

SSRO

Single Source
Regulations Office

Pricing guidance review 2018
Summary of consultation responses
January 2019

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1. Introduction

- 1.1. Section 18 of the Defence Reform Act 2014 (the Act) requires that the Secretary of State, or an authorised person, and primary contractors have regard to guidance issued by the SSRO in relation to any of the six steps for determining the contract profit rate for a qualifying defence contract (QDC) or qualifying sub-contract (QSC). Section 20 of the Act states that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs. The SSRO aims to keep its guidance on these matters current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2. The current pricing guidance was published in spring 2018. It includes guidance on:
 - a. Allowable Costs¹ (Allowable Costs guidance); and
 - b. the application of the six-step process to calculate the contract profit rate² (profit rate guidance).
- 1.3. Following engagement with key stakeholders during summer 2018, the SSRO conducted an eight-week public consultation³ on proposed changes to its pricing guidance in three areas:
 - a. the requirements of Allowable Costs (the AAR test);
 - b. research and development costs (R&D); and
 - c. capital servicing adjustment (CSA).
- 1.4. During the consultation period, the SSRO:
 - a. held group and individual discussions with members of the SSRO's Operational Working Group⁴ and other interested parties;
 - b. received written responses to the working papers from 13 stakeholders, including the MOD, ADS, ten defence contractors and one consultant.⁵
- 1.5. The SSRO would like to take this opportunity to thank all those who responded to the consultation for sharing their views with us. The majority of respondents gave permission for their responses to be published and these are available in SSRO (2019) *Pricing Guidance Review 2018: Consultation Responses*.
- 1.6. Overall, consultation respondents welcomed the opportunity to engage with the SSRO on the development of guidance prior to the publication of proposals for consultation. This was considered helpful to the development of improved guidance. Respondents expressing a view considered that the proposed revisions made the guidance clearer and easier to apply. However, they also considered that further changes were needed in some aspects of the proposed guidance to address material issues, which they addressed more specifically in their responses (Table 1).

¹ SSRO (2018) *Allowable Costs Guidance*.

² SSRO (2018) *Guidance on the Baseline Profit Rate and its Adjustment 2018/19*.

³ From 15 October to 7 December 2018. See SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20*.

⁴ Comprising the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors.

⁵ The ADS response was explicitly supported by four of the defence contractors that responded to the consultation.

Table 1: Responses to consultation questions

Question	Percentage of respondents			
	More clear	Less clear	Don't know	No response
Do the proposed revisions make the guidance more or less clear?	38%	0%	0%	62%
Will the proposed revisions make the guidance more or less easy to apply?	Easier to apply	Harder to apply	Don't know	No response
	23%	0%	8%	69%
Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?	Yes	No	Don't know	No response
	31%	0%	0%	69%
Do you have any concerns regarding the proposed publication and application dates of the revised guidance?	Yes	No	Don't know	No response
	0%	54%	0%	46%

- 1.7. The following sections of this paper summarise the views and evidence provided by consultation respondents, together with the SSRO's commentary on how these responses have informed the final guidance in the areas on which we consulted.
- 1.8. The final guidance resulting from the consideration of consultation responses has been published in SSRO (2018) *Pricing Guidance Review 2018: Changes for 2019/20*.

2. Requirements of Allowable Costs (the AAR test)

- 2.1. We set out below a summary of the key points made by stakeholders with regards to the proposed guidance on the requirements of Allowable Costs (the AAR test) and how this has informed the final guidance to apply from 1 April 2019.

Applying the guidance

- 2.2. The need for the guidance to be clearly and consistently interpreted by the MOD's project teams and contractor staff was raised by members of the SSRO's Operational Working Group at a meeting held during the consultation period.
- 2.3. One consultation respondent drew attention to the NAO's October 2017 report on non-competitive defence procurement which found that a shortage of accountants within the MOD's Cost Assurance and Analysis Service was increasing the need for commercial officers to make judgements on contracts in the absence of specialist accounting expertise or advice from colleagues on the application of the Regulations. It was suggested that this increased the need for the SSRO's guidance to be easily interpreted to ensure consistent application.

SSRO response

- 2.4. We acknowledge the need for guidance to be clear and consistently applicable by both the MOD's project teams and contractors' staff. A key aim of the current review has been to improve the clarity of the guidance. Feedback from respondents indicates that the guidance has become clearer and easier to apply. In finalising the guidance changes for 2019/20 we have made additional revisions where feedback from respondents indicated clarity could be improved.

Application to QSCs and sub-contractors

- 2.5. One area where respondents considered greater clarity was needed concerned the particular responsibilities of prime contractors and sub-contractors in relation to showing (if so required by the Secretary of State) that the requirements of Allowable Costs are met.

SSRO response

- 2.6. We have made a number of revisions (notably paragraphs 2.2 to 2.4) to provide the clarity requested.

Showing costs meet the requirements

- 2.7. Industry respondents considered that the guidance should place an explicit obligation on the Secretary of State to tell contractors what information he requires to be satisfied that costs are Allowable Costs in cases where the information provided by the contractor has been considered unsatisfactory.

