidance is scheduled for January 2018 but the SSRO will consult on the implications of releasing the new guidance at this time.

**APPENDIX 1 – Definitions**

<b>Term used in guidance</b>	<b>Reference to 2016 SSCRs</b>	<b>Suggested revised term</b>	<b>Suggested definition</b>
Depreciation	9.6		Depreciation is an accounting method of recognising the cost of a tangible asset over its useful life.
Amortisation	9.6		Amortisation is an accounting method of recognising the cost of a tangible asset over its useful life.
Impairment	9.5, 9.7		Impairment is an accounting principle that describes a permanent reduction in the value of a company's asset.
Expenditure of a capital nature	9.5	Fixed assets	Fixed assets are a company's tangible, noncurrent assets that are used in its business operations. A common example of fixed assets are property, plant and equipment.
Non-current assets	9.6	Fixed assets	See fixed assets.
Re-valuation	9.6		Revaluation of a company's assets takes into account inflation or changes in fair value since the assets were purchased or acquired.
Intangible asset	9.7		An asset that is not physical in nature. Examples of which are intellectual property, goodwill and brand recognition.
Goodwill	9.7		Goodwill is an intangible asset recorded after a company acquires assets and liabilities normally following an acquisition or merger, and pays a price in excess of the asset's identifiable value.
Net book value	New reference		The value at which a company carries an asset on its balance sheet. It is equal to the cost of the asset minus the accumulated depreciation.





Single Source  
Regulations Office

*Assuring value, building confidence*

# **Allowable Costs Working Paper – 2017/18 review**

- Sales, Marketing and Bid Costs
- Entertainment Costs
- Faulty Workmanship and Reworks Costs

June 2017

**Allowable Costs – Working Paper  
(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

**Contents**

1.	Introduction	3
2.	Current Guidance	4
3.	Key outcomes from referrals	6
4.	Stakeholder views	8
5.	Discussion of issues	10
6.	Relationship with profit	17
7.	Questions for stakeholders	18
8.	Conclusion	18

## Allowable Costs – Working Paper

(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)

### 1. Introduction

- 1.1 This working paper reflects the outcome of an initial review of the SSRO's current statutory guidance on Single Source Cost Standards (*Allowable Costs* Guidance). The Guidance was last updated on 1 July 2016. The SSRO has prioritised a number of areas where guidance may be developed during 2017. These are:
  - a) Cost Accounting and Financial Reporting;
  - b) *Allowable Costs* associated with Tangible Assets and Intangible Assets; and
  - c) Specific Cost Types – Sales, Marketing and Bid costs, Entertainment costs and Faulty Workmanship and Reworks costs.
- 1.2 This working paper focuses on the topics of **Sales, Marketing and Bid costs, Entertainment costs and Faulty Workmanship and Reworks costs**. The approach to these costs is included in section 9 of the **current guidance**:
  - a) Sales and Marketing costs (paragraph 9.26 and 9.27);
  - b) Bid costs (paragraph 9.28 and 9.29);
  - c) Entertainment costs (paragraph 9.30); and
  - d) Faulty workmanship and reworks costs (paragraphs 9.33 – 9.36).
- 1.3 Risk is addressed in paragraphs 9.8 – 9.10. The SSRO is undertaking a separate study on this topic which will produce findings which will provide a basis for revisions to the guidance. Stakeholders are invited to contact the SSRO separately on this topic.
- 1.4 The issue of working papers in advance of a public consultation on guidance changes is a new approach which the SSRO is adopting. This is to ensure that we understand the issues fully before proposing any changes to the guidance and to capture information and examples from stakeholders that will help ensure the right change is made, if any is required. As well as comments on the specific contents of this working paper we also welcome any comments on the approach.
- 1.5 Section 20 of the Defence Reform Act 2014 ('the Act') states that the SSRO must issue guidance about determining whether costs are *Allowable Costs* under qualifying defence contracts and qualifying sub-contracts. The SSRO aims to review its *Allowable Costs* guidance on an annual basis and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.6 This working paper has been issued on Monday 19 June 2017. Stakeholder views on this working paper are welcomed and should be sent to **Simon.McCullough@ssro.gov.uk** by Friday 21 July 2017. Comments on the working paper will inform the development of a public consultation document on statutory guidance changes to be published in October 2017. The SSRO aims to publish the final guidance in January 2018 and it would apply to new contracts from that date although we will consider applicability of the guidance in the consultation in the autumn.

**2. Current Guidance**

2.1 The current Guidance on Sales, Marketing and Bid costs is set out in Table 1 below.

**Table 1 – Current Allowable Costs guidance on sales, marketing and bid costs**

Current paragraph reference	Guidance
9.26	Marketing and sales costs should only be considered <i>Allowable</i> if they are demonstrably linked to a qualifying defence contract or qualifying sub-contract. Marketing and sales costs may include such items as salary costs and related staff expenses (travel and subsistence), marketing and sales campaigns, sponsorships and other related commercial activities, and in general should be retrospective in nature.
9.27	A demonstrable link should be made that evidences financial benefit to the qualifying contract or qualifying sub-contract in question as a result of the particular sales and marketing expenditure. This may include a reduction to the overheads apportioned to the qualifying defence contract or qualifying sub-contract from a relevant qualifying business unit.
9.28	Bid costs, which were incurred for the qualifying defence contract or qualifying sub-contract, if properly evidenced may be <i>Allowable</i> .
9.29	In addition, bid costs may include for instance staff costs to prepare and review proposals, and may be more appropriate to be charged directly to the contract, rather than being apportioned as indirect costs.

