

Response 1

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10th December 2014

SSRO Consultation on Single Source Cost Standards

Thank you for providing an opportunity to comment on the draft Statutory Guidance on Allowable Costs. I am pleased to enclose our response to the SSRO's consultation.

The Guidance has been reviewed by an expert working group consisting of senior commercial and legal specialists from member companies. In addition to providing responses to the questions posed in the consultation form, a series of additional points relating to the draft Guidance are included in the annexes attached to the questionnaire. If the SSRO would find it helpful, members of the working group would be pleased to meet to discuss these points in greater detail.

We are very grateful for the significant degree of consultation already undertaken by the SSRO, and we will continue to support you and your team as we move towards this important transition.

Thank you again for the opportunity to comment on the draft Guidance. Please do not hesitate to contact me should you have any questions regarding our submission.

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes

No

Please add comments to support your answer:

The draft is a good basis from which workable Guidance can be developed. Reviewers noted the following with regards to its structure:

1. The Guidance should avoid repeating information contained in the Act and readers should be directed to the latter via cross references. This approach will reduce the likelihood of introducing ambiguities, inconsistencies and uncertainty.
2. The SSCRs will be referred to frequently and extensively by parties during negotiations. Numbering each paragraph and eliminating bullets will assist them and improve the user-friendliness of the document. Consideration should be given to using a single column format consistent with the Act and the Regulations.
3. The narrative style adopted had created a number of areas where a reader might have to surmise the intention. Reviewers felt the tauter drafting style of the Act and Regulations would give the precision required by parties negotiating an Allowable Cost.
4. Clarity and understanding would be improved if the expression 'Qualifying Defence Contract' was replaced throughout the document with 'Regulated Contract', this being defined as a Qualifying Defence Contract or Qualifying Subcontract under the Defence Reform Act 2014. It was felt that 'Qualifying