SSRO response

- 2.8. We recognise it would be helpful if the parties were transparent with each other in how they have applied the guidance in determining whether costs meet the requirements to be Allowable Costs. We have amended the final guidance to reflect this. However, we consider that the SSRO is neither required nor empowered to provide guidance that creates a procedural obligation on the MOD.

The meaning of 'enable the performance of the contract'

- 2.9. The proposed guidance made more consistent reference to costs that 'enable the performance of the contract' to describe the relationship of costs that may be suitable for recovery as Allowable Costs in a QDC or QSC. While industry respondents deemed the concept of costs that 'enable the performance of the contract' to be adequate to permit many types of cost to be considered as potentially Allowable Costs, they suggested that more specific allowance needed to be made in the guidance for costs they described as general business operating costs. Such costs, they suggested, could not readily be shown to enable the performance of a particular contract as the guidance appeared to present a test that was too restrictive, requiring a strong or causal link between the cost and the contract.
- 2.10. One respondent reported that the MOD often allowed general business costs to be included in the cost base for the development of rates used in contract pricing although they would fail the test described in the guidance. Another indicated that the MOD's officers were now wary of permitting such costs and taking a more literal interpretation of the guidance. One highlighted that negotiations related to the inclusion of such costs were often problematic.
- 2.11. Examples provided by respondents of costs that were considered necessary to sustain the contractor's capability, expertise and qualifications to undertake MOD contracts efficiently included:
- a. redundancy and restructuring costs;
 - b. preventative maintenance of buildings and equipment;
 - c. apprentice training;
 - d. intellectual property/patent costs;
 - e. training indirect staff;
 - f. private venture research and development;
 - g. development and implementation of strategic business and operational systems;
 - h. insurance exceeding legal or contractual requirements;
 - i. investor relations;
 - j. company group costs;
 - k. corporate social responsibility, eg, green initiatives; and
 - l. membership of trade or professional bodies.
- 2.12. Respondents said that excluding these costs from overhead recovery rates used in contract pricing resulted in them being unfairly distributed across the contractor's other business. It was suggested that including them may, in the case of sales and marketing costs, be beneficial to the MOD where they result in the distribution of costs across a larger volume of activity. It was suggested that addressing this matter would make the guidance on specific cost types, for example, research and development, clearer and more logical to apply.
- 2.13. In support of their inclusion, industry respondents pointed out that such costs would still need to satisfy the requirements to be appropriate and reasonable in the circumstances.

SSRO response

- 2.14. The Act requires that Allowable Costs are 'attributable to the contract'. The term implies that there is some form of causal relationship between the cost and the contract through which the cost is to be recovered as an Allowable Cost. We cannot change this requirement but note that causation may be direct or indirect. For example, a cost may indirectly enable the performance of a contract if it would sustain a contractor's capability to undertake the contract in question. We consider the sustenance of capability to have the potential to deliver financial and operational benefits for the Secretary of State.

- 2.15. We are content that for the majority of cost types or activities, including those identified by respondents, demonstrating the relationship of costs to contracts should be unproblematic. We recognise, however, that for some costs, differences between the timing of the expenditure and the outcomes which result from it make attribution to contracts less easy to demonstrate. This is particularly the case for certain costs suitably and necessarily incurred to sustain the capability that delivers the contract. We are not persuaded, however, that 'the general costs' of a business (even when properly apportioned) is a more appropriate definition of costs that should necessarily be considered attributable to a QDC or QSC.
- 2.16. To facilitate the identification of costs that enable the performance of the contract we have provided additional guidance (3.8) to clarify that the term refers to costs suitably and necessarily incurred by the contractor to:
- a. deliver the contract in question; and
 - b. deliver multiple contracts including the contract in question and equitably apportioned to those contracts.
- 2.17. Delivering the contract in question may require sustaining an essential or desirable capability.

Reporting deviations from the guidance

- 2.18. The Secretary of State and contractors must have regard to the SSRO's pricing guidance. Where they deviate from the guidance this should be made clear in the statutory reports contractors are required to provide on their contracts. The proposed guidance (3.2) identified that determining Allowable Costs required the Secretary of State and the contractor or sub-contractor to apply judgement concerning the relative importance of the cost characteristics identified in the guidance. The MOD supported the intent of this change but considered that more explicit guidance was needed on when a deviation from the guidance would need to be reported within the contractor's statutory contract reports.

SSRO response

- 2.19. We acknowledge that additional guidance in this respect may be beneficial to mitigate the risk that deviations from guidance are going unreported but consider that to be a matter to be addressed within the SSRO's reporting guidance, not the pricing guidance. We have logged the issue for future consideration and discussion with stakeholders prior to proposing any specific guidance changes.

Value for money

- 2.20. The proposed guidance required consideration of whether Allowable Costs supported a contract price that ensured good value for money was obtained in government expenditure and that prices paid to contractors were fair and reasonable.
- 2.21. Industry respondents did not support the inclusion in the current or proposed guidance of the consideration of how Allowable Costs contribute to the achievement of value for money. They indicated that the consideration of whether a contract price delivered value for money should be separate from any assessment of whether the contract costs met the requirements to be appropriate, attributable to the contract and reasonable in the circumstances. It was, industry respondents suggested, for the MOD to defend whether the contract price was value for money in relation to the requirements of the contract, not the contractor.
- 2.22. The MOD was not persuaded that the requirement should be included in the guidance as it had no foundation in Section 20(2) of the Act, which specifies the requirements of Allowable Costs as being appropriate, attributable to the contract and reasonable in the circumstances.