2.2 The SSRO also regularly publishes SSRO Answers which are based on queries that are received via the SSRO’s Helpdesk. Answer 2.5 below considers marketing costs. This additional guidance has not been incorporated into the statutory guidance and the SSRO is using this working paper as the opportunity to consider whether its inclusion is merited.

**Are marketing costs Allowable?<sup>1</sup>**

*Costs included in QDCs and QSCs (must be appropriate, attributable and reasonable if they are to be ‘Allowable’ under the Defence Reform Act 2014 (Section 20(2)(a)-(c)). The SSRO’s guidance on Allowable Costs states that marketing costs can only be considered Allowable if they are ‘demonstrably linked to a qualifying defence contract’ (10.14). Additionally, marketing costs must be incurred in the delivery and conduct of the QDC in question for the costs to be appropriate and attributable (9.2 and 9.3).*

*We would not normally regard as Allowable marketing costs incurred on export campaigns in anticipation of potential future sales of the same product or services being delivered to the MOD under a QDC. We would however expect the MOD to be interested in securing some of the benefits of future sales to other customers for the UK taxpayer. This can be achieved through contract terms that provide for rebates to MOD contingent upon future sales. It is not a requirement of such arrangements that marketing costs should be paid for upfront by MOD.*

<sup>1</sup> The paragraph references in this answer refer to an earlier version of the Allowable Costs guidance.

## Allowable Costs – Working Paper

(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)

*Furthermore, it is a better allocation of commercial risk for the marketing costs to be borne by the party directly incurring those costs, incentivised to secure further sales both for its benefit and for the benefit of its major UK customer.”*

- 2.3 The current guidance on Entertainment costs is set out in Table 2 below. There have been no SSRO Answers on this topic.

**Table 2 – Current *Allowable Costs* guidance on entertainment costs**

Current paragraph reference	Guidance
9.30	Entertainment expenses of any sort are not <i>Allowable Costs</i> .

- 2.4 The current guidance on Faulty Workmanship and Reworks costs is set out in Table 3 below.

**Table 3 – Current *Allowable Costs* guidance on faulty workmanship and rework costs**

Current paragraph reference	Guidance
9.33	The cost of rework and wastage may be <i>Allowable</i> if it meets the principle of being <i>Appropriate, Attributable and Reasonable</i> . These costs have to be agreed between the contractor and the Secretary of State based on the expected level of rework and wastage given the nature of the contract in question.
9.34	Contractors must have appropriate quality management systems in place and be able to evidence the causes of rework and wastage.
9.35	Rework and wastage costs arising from experimental manufacturing processes agreed as part of the contract with the Secretary of State may be <i>Allowable</i> .
9.36	Conversely, damages or compensation or loss of profit for poor performance, such as faulty workmanship or breach of contract are not <i>Allowable Costs</i> .

- 2.5 The SSRO Answer (2.2) provides some additional guidance on reworks which resulted following the first opinion. The SSRO is keen to hear stakeholder views on whether this provides additional clarity which should be incorporated into guidance.

### **Is rework an *Allowable Cost*?**

*The cost of rework will similarly be Allowable if it meets the principle of being appropriate, attributable and reasonable and is agreed between the contractor and the Ministry of Defence (MOD), who will have regard to our guidance on Allowable Costs.*

*For example:*

1. **First in Class** - rework which occurs during the process of manufacturing an item for the first time would generally be considered Allowable.
2. **Re-specification** - rework which occurs due to a change in design specification from the MOD would generally be considered Allowable.
3. **Faulty Workmanship** - the costs of rework due to faulty workmanship or the consequences that result from faulty workmanship are generally non Allowable. Similarly, rework that is a result of a contractor not delivering a specification would generally be non-Allowable.

*To demonstrate that rework is appropriate, attributable and reasonable the contractor will clearly need to be able to measure reliably how much rework falls into the various categories outlined above.*

- 2.6 The SSRO's statutory guidance takes precedence over **SSRO Answers**, and we recognise the need to ensure that such publications which are supplementary to the statutory guidance are kept under review to ensure that they are not contradictory.