SSRO response

- 2.23. In carrying out its functions the SSRO is required to ensure that good value for money is obtained from government expenditure and that prices paid to contractors are fair and reasonable. To the extent that the price of a contract is a function of the Allowable Costs, we consider that the correct determination of Allowable Costs is inseparable from the achievement of value for money and fair and reasonable prices.
- 2.24. The change to the guidance we proposed was intended to achieve two objectives in response to stakeholder feedback. The first was to ensure that value for money and fair and reasonable prices received equal consideration in determining Allowable Costs. The second was to focus the consideration of value for money on the Allowable Costs as a whole, in preference to attempting to consider whether a particular cost demonstrated value for money or was fair and equitable, as required in the current guidance.
- 2.25. We maintain that these are important considerations for the determination of Allowable Costs. They have informed the development of the guidance and we believe the relevant parties should have regard to them also. Our final guidance (3.6 to 3.7) seeks to clarify this.

Public scrutiny

- 2.26. Industry respondents mostly contested the inclusion in the current and proposed guidance (3.4 and 3.8) of the consideration when determining Allowable Costs of whether particular costs would withstand public scrutiny. They consider this to be an inappropriate extension of the requirements set out in the legislation. However, some respondents welcomed the inclusion in the proposed guidance of more specific concepts (3.5 and 3.9) that might support the consideration of public scrutiny.
- 2.27. The proposed introduction of Parliament's expectations of the MOD with regard to regularity, propriety and prudence (as a consideration in whether costs were appropriate and reasonable in the circumstances) was regarded by industry respondents to be a matter for the MOD and of no relevance to QDC/QSC contractors. Contractors would not, they said, be held to account by Parliament or its committees. One industry respondent suggested that the MOD was best placed to defend its decisions to Parliament. Industry respondents considered that regularity and prudence were not relevant where there was significant uncertainty arising from the contract programme, and that the SSRO should not seek to reference external standards in defining the requirements of Allowable Costs.
- 2.28. One respondent questioned the necessity of including a public scrutiny test when determining if costs were reasonable in the circumstances, considering this was essentially a test of what was appropriate to recover as an Allowable Cost.

SSRO response

- 2.29. We remain of the view that, as QDCs and QSCs are publicly-funded contracts, it is relevant to consider whether the contractor's costs are able to withstand public scrutiny in determining the extent to which they are Allowable Costs. Particular considerations include: whether the costs have been incurred for the purpose of delivering the contract objectives (regularity); whether the subject matter of the costs is a proper use of public money (propriety); and whether the amount paid for the goods or services contracted demonstrates due regard for economy and efficiency (prudence).
- 2.30. We believe it would be necessary that the MOD considers Parliament's expectations of regularity, propriety and prudence in determining if a cost was appropriate or reasonable. To the extent that both parties must be satisfied that costs meet the requirements to be Allowable Costs, and the guidance is written to facilitate this, considerations which are relevant to one party are inseparable from those which apply to another. We agree, however, that the MOD are likely to be better placed to specify what may be required to demonstrate Parliament's expectations had been met.

- 2.31. We have provided additional guidance (3.9) to clarify that costs which 'would withstand public scrutiny' include those which meet high standards of regularity, propriety and prudence, such that the relevant standards expected by Parliament of the Ministry of Defence can be met.

A reasonable person informed of the facts

- 2.32. The proposed guidance introduced a requirement to consider what a reasonable person informed of the facts might consider was appropriate and reasonable in the circumstances (3.5 and 3.9). Industry respondents considered that what might be expected by a reasonable person, informed of the facts, had no link to the legislation, to be too subjective, and impossible to ascertain given that such a person was unlikely to be identifiable for the purpose of evidencing the requirements had been met. The nature of the MOD's contract requirements was, respondents argued, beyond the ability of a reasonable person to relate to. It was suggested by industry respondents that only 'an expert having skills comparable to the supplier and awareness of the requirement, the resources available and the economic environment could have a fair-minded view of a cost'. One industry respondent contended that the requirement to consider what a reasonable person informed of the facts would think would undermine the basis of an agreement between the parties to the contract. Another respondent proposed including what they considered to be a more demanding test of what a 'prudent person undertaking commercial work' might expect.

SSRO response

- 2.33. We continue to believe it useful to direct the Secretary of State and contractors to apply the discretion which is necessary in the determination of Allowable Costs in a reasonable and informed manner. The alternative formulations suggested would, in our view, fall within the description of a reasonable person informed of the facts and so we have not further revised our proposal.

Alignment with accounting standards

- 2.34. One respondent suggested that the guidance needed to be aligned to a single set of accounting standards (EU adopted IFRS) to ensure there was a consistent application of the guidance by different contractors. An example of where differences in accounting frameworks could result in (dis)advantage for some contractors was the treatment of Defined Benefit Pension Scheme costs. However, industry respondents expressed differing views on the need for any mention to be made in guidance of the accounting treatment of costs.

SSRO response

- 2.35. We have examined the accounting treatment of defined benefit pension schemes within UK GAAP and IFRS and found there are no significant differences. Both standards allow for simplified accounting of such schemes in some circumstances, but we do not consider this requires us to provide additional guidance at this time.
- 2.36. We have noted previously the benefit to the regime of using data consistent with that from published financial statements, given the assurance that is provided by financial reporting standards and external audit.⁶ We consider that the majority of contractors adopt financial reporting frameworks which are broadly aligned. Consequently, the SSRO is not persuaded that any benefits derived from requiring contractors to restate financial information to a specified accounting framework would exceed the associated costs.

⁶ Paragraph 4.12 in SSRO (2018) *Pricing Guidance Review 2018: Stakeholder Responses to Working Papers*.

Economy and efficiency

- 2.37. The proposed requirement (3.9e) to consider whether the contractor has taken adequate steps to enhance economy and efficiency in the use of resources was considered inappropriate by several industry respondents as it was seen to relate to business improvement. One considered it too subjective to be applied in practice. Some industry respondents suggested economy and efficiency were likely to be a feature of the way that a contract was priced in order to incentivise efficient performance. The application of this consideration to contracts priced on actual costs was also considered problematic. One respondent considered that effectiveness was a more important consideration than economy and efficiency. The MOD suggested the requirement should focus on 'whether cost estimates assume that the contractor has taken reasonable steps to enhance economy and efficiency in the use of resources'.

SSRO response

- 2.38. The proposed guidance was intended as a more easily demonstrable and assessable consideration than whether, as in the current guidance, particular costs deliver value for money. We remain of the view that economy and efficiency are key enablers of costs that are reasonable in the circumstances and consistent with Parliamentary expectations regarding prudence in public spending. While we recognise the importance of effectiveness in the delivery of value for money, we consider that, as with value for money, this would be difficult to assess in relation to particular costs.
- 2.39. To the extent that economy and efficiency have influenced contract pricing, as suggested by some respondents, it should not be problematic for contractors to satisfy the MOD that due regard has been given to the cost of inputs (economy) or the outputs these inputs generate (efficiency). The guidance we have proposed (3.12d) now indicates that the amount of a cost is reasonable in the circumstances if it demonstrates due regard to these factors.

Other matters

- 2.40. In finalising the guidance we have made a number of minor revisions where feedback from respondents suggested greater clarity or alignment with the Act and Regulations was needed or could be provided. We are grateful to those who suggested specific changes.

3. Research and development

- 3.1. We set out below a summary of the key points made by stakeholders with regards to the proposed guidance on research and development and how this has informed the final guidance to apply from 1 April 2019.

Scope of guidance

- 3.2. Respondents considered that greater clarity was required in the proposed guidance concerning the consideration of costs from customer-funded (contracted) research and development and those related to private venture funded research and development. Some suggested that the guidance only needed to address private venture research and development as costs associated with contracted research and development would be treated as direct costs, not recovered through overheads.

SSRO response

- 3.3. We consider that the guidance should assist the Secretary of State and contractors to determine whether any costs of research and development are Allowable Costs. The principles described in the guidance apply equally to both customer-funded and private venture research and development. The guidance (D.1.3) acknowledges that some costs will be applied directly to contracts and some will be applied indirectly. The guidance at D.2 has been clarified to indicate that it relates to research costs applied indirectly.

Defining research and development

- 3.4. Overall, industry respondents agreed that research and development should be dealt with separately in the guidance. The proposed definitions of research and development were welcomed by some respondents although most industry respondents considered these were an unnecessary attempt to define generally accepted accounting principles. One respondent considered the guidance needed to be clearer about the difference between research – which would be undertaken to sustain expertise and, in turn, the operation of the business – and development – which was likely to be directly related to a product or contract requirement.

SSRO response

- 3.5. We are satisfied that it is helpful to provide a general definition of the activities giving rise to costs to which the guidance relates. The definitions provided (D.1.1 and D.1.2) reflect accounting principles and will be familiar to stakeholders.

Allowability of research costs

- 3.6. Our proposed guidance described how Allowable Costs arising from research should be determined. This included considering research costs incurred during the period of the contract as a proxy for historic costs subject to a number of considerations
- 3.7. Industry respondents considered research costs were necessarily incurred to sustain the contractor's skills, expertise and capability to deliver contracts, and should therefore be considered to be Allowable Costs. However, they noted that research conducted in year may not be considered to enable the performance of the contract in question as its success and applicability to the contract were uncertain. They considered that the approach described in the proposed guidance was unnecessarily complex and likely to result in the disallowance of all indirect research expenditure. They contested the need for consistency between current and historic expenditure for costs to be considered Allowable. One respondent considered that the proposed guidance provided insufficient explanation of the allowability of research expenditure applied directly or indirectly to contracts.

- 3.8. Respondents suggested that the requirement for research to enable the performance of the contract should be removed. Instead, research should be allowable as a general business overhead, recovered as a period expense through overhead recovery rates used in contract pricing. Respondents, including the MOD, considered that the key principles in determining whether research costs were Allowable Costs were that: costs were only recovered once; the research was of interest to the Secretary of State; and the methodology for allocating costs should be agreed with the Secretary of State.