### **3. Key outcomes from referrals**

#### ***Sales, marketing and bid costs***

- 3.1 A question referred to the SSRO in December 2015 related to the extent to which sales and marketing costs provided in the Contract were *Allowable Costs* within the meaning of Section 20(2) of the Act.
- 3.2 It was the SSRO's determination in May 2016 that the sales and marketing costs under dispute were not *Allowable Costs* on the basis that the contractor had not provided sufficient evidence to demonstrate that the costs are appropriate, attributable to the contract and reasonable in the circumstances (the AAR principles). The Single Source Cost Standards<sup>2</sup> did not require sales and marketing costs to be directly attributed to a contract to enable them to be *Allowable Costs*, but they must have a demonstrable link to the QDC in question. It was not the SSRO's determination that all sales and marketing costs, direct or indirect, are not *Allowable*.
- 3.3 One of the reasons why the SSRO did not determine that costs were *Allowable* was the lack of supporting evidence for its arguments. It was the SSRO's determination that the burden of proof rests with the contractor to demonstrate such links and any such evidence should reflect the benefits to the contract from the successful sales and marketing efforts.
- 3.4 The determination aimed to outline what the contractor had failed to evidence, for instance, the contractor did not:
- articulate the sales and marketing costs to a sufficient level of detail to enable them to be properly understood;
  - provide evidence and demonstrate what assumptions are applied to these costs;
  - describe why this level of sales and marketing expenditure is appropriate to include in the estimated rates every year of the contract (i.e. the assumed cost allocation rate);

---

<sup>2</sup> Issued on 26 January 2015

## **Allowable Costs – Working Paper**

### **(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

- demonstrate how the costs will deliver benefits for the contract;
- provide calculations, supporting explanations or evidence in relation to the derived value of benefits put forward as evidence for the inclusion of costs;
- evidence that overheads for the contract were based on assumed future sales and that future sales and marketing will have a positive effect on the contract's overheads; and
- provide the basis of its speculative sales forecast and of underlying assumptions driving that calculation (i.e. how it determined the level of speculative sales, the soundness of those sales assumptions, the impact on cost for the contractor's defence business, the link between sales forecasts and indirect costs, and the impact on the direct and indirect costs of the contract).

- 3.5 The list of points above were not included in the statutory guidance during the 2016 review but the SSRO would welcome views as to whether incorporating it would improve understanding of what would be required to meet the AAR principles.
- 3.6 The SSRO set out in the determination that it does not prescribe upon what basis costs are linked to a contract, only that the supporting evidence and narrative should be provided on which a judgement can be made. The SSRO observes that any evidence provided to demonstrate a link between sales and marketing expenditure should be based on retrospective sales as evidence of the costs reducing over time and therefore founded in actuals rather than subjective forecasts and concomitant benefits. Any evidence should clearly articulate and demonstrate that the costs are linked to, and benefit, the QDC in question and that they satisfy the AAR principles.
- 3.7 The SSRO's determination did not preclude contractors from including sales and marketing in their costs, but did reiterate the need for evidence to be provided to the MOD, and made available to the SSRO for compliance and referral purposes.
- 3.8 The submission that export sales contribute to levy payments to the government was not considered to be relevant to the referral as the payments do not benefit the contract in question, and therefore do not support the sales and marketing costs supporting the AAR principles.
- 3.9 Bid costs that relate directly to a contract may be *Allowable* if they satisfy AAR principles and may be charged directly to the contract to which they relate, rather than being apportioned as indirect costs. For this specific case, evidence that these bid costs supported the AAR principles was not forthcoming.

#### ***Entertainment costs***

- 3.10 There have been no opinions or determinations on entertainment costs to date.

#### ***Faulty workmanship and reworks costs***

- 3.11 The SSRO's first opinion considered the extent to which the cost for reworks and defects and deficiencies included within the proposed Target Cost were *Allowable Costs*.
- 3.12 The SSRO's opinion stated that making the cost of re-work and defects and deficiencies Allowable under the Act, and reflecting this in the Single Source Cost Standards, would by definition enable these costs to attract profit based on the formula for determining contract price specified in Regulation 10 of the Regulations (i.e. price = AC + (CPR x AC)). Changing the definition in this manner may theoretically reward inefficiency, which was not the intent of the Currie Report and the resultant legislation, Regulations and published SSRO

## **Allowable Costs – Working Paper**

### **(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

Single Source Cost Standards. Any production inefficiency should represent a concomitant reduction to the bottom line, and in Target Cost contracts should constitute an impact to the share-line.

- 3.13 The SSRO's opinion was that cost disallowed by the parties for faulty workmanship and defects and deficiencies was within the bounds of reasonableness. However, the SSRO would have expected the contractor to have collated historic reworks data from which to make an accurate estimate of the costs that should be *Allowable*. The SSRO recommended that new and accurate measurement processes are put in place.
- 3.14 Reworks do not add value to the product and are factors that reduce the productivity of a company and increase the lead time for implementing the final product, making it uncompetitive compared to its main competitors<sup>3</sup>.

## **4. Stakeholder views**

- 4.1 Industry stakeholders have made specific comments to the SSRO in previous consultations about these cost types. These comments are set out below.

### ***Sales, marketing and bid costs***

- There was difficulty in understanding what is meant by the terms 'evidence' and 'demonstrable link' as well as what would be sufficient, and the guidance lacks specific examples to aid contractors with what is required.
- There were issues raised with the reference to 'retrospective' in the guidance, as contractors felt the long-term benefit of sales and marketing expenditure must be assessed and taken into consideration.
- 'Evidence' takes a lot of effort to produce and is only accepted if it is retrospective.
- The current approach taken ignores the benefit of spreading costs over the whole business base. An improvement in throughput by investing in sales and marketing in all competitive environments would mean, if successful, that the fixed costs of a company could be recovered over a larger number of throughput hours and therefore result in a reduction in the rate per hour charged.
- The principle of attributability needs to be examined. Some contractors have been told that sales and marketing costs are not attributable as the costs are not required for single source contracts.
- There may be a difference in treatment for different costs within the sales and marketing category as some costs are pure marketing and others are general relationship building and advantageous for the MOD's single source procurement as it enables the contractor and the customer's familiarity with capabilities, needs, organisation structures, and budgets.
- Disallowing bid and proposal costs on the grounds that such costs have not been incurred for the single source procurement is denying the activity to get to contract.

---

<sup>3</sup> Sustainable Maritime Transportation and Exploitation of Sea Resources – Rizzuto & Guedes Soares (eds) © 2012 Taylor & Francis Group, London, ISBN 978-0-415-62081-9



## **Allowable Costs – Working Paper**

### **(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

- 4.2 In addition, on 2 June 2017 ADS submitted the views of their Chief Finance Officer Steering Group to the SSRO on the cost types covered in this working paper. These views are included at paragraphs 4.3, 4.4, 4.8 and 4.10 below.
- 4.3 Industry consider sales and marketing to be a normal cost of doing business. Companies will only spend money on marketing and sales campaigns when it is calculated that the cost of winning an order is outweighed by the benefit the order will generate for the company via increased throughput in its factories. In light of this, industry disagrees with the principle that sales and marketing costs can only be allowable when export campaigns are successful. Ultimately, successful campaigns benefit the MOD as, for example, the recovery of all fixed and semi-variable overhead costs will be spread across a greater number of direct hours, resulting in a reduction of the hourly production rate for all work.
- 4.4 Industry wish to better understand what information the MOD would regard as sufficient to constitute ‘*a demonstrable link that evidences financial benefit to the qualifying contract or qualifying sub-contract in question as a result of the particular sales and marketing expenditure*’. It is imperative that the evidence requested is feasible for industry to provide.
- 4.5 The Ministry of Defence’s views on these costs are:
- The MOD agrees with the intent of the current Statutory Guidance but the wording needs further clarity.
  - The MOD have agreed sales and marketing costs are *Allowable* where the contractor can demonstrate increased throughput and benefit through reduced overheads, but generally contractors are not good at providing evidence to support their case.
  - MOD may agree the recovery of sales and marketing costs through overheads where it is in the Government’s interest to do so.
  - The term ‘demonstrably linked’ could be replaced with ‘benefit is demonstrated and it is greater than the costs to the MOD’.
  - Successful bid costs should only be *Allowable* if they are direct costs to a contract. They should not be included in overheads.
  - Unsuccessful bid costs may be *Allowable* through the overheads where the MOD has aborted the bid process.
- 4.6 The SSRO would like to understand whether there are aspects of its guidance on sales, marketing and bid costs which are unclear. In particular, stakeholders are encouraged to provide information on whether it is difficult to apply the AAR principles to these costs, especially given the need to demonstrate benefit to the MOD in relation to sales and marketing. These costs are discussed further in paragraphs 5.4 – 5.13.

### ***Entertainment costs***

- 4.7 The SSRO did not receive any specific comments about entertainment costs in the 2016 consultation on the *Allowable Costs* guidance but industry has indicated through its engagement with the SSRO that there may be cases where entertainment costs may be *Allowable*. The Ministry of Defence has indicated that these costs should remain not *Allowable* in all cases as set out in the SSRO’s current statutory guidance because they are concerned with the use of public money and that clarity of the definition of entertainment costs would be helpful.

## **Allowable Costs – Working Paper**

### **(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

4.8 Industry consider that in the wake of the Bribery Act 2010, companies have comprehensive policies on entertainment and hospitality. Therefore, practical and proportionate principles can be developed to deal with these cost elements in the price of single source contracts. The SSRO is keen to explore what these principles might be.

#### ***Faulty workmanship and reworks costs***

4.9 The SSRO has received the following comments from industry stakeholders in relation to this cost type:

- Some items are scrapped not reworked, these should be *Allowable*, for normal levels of scrap/yield, where the contractor is not negligent. Substantiation may require the provision of learning curves, historical non-conformance rates and quality control systems.
- Reworks, rectification and concessions are an intrinsic part of any process and therefore should be *Allowable*. Contractors should be encouraged to minimise reworks and potentially high levels should not be *Allowable*, but no process will ever give a 100 percent pass rate. This could be judged under industry or historic norms.
- There can be an agreed level of faulty workmanship which becomes reworks. Eliminating faulty workmanship is almost impossible and use of apprentices also needs to be considered.