SSRO response

- 3.9. The guidance on the requirements of Allowable Costs has been revised, in response to consultation feedback from stakeholders, to more explicitly include consideration of costs that enable the contractor to sustain the capability that delivers the contract. (See 2.9 to 2.17 above for further details.) This change provides the basis for determining whether research costs incurred during the period of the contract are Allowable Costs in the contract. The final guidance includes principles to assist the parties in determining whether research costs applied indirectly to contracts are Allowable Costs (D.2.1 to D.2.2), noting that in determining whether the research enables the performance of the contract, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research may be necessary if it is required to maintain capability to perform the contract. We have removed the specific guidance concerning consistency with historic spending as we consider the general guidance on whether costs are reasonable in the circumstances (3.12 to 3.13) is sufficient to determine what amount of research costs are Allowable Costs.

Research or development that did not achieve planned objectives

- 3.10. Our proposed guidance addressed the costs of research and development that did not achieve its planned objectives, which was referred to as 'abortive research or development'.
- 3.11. Industry respondents considered that references to 'abortive research' should be deleted or its meaning clarified. They considered that research was never 'abortive' even where it did not deliver the insights originally expected.
- 3.12. Respondents considered that the guidance needed to support the continuation of research and development by the MOD's contractors. While it was sometimes the case that research and development did not deliver the intended benefits, it would be inappropriate for the MOD only to pay for 'successful' research that resulted in knowledge that could be applied to QDCs and QSCs.
- 3.13. The MOD suggested removing the proposed guidance as it implied that costs could be Allowable whether or not the expenditure had resulted in the development of a product. It considered that development expenditure that did not result in a product should not be recoverable from the MOD although research expenditure would be recoverable through overheads if the MOD had an interest in its potential outcome.

SSRO response

- 3.14. We acknowledge that research and development are, by their nature, activities which are exploratory and may not always achieve the objectives planned. We also accept that where planned objectives were not achieved there may yet have been valuable insights for the contractor or the MOD which could inform decision-making or have benefit for current or future contracts.
- 3.15. We consider that the general guidance on the requirements of Allowable Costs provide the principles necessary to guide the parties in determining whether such costs are appropriate, attributable to the contract and reasonable in the circumstances. Consequently, in finalising the guidance we have removed the proposed guidance on assessing what is a reasonable level of cost.

Research and Development Expenditure Credit

- 3.16. Our proposed guidance removed specific reference to credits or benefits received by contractors through the taxation system related to research and development expenditure. We proposed revised guidance on how reimbursements, credits, grants or refunds received by contractors should be considered in determining Allowable Costs. Our proposal indicated that un-ringfenced grants and adjustments made through company income tax regimes are not relevant to the determination of Allowable Costs as they are not given with a view to directly reduce particular costs.
- 3.17. Industry respondents generally welcomed the proposed changes in the guidance concerning the treatment of reimbursements, credits, grants or refunds received by contractors. Those in favour considered this supported their view that tax credits associated with research and development expenditure (RDEC⁷) should not be used to offset Allowable Costs, as required by the current guidance. They considered that the requirement to offset RDEC against Allowable Costs was contrary to government's policy intent in rewarding and incentivising companies that undertake qualifying activity. They also considered that the pricing of contracts where RDEC was used to offset Allowable Costs was complex due to the risk of changes in the qualification criteria or that the credit rate may be amended by government. One considered that contractors would have no incentive to claim the credit on qualifying expenditure if they are unable to retain the benefit of it. Another noted that contractors might take different approaches to accounting for any credits received and the guidance should not differentiate between these.
- 3.18. One industry respondent that favoured the change suggested consideration be given to differentiating between RDEC arising from private-venture research and development and RDEC arising from research and development funded by the MOD.
- 3.19. One industry respondent that opposed the change drew attention to the consideration that was previously given to the treatment of RDEC by the (then) Review Board for Government Contracts in 2014. This respondent indicated that, in the light of the Review Board's comments it, and other contractors, had entered into formal or in-principle arrangements with the MOD concerning RDEC. In its own case, this would see RDEC being paid to the MOD once the credit had been received by the contractor. It noted the ambiguous accounting treatment of RDEC, as either tax or grant.
- 3.20. One other respondent that opposed the change considered the guidance proposed was not sufficiently clear and that the change in the approach to research and development related tax credits would result in a 'misuse' of taxpayer funds. For this respondent, RDEC should be considered as any other grant that reduces an otherwise allowable cost. Failure to apply such a treatment would result in inappropriately increased operating profit for contractors.
- 3.21. The MOD considered that some adjustments made through company income tax, including RDEC, were given with a view to directly reducing particular costs. It contended that the proposed changes were diametrically opposed to the intent of the RDEC scheme, as they would effectively provide additional money to companies who did not use their own resources to fund research and development. The MOD considered that if RDEC payments were not offset against Allowable Costs this would result in the contractor being paid twice by government, something it considered would fail to withstand public scrutiny. It also considered the proposed guidance contradicted the principle that costs should not be allocated to a QDC or QSC unless they were incurred by the contractor: which, in its view, was not true of research and development costs recovered through RDEC.