4.10 Contractors have stated that they would welcome clarity and agreement on faulty workmanship, particularly around the distinction between it and the level of rework that would normally be expected as part of a contract of that type.

4.11 The MOD has shared the following views on these types of costs.

- Further work needs to be carried out on how quality control and efficiency feeds into the calculation of rework.
- MOD would expect suppliers to understand levels of efficiency and be able to demonstrate a plan for improvement where required.
- It is reasonable for the MOD to assume generally that there will be improvements which will result in a reasonable trajectory to reduce faulty workmanship, wastage and reworks over time.
- No manufacturing or production process will ever be 100 percent efficient and the MOD should not be paying contractors to do so.

## **5. Discussion of issues**

5.1 The SSRO is of the view that the considerations in relation to these individual cost types is different and can be summarised below:

- a) **Sales and Marketing costs** – benefit to the MOD must be demonstrated and costs should be lower than the benefit realised.
- b) **Bid costs** – must be a direct cost to a contract.
- c) **Entertainment costs** – not Allowable under any circumstances.

## **Allowable Costs – Working Paper**

### **(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)**

d) **Faulty Workmanship and Reworks costs** – should be measured and shown to be reasonable with an expectation that they will reduce as learning and efficiency have an impact.

5.2 This section of the working paper discusses the issues associated with these cost types. The SSRO intends to keep its guidance principles rather than rules based, however it recognises that within certain cost types there may be cases where some elements of the same cost type may be judged to be Allowable whereas others are less likely to be and that specificity would be helpful to those trying to apply guidance consistently.

5.3 The SSRO is seeking evidence from contractors about why the current guidance may need to be amended, ideally with examples that support the reason for change.

#### ***Sales, marketing and bid costs***

5.4 Guidance on sales, marketing and bid costs is included in paragraphs 9.26 – 9.29 of the current guidance document.

5.5 Defence contractors are likely to have a sales and marketing function. The costs of these functions often reflect investment choices by companies and as a result they can be considerable as they cover a range of different activities (campaigns, travel and subsistence and sponsorships) as described in paragraph 9.26 of the guidance. These costs will typically be captured in corporate overheads which can be recovered across various aspects of a defence company's business or they may be a direct charge to a contract.

5.6 The defence contractor must consider whether it is appropriate for the MOD to pay for those costs. Firstly, the contractor needs to be sure that these costs will not be recovered through other means. For example, if the product being delivered by the single source contract could also be exported, the sales and marketing costs could form part of the export price or another part of government may fund the export campaign. In these cases the charging of sales and marketing costs to the MOD would not be appropriate as they will be recovered through a different mechanism.

5.7 The extent to which a contractor can articulate and monitor their sales and marketing costs could also help them to identify whether it is appropriate to charge the MOD for all costs or an element of these costs. The SSRO has heard examples of defence contractors who have confirmed that they do not separate out the different elements of their sales and marketing costs or monitor actual costs against particular products. Some sales and marketing costs will be more appropriate to charge to the MOD than others and therefore this ability to separate out these types of cost is important. For example, liaison activity with the MOD may be categorised as sales and marketing costs and may be more appropriate to charge than events aimed at other customers.

5.8 The SSRO uses the term 'demonstrably linked' in paragraph 9.27 of its Guidance and notes that the term 'attributable' is one of the AAR principles. In the updated Guidance the SSRO may explain that demonstrably linked and attributable are equivalent terms. The MOD has suggested in paragraph 3.3 that the focus should be on demonstrating benefit in addition to cost attribution.

5.9 Financial benefit to the MOD needs to have been realised (retrospective effect) and have resulted in reduced costs of the contract than had there been no sales and marketing activity. Therefore, the benefit needs to be quantifiable, such as in increased throughput which results in a reduction to corporate overheads or recovery rates applied to the contract. This would form part of the evidence that may result in the costs meeting the AAR principles.