⁷ RDEC gives corporation tax relief to companies that do research and development. Details are available at <https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-large-companies>.

SSRO response

- 3.22. We note that the MOD and contractors had differing views on whether it was the policy intent of RDEC to reimburse a particular cost. The SSRO has been unable to identify any particular aspect of the rules on RDEC claims which direct how the ultimate benefits should be distributed between customers and shareholders. In the absence of clarity regarding the intent of the policy we do not consider it appropriate for the SSRO's guidance to provide unequivocal direction on this matter.
- 3.23. We maintain the view that Allowable Costs should reflect the net costs incurred by the contractor and the principle remains that costs should only be recovered once. In practice this means that where the cost the contractor bears is lower than it otherwise might have been, for example, because a discount has been applied or it has been recouped from another source, then this reduction should be reflected in the costs claimed from the MOD as Allowable Costs.
- 3.24. Given the many sources of income, tax credits and other reliefs which may (or may not) act to reimburse a particular cost, and the need for the guidance to be broadly applicable, we have included additional guidance to assist the parties to agree an appropriate treatment for credits taking account of the specificities of the case.

Allowability of development costs

- 3.25. The proposed guidance recognised that accounting standards permitted contractors to account for development costs in different ways and indicated that the treatment already established for the contractor's own purposes should normally be adopted when determining Allowable Costs.
- 3.26. Respondents suggested that development costs should be allowable and recovered either as a period expense through overhead recovery rates used in contract pricing or recovered against specific outputs, as agreed with the MOD. Consistency with the contractor's accounting treatment of development costs was considered unnecessary in this case as such a treatment may not result in the most appropriate allocation of development costs to contracts. The MOD considered that product development costs should be recovered as direct costs through the relevant products when they are sold, with the methodology agreed with the Secretary of State.
- 3.27. One respondent considered that contractors' tendency to impair development costs, treat them as a period expense by failing to segregate research and development, or amortise development expenditure over a short period of time (typically three years) could have a distortionary effect on costs in QDCs and QSCs. It considered that greater specificity was needed on the preferred cost accounting treatment for different types of development cost and that the guidance also needed to be applicable by non-typical defence contractors and those with no prior experience of pricing QDCs or QSCs.

SSRO response

- 3.28. We note stakeholders' feedback concerning the potential for application of the contractor's normal accounting practice for development costs to result in an inappropriate allocation of costs to contracts. The MOD and industry respondents concurred that the method of cost allocation to contracts should be agreed with the Secretary of State. The guidance on determining whether costs are attributable to the contract already provides for costs to be applied to the contract 'using a methodology agreed with the Secretary of State'. Consequently, our final guidance (D.3.1) no longer expects that the treatment already established for the contractor's own purposes should normally be adopted.

Other matters

- 3.29. In finalising the guidance we have made a number of minor revisions where feedback from respondents suggested greater clarity or alignment with the Act and Regulations was needed or could be provided. We are grateful to those who suggested specific changes.

4. Capital servicing adjustment

- 4.1. We set out below a summary of the key points made by stakeholders with regards to the proposed guidance on the capital servicing adjustment (CSA) and how this has informed the final guidance to apply from 1 April 2019.

Calculating the capital servicing adjustment

- 4.2. The proposed guidance set out the approach that should be followed to calculate the CSA using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor's obligations under the contract.
- 4.3. The proposed simplification of the existing guidance was welcomed by many industry respondents. The MOD noted that while the business unit CP:CE approach was almost always used to calculate the CSA, there may be circumstances where the capital directly attributable to a contract was used instead. It considered that the guidance should recognise this possibility and guide the parties to clearly set out the method employed where the CP:CE ratio approach was not used. One industry respondent suggested the guidance be revised to permit alternative approaches to calculating capital employed, as legislation did not mandate that an average of opening and closing balances (as featured in the proposed guidance) be used.

SSRO response

- 4.4. The SSRO considers the business unit CP:CE ratio method to be the approach that best compensates for servicing all capital employed for the purpose of performing the contract. The CP:CE approach is well-understood by stakeholders and we perceive there to be very limited appetite for using alternative approaches. Consequently, the SSRO does not consider that additional guidance is required on how to apply other approaches to calculating the CSA or on how any deviations from the SSRO's guidance should be reported in statutory contract reports.

Information to support the calculation

- 4.5. Industry respondents considered that the current and proposed guidance (20.2) concerning 'adequate justification' to support the calculations of fixed and working capital was too subjective, leading to disagreements with the MOD and delays in agreeing contracts. They repeated their desire for the guidance to require the MOD, in cases where it was not satisfied, to more clearly state what it required.
- 4.6. It was suggested by one respondent that when data used to calculate the CSA related to a business unit which was not a single legal entity, it should be possible to reconcile the data to the statutory accounts of the legal entities from which the business unit was formed. It additionally suggested that the data values used in the calculation should accord with IFRS unless a valuation difference was agreed by the parties to be immaterial.