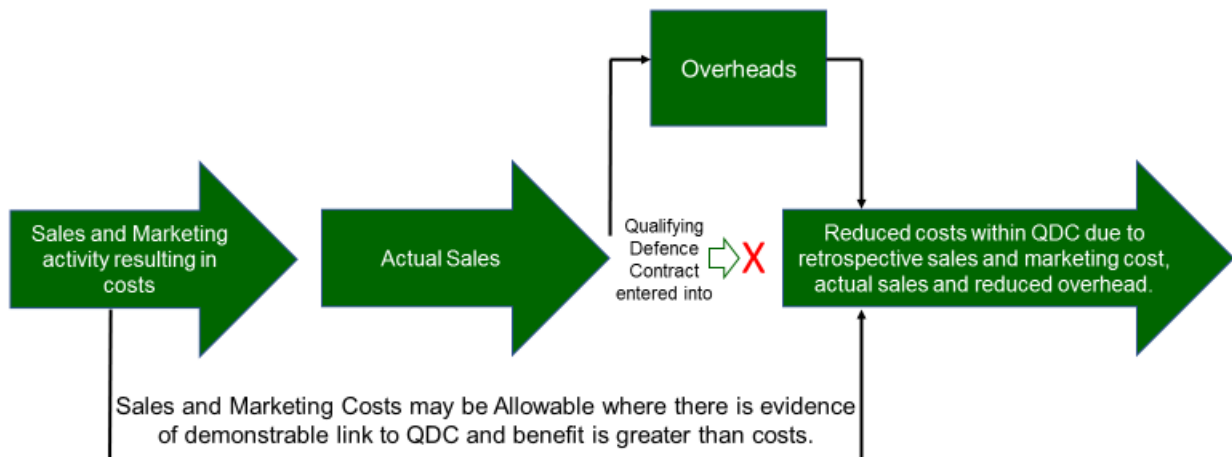
## Allowable Costs – Working Paper

(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)

5.10 When considering whether costs are reasonable there might be two aspects to look at. Firstly, are the costs themselves reasonable in the circumstances. For example, contractors may benchmark data on sales and marketing costs which could demonstrate the costs are reasonable when compared to those of competitors. The success rate of converting sales and marketing activity to sales might also indicate that the costs invested were reasonable to have committed in the first place.

5.11 Figure 1 below, illustrates the points made above.

**Figure 1: Retrospective nature of sales and marketing costs**



5.12 The SSRO considered it helpful to also review its Guidance on bid and proposal costs as the principles which apply are similar, in that these costs may satisfy the AAR principles and be considered *Allowable*. Contractors have stated that they have at times found it difficult to discuss these costs with the MOD because there is an assumption that because there has been no competitive process then any costs to the contractor will be minimal. The MOD have made clear that these costs may be *Allowable* if they are direct costs.

5.13 The SSRO recognises that contractors may have been in a competitive situation before the contract award converts to a single source arrangement. Preparation of single source contracts can also take considerable time and effort. Therefore, there may be cases where bid costs may be *Allowable* and the MOD project team would be best placed to understand the reasonableness of bid costs and agree with the contractor whether they are *Allowable*. The extent to which these costs can be tracked, demonstrated and evidenced should support this.

### ***International comparisons***

5.14 Below for reference is guidance from the United States and Australia on sales and marketing costs. This appears to be broadly consistent with the statutory guidance on *Allowable Costs* although neither include the need to demonstrate the link to the contract. We welcome stakeholder views on how this compares to the SSRO's guidance.

## Allowable Costs – Working Paper

(Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)

### United States FAR 31.205-38 (only relevant paragraphs included)

- (b) Advertising costs are defined at 31.205-1(b) and are subject to the allowability provisions of 31.205-1(d) and (f). Corporate image enhancement activities are included within the definitions of public relations at 31.205(a) and entertainment at 31.205-14 and are subject to the allowability provisions at 31.205-1(e) and (f) and 31.205-14, respectively. Bid and proposal costs are defined at 31.205-18 and have their allowability controlled by that subsection. Market planning involves market research and analysis and generalized management planning concerned with development of the contractor's business. The allowability of long-range market planning costs is controlled by the provisions of 31.205-12. Other market planning costs are allowable to the extent that they are reasonable. Cost of activities which are correctly classified and disallowed under cost principles referenced in this paragraph (b) are not to be reconsidered for reimbursement under any other provision of this subsection.
- (c) Direct selling efforts are those acts or actions to induce particular customers to purchase particular products or services of the contractor. Direct selling is characterized by person-to-person contact and includes such activities as familiarizing a potential customer with the contractor's products or services, conditions of sale, service capabilities, etc. It also includes negotiation, liaison between customer and contractor personnel, technical and consulting activities, individual demonstrations, and any other activities having as their purpose the application or adaptation of the contractor's products or services for a particular customer's use. The cost of direct selling efforts is allowable if reasonable in amount.
- (d) The costs of any selling efforts other than those addressed in paragraphs (b) or (c) of this subsection are unallowable.

### Australian Government Capability Acquisition and Sustainment Group Cost Principles (September 2015 – Section 52)

Selling and promotional costs which are common to the marketing of the contractor's products to defences and to other commercial customers, may be allowable to the extent the costs are within the definition of contract cost, and are of the nature of:

- a) providing technical data and specifications;
- b) disseminating printed matter containing instructions for operating and maintaining the contractor's products;
- c) liaison between customer representatives and the contractor's personnel; and
- d) other similar activities.

5.15 The Public Services Procurement Canada Supply Manual is about to be reviewed but includes a bulletin on **sales and marketing expenses** and one on **bid and proposal costs**.

5.16 Table 4 below sets out the SSRO's views on the key points that the Guidance on this cost type could reflect.

Table 4 – Focus of guidance on Sales, Marketing and Bid costs

**Key points**

- Sales and marketing and bid and proposal costs need to have been incurred in advance of the contract in question.
- If recovered through other means then costs would not be *Allowable*.
- The benefit of sales and marketing needs to have been realised and outweigh the costs.
- Bid costs need to be attributable to the contract and charged as a direct cost.

**Entertainment costs**

- 5.17 Paragraph 9.30 of the current *Allowable Costs* Guidance is clear that all entertainment costs are not *Allowable Costs*. The SSRO and the MOD still consider this to be the right approach. However, the SSRO is keen to hear from stakeholders about possible one-off exceptional cases where entertainment costs may satisfy the AAR principles.
- 5.18 A particular example where this might be the case, which has been stated to the SSRO is where a launch ceremony is required for a new submarine or ship. The MOD and the contractor may have agreed during the contract negotiations that this is a key component or term of the contract..
- 5.19 Entertainment costs, although often a small proportion of overall costs, can attract public attention, especially as these costs may attract an element of profit. To the extent that entertainment satisfied AAR principles, alternative arrangements that do not apply profit to these costs may be relevant.
- 5.20 Some contractors have stated that entertainment costs may actually be an employment cost (for example, bonuses or long service awards). The SSRO does not consider that such costs would satisfy the AAR principles but is open to stakeholder views on this.

**International comparison**

- 5.21 Guidance below from the United States and Australia on entertainment costs appears to provide more detail than the SSRO's guidance in terms of identifying the different elements of this cost type and it is clear that there is consistency of approach taken by both these countries. The Australian guidance considers exceptions to the overall not *Allowable* principle.

**United States FAR 21.205.14**

Costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs made specifically unallowable under this cost principle are not allowable under any other cost principle. Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees.

**Australian Government Capability Acquisition and Sustainment Group Cost Principles (September 2015 – Section 20)**

Entertainment costs are unallowable as a contract cost, to the extent that they are:

- a) costs of or incidental to, sale, distribution or promotion of its products;
- b) costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities; or
- c) costs of membership in social, dining or country clubs or other organisations having similar purposes.

Costs made specifically allowable under this principle are unallowable under any other principle.

Expenses associated with meeting and industry conferences, when called for the dissemination of technical information or discussion of production problems and the like, are allowable as a meeting cost. These latter expenses may include the cost of meals, transportation, rental of meeting places and other incidentals provided the costs are reasonable.

5.22 Table 5 below sets out potential ways in which the Guidance on this cost type may be developed.

**Table 5 – Focus of guidance on Entertainment costs**

**Key points**

- Entertainment costs which are allowable would be highly unusual.
- In exceptional cases, costs could be agreed with the MOD in advance of being incurred.
- Costs should not attract profit.

***Faulty workmanship and reworks costs***

5.23 The SSRO clarified its current *Allowable Costs* Guidance (paragraphs 9.33 – 9.36) following the opinion which considered this issue. The current Guidance deals with reworks in sufficient detail but is relatively silent on faulty workmanship so this is an area where further direction may be required.

5.24 The SSRO does not consider faulty workmanship and reworks to be a cost in the same way as sales and marketing or entertainment. Costs are generated as a result of something not happening as planned, fault that results because a process is complex or because a process is inefficient. Wastage can be planned or unplanned (due to fault on the contractor's part or caused by defects in materials provided by a supplier to the contractor). The contractor can have planned levels of these costs which have been categorised and/or risk or contingency for unplanned circumstances.

## Allowable Costs – Working Paper

### (Sales, Marketing and Bid Costs, Entertainment Costs and Faulty Workmanship and Reworks Costs)

- 5.25 Contractors state that there are very few manufacturing or development processes where quality can always be completely assured and where reworks and to a lesser extent faulty workmanship are eliminated. The MOD and the SSRO recognise that perfection is not something that is always possible or desirable and the efficiency and effectiveness of processes will vary from contractor to contractor depending on their maturity. The focus therefore needs to be on what are reasonable expected levels, depending on the product or service which is being delivered, the way it is being delivered (e.g. skill and experience level of staff) and who should pay for any planned and unplanned costs which result. Any costs above an agreed level should be borne by the contractor rather than the MOD.
- 5.26 There also needs to be appreciation of the impact of learning curves and continuous improvement. Learning curve theory legislates for labour inefficiencies in early production units which includes rework, defects and deficiencies. First in class will require more re-work than the 8<sup>th</sup> ship in a programme of warship delivery, assuming the original specification of the 1<sup>st</sup> ship has not changed significantly. Within a contract or from one contract to the next, the SSRO would expect that costs could be reduced where processes or production methods are repeatable and become more efficient. Small percentage decreases in the level of assumed reworks could lead to significant cost reduction.
- 5.27 The key aspect of determining whether the AAR principles can be satisfied is the evidence that might be available. Some defence contractors have or are putting in systems to measure reworks. They may also be able to track the impact of improved training on faulty workmanship, particularly where apprentices are being used. The SSRO would expect contractors to be collecting historic data from their information systems to understand the level of faulty workmanship and reworks that would typically occur when delivering a product which has been produced before. Some may also be sharing data or using benchmarks to identify industry norms.
- 5.28 Alongside this might be a plan to reduce costs related to these areas over time as improvement programmes are rolled out and delivered. The demonstration that a benefit outweighs the cost may be an important factor to consider.
- 5.29 In previous reviews of the *Allowable Costs* Guidance the SSRO considered the following Guidance relating to faulty workmanship which was not included. The SSRO welcomes views on whether this should be included and how it might be assessed:

*Faulty workmanship is generally not allowable if it is a result of poor process, unskilled labour or inefficient programme or project management.*

*However, if the faulty workmanship is as a result of the manufacturing process or is at an acceptable level as a result of employing apprentices or undertaking experimental work, in which cases it will be re-classified as rework and may therefore become an Allowable Cost.*

- 5.30 The SSRO considers that the current Guidance on *Allowable Costs* (paragraph 9.42) on use of insurance as a risk mitigation against faulty workmanship remains correct:

*Insurance against faulty workmanship, defective parts, breach of contract or loss of profit associated with poor performance should not be Allowable.*



***International comparisons***

- 5.31 There does not appear to be any specific guidance in the United States or Canada that relates to this cost type. Guidance from Australia suggests that a reasonable allowance for these types of cost is accepted as a starting point.

**Australian Government Capability Acquisition and Sustainment Group Cost Principles (September 2015 – paragraph 33)**

The cost in excess of a reasonable allowance for faulty materials, faulty workmanship and rejected components shall be unallowable as a contract cost.

- 5.32 The SSRO will continue to engage with professional bodies to better understand this topic and identify what might be acceptable levels in the defence industry. Stakeholders are asked to identify any benchmarks which are used in the industry currently.
- 5.33 Table 6 below sets out the SSRO's views on the key points that the Guidance on this cost type could reflect.

**Table 6 – Focus of guidance on faulty workmanship and reworks costs**

**Key points**

- Costs need to be clearly categorised and measured as either faulty workmanship, wastage or reworks.
- Allowance for these costs should be built in from the outset as a result of expected levels using evidence like benchmarks and potentially only reimbursed to those levels.
- There should be an expectation that increased efficiency and continuous improvement should over time reduce these costs.
- Insurance associated with poor performance should not be *Allowable*.

**6. Relationship with profit**

- 6.1 Consideration of the AAR principles in relation to costs incurred in a competitive environment may differ to that in single source MOD contracting. The SSRO is minded to consider that contractors should not recover through an uplift to the profit rate such costs that do not meet the AAR principles set out in the *Allowable Costs* guidance because to do so would be not represent value for money.
- 6.2 The SSRO is also minded to consider that it is simply not practical to adjust benchmark companies for costs that do not meet AAR principles because the level of disclosure in financial statements is generally not sufficient.
- 6.3 The SSRO welcomes quantitative evidence in relation to this matter.
- 6.4 The working paper on *Allowable Costs* related to Tangible and Intangible Assets also discusses these issues in relation to depreciation and amortisation costs.

## **7. Questions for stakeholders**

7.1 The SSRO asks stakeholders for views on the following questions:

- What are the difficulties experienced by stakeholders in applying guidance in relation to any of these cost types?
- What examples are there that might support a change to guidance?
- What are stakeholders' views on the international comparisons included in this working paper?

## **8. Conclusion**

8.1 The SSRO welcomes views from stakeholders on the questions in section 7 and on any other aspect of this working paper. While there is a programme of engagement through the SSRO's Operational Working Group and separate workshops, the SSRO also invites stakeholders to discuss any of the issues raised in this working paper with the SSRO on an individual basis.

8.2 Once the SSRO has reflected on the comments received on this, and the other two working papers being published at the same time, draft changes to guidance will be included in a public consultation document which will be issued at the beginning of October, giving stakeholders the opportunity for further comment and engagement over a six week period. The publication of the final guidance is scheduled for January 2018 but the SSRO will consult on the implications of releasing the new guidance at this time.

---

**From:** [REDACTED]

**Sent:** 02 October 2017 16:47

**To:** Enquiries <enquiries@ssro.gov.uk>

**Subject:** Re access to Allowable Costs working Papers for stakeholders

Dear Sir/Madam,

My name is [REDACTED]. I am currently writing a book (under contract) on the Single Source Contract Regulations. I have read in full the consultations published today by the SSRO on its single source costs standards statutory guidance. I understand that working papers on discrete aspects were sent to organisations with an interest in the ongoing review but that these were not published on the SSRO website (see Allowable Costs Working Papers: Stakeholder Response, para.1.2).

Is there any possibility of me obtaining these working papers? I must confess, it is difficult to properly respond to a public consultation on draft guidance based on working papers that have never been published. The SSRO helpfully provides a summary of those working papers but these are insufficient. It is exacerbated by the fact that certain aspects of the guidance will remain under consultation and consideration pending further reviews (e.g. concerning the baseline profit rate and risk).

I am happy to put in a formal freedom of information request if necessary but I thought a polite email might be preferable in the first instance. These documents would really assist my research.

If you could provide these, I should be most grateful and the SSRO's assistance will be duly credited in my work for doing so. If not, I will make a formal request accordingly.

Many thanks for your consideration,

[REDACTED].