SSRO response

- 4.7. We noted above (paragraph 2.8) in relation to the determination of Allowable Costs that the SSRO is neither required nor empowered to provide guidance that creates a procedural obligation on the MOD. We consider that also to be true with regard to the profit rate guidance. We agree, however, that the guidance would benefit from further clarification. We consider that the statutory requirement to keep relevant records for use by the Secretary of State for specific purposes, such as verifying certain matters relating to the price payable under a QDC or QSC, is relevant to the calculation of the CSA. It is also more generally relevant to the process by which the contract profit rate for a QDC or QSC is determined. The final guidance, therefore, includes a similar statement to that which we have introduced to the Allowable Costs guidance, reminding contractors of their statutory obligations in this regard. Additionally, we consider that it would be appropriate for the parties to take a proportionate approach when seeking and providing information to support the CSA calculation. Our final guidance (20.2) reflects this, using language similar to that introduced to the Allowable Costs guidance (2.4).

- 4.8. As noted earlier (paragraph 2.36) there is benefit to the regime of using data consistent with that from published financial statements and the majority of contractors adopt financial reporting frameworks which are broadly aligned. Consequently, the SSRO is not persuaded that any benefits derived from requiring contractors to restate financial information to a specified accounting framework would exceed the associated costs.
- 4.9. In finalising the guidance we have sought to clarify (18.6) that the calculation of capital employed and cost of production to inform the CSA should be made using data drawn from the same financial records, or using data that is adjusted, to ensure that these elements are calculated on the same basis.

The treatment of cash

- 4.10. The proposed guidance (19.5) provided a simplified calculation for the CSA, resulting in the removal of specific mentions in the guidance of some items previously referenced, such as customer advances.
- 4.11. Industry respondents were generally positive about the simplified calculation. However, Industry respondents and the MOD sought clarification on how 'cash in excess of the amount required for normal operations' was to be evaluated, in order to be excluded from the calculation of capital employed. Industry respondents suggested that cash required for normal operations should include cash that is required to complete MOD contracts and settle payments related to price adjustments on contract completion (including both target cost contracts and those where a final price adjustment is applied). They also contested the proposed removal of guidance concerning the treatment of cash advances in the calculation of the CSA and the treatment of associated liabilities. They considered that these changes would result in contractors being penalised unfairly.

SSRO response

- 4.12. Our consultation proposal consolidated into a single principle several instances in the guidance that related to the treatment of cash in the capital servicing calculation. The aim was to simplify this area. Our intention with regards to cash was to exclude only that which is not required for 'normal operations'. The SSRO considers that normal operations includes holding cash to settle contractual liabilities, for example, those that have arisen due to a customer advance. We have made a change in finalising the guidance (19.5a(vi)) to ensure this is clear.

Capital employed to enable the performance of the contract

- 4.13. Industry respondents sought further clarity regarding the meaning and interpretation of 'capital employed to enable the performance of the contract' (G.2.1 of Allowable Costs guidance and elsewhere). It would be difficult, or impossible, they said, for contractors to identify these assets as distinct from those used by the business unit undertaking the contract. Respondents considered the proposed guidance at paragraphs 18.4 and 18.5 of the profit rate guidance (concerning the assumed equivalence in the CSA calculation between the capital intensity of a business unit performing the contract and the capital intensity of the contract) provided a pragmatic alternative to considering capital employed in performance of the contract.

SSRO response

- 4.14. Section 17(2) of the Act describes the intent of the CSA as being to ensure that the contractor 'receives an appropriate and reasonable return on the fixed and working capital employed... for the purposes of enabling the primary contractor to perform the contract'. The language used in the pricing guidance reflects this terminology.

Intangible assets with indefinite useful life

- 4.15. Industry respondents were unclear as to why these should be excluded, particularly in cases where the MOD was receiving benefit from the use of the asset. They considered there was inconsistency between the treatment proposed in the guidance on the CSA and the SSRO's guidance on Allowable Costs and the calculation of the baseline profit rate, to the disadvantage of contractors.

SSRO response

- 4.16. The intent of the consultation proposal was to exclude from the calculation internally-generated intangible assets like goodwill, brands, or customer lists that are recognised in the balance sheet of the acquirer during a business combination, which usually have an indefinite useful life. These differ from some other classes of intangible assets that have a finite useful life, such as development costs, which should not be excluded.
- 4.17. The distinction between different intangible assets based on their useful life is one that does not exist in the Allowable Costs guidance. Including this principle in one piece of guidance and not another risks an inconsistent approach to the pricing of contracts.
- 4.18. The final guidance (19.5a)i) is that goodwill, brands and customer lists should generally be excluded. This is because it is likely that these are not relevant for QDCs and QSCs and including the related balance sheet and income statement transactions in capital employed and cost of production respectively might skew the CP:CE ratio and, consequently, the CSA calculation.

Fair value adjustments

- 4.19. Industry respondents considered fair value adjustments should be permitted in the calculation of capital employed as these were required by generally accepted accounting principles in certain situations and would avoid the CSA being based on out of date values. The absence of additional input of capital was not considered relevant.

SSRO response

- 4.20. The guidance to generally exclude fair value adjustments that did not require additional input of capital would cover items like the upward revaluation of property or gains on ineffective hedging instruments. There are several reasons for generally excluding these.
- to exclude irregular adjustments that might make the business unit CP:CE ratio a less reliable estimate of capital intensity over the life of the contract;
 - to exclude from the calculation of capital employed any balance sheet items whose revaluations are not also recognised in the calculation of cost of production; and
 - to provide symmetry with the Allowable Costs guidance, which provides for costs that are incurred, not the opportunity cost of potentially selling an asset.
- 4.21. The Secretary of State and the contractor may conclude, however, not to exclude certain assets if they consider it would result in CSA that provides a more appropriate and reasonable return on the fixed and working capital employed by the contractor for the purposes of enabling it to perform the contract.

Items not relevant for single source MOD contracting

- 4.22. The proposed guidance indicated that items (19.5c) and costs (21.3c) generally not relevant for single source MOD contracting should generally be excluded from the calculation of capital employed and cost of production respectively. Industry respondents believed this required further explanation and consideration.

- 4.23. One respondent considered the exclusion of such items from capital employed inappropriate as MOD contractors undertaking a mixture of work would inevitably have such assets and liabilities. The MOD noted that excluding these items would distort the CP:CE ratio without a compensating adjustment to the calculation of cost of production. It suggested this be removed. One respondent considered that the reference in the current guidance to exclusion of items from the calculation of cost of production that were generally not Allowable might usefully be retained.

SSRO response

- 4.24. In most cases, the selection of an appropriate unit of business will ensure that only relevant items are included in the CSA calculation. However, there may be some cases where the CSA calculation is performed using financial information from a wider source, or where the contractor's business unit structure does not align in a way that is most ideal for the purpose of calculating a CP:CE ratio.
- 4.25. The intent of the exclusions in the proposed guidance was to ensure the parties consider any items or costs that are not relevant for the calculation or that would distort the result. In finalising the guidance we have revised the wording to better reflect the intent, which is to exclude items and costs 'whose inclusion would not result in an appropriate Step 6 adjustment'.
- 4.26. The removal of reference to Allowable Costs in the calculation of cost of production reflects our view that the Allowable Costs guidance is not written for the purpose of determining cost of production for the CSA calculation.

Cash in group pooling arrangements

- 4.27. We proposed guidance on the treatment of cash held in a group pooling arrangement (19.6) in the calculation of capital employed. Industry respondents considered the guidance should be more directive: that such cash must, rather than may, be included.

SSRO response

- 4.28. We have retained the guidance as proposed as we consider that it would be appropriate for the relevant parties to exercise a degree of judgement in this regard.

Further adjustments in calculating capital employed

- 4.29. The proposed guidance addressed the possible need for further adjustments to be made in the calculation of capital employed where they could be 'reliably estimated and have a material impact on the result' (19.7).
- 4.30. Industry respondents suggested that the guidance should refer to 'material' rather than 'pervasive changes. They also considered that the requirement in the proposed guidance for these to be reliably estimated was too stringent and should be replaced with a requirement to be 'reasonably estimated'.
- 4.31. The MOD considered the guidance needed to allow exceptions by agreement with the MOD.

SSRO response

- 4.32. We consider that the issue of materiality is already addressed in the proposed guidance. To the extent that any adjustments are likely to be exceptional we consider that they should be limited to known events that are significant and which it is, therefore, likely can be reliably estimated. In finalising the guidance we have sought to emphasise the exceptional nature of any such adjustments and note that these should be agreed with the Secretary of State.

Other matters

- 4.33. In finalising the guidance we have made a number of minor revisions where feedback from respondents suggested greater clarity or alignment with the Act and Regulations was needed or could be provided. We are grateful to those who suggested specific changes.

5. Other changes and future review

- 5.1. As part of the consultation we invited respondents to identify whether there were any aspects of the SSRO's pricing guidance that we should prioritise for review in 2019.
- 5.2. Most respondents indicated that the identification of topics for future review was contingent on the outcome of the current consultation.
- 5.3. A small number of respondents identified issues related to contract pricing that they considered required attention, although these were not specifically related to pricing guidance (Table 2).

Table 2: Pricing issues identified by consultation respondents

Topic	Comments
Multiple baseline profit rates	One respondent considered a single baseline profit rate was inappropriate given the diversity of contracts and contractors.
Comparator company selection	One respondent questioned the appropriateness of determining the baseline profit rate recommendation with reference to profits earned by non-UK and non-defence companies.
Activity types	One respondent considered the current baseline profit rate activity types did not adequately relate to companies undertaking work in the field of computing and information systems.
Product prices	One respondent suggested that the guidance should permit product prices to inform Allowable Costs.
Bids and proposals	One respondent sought clarification on bid and proposal costs.
IFRS 15	One respondent suggested IFRS 15 Revenue from contracts with customers required consideration.
Cost risk adjustment	One respondent suggested that guidance on the cost risk adjustment would require attention pending the MOD's expected legislative changes.
Defined benefit pension schemes	One respondent suggested the different accounting treatment of define benefit pension schemes resulted in potential inequity between contractors and should be addressed in the guidance.

- 5.4. These matters have been logged for future consideration and discussion with stakeholders as part of the SSRO's corporate planning for 2019/20 and beyond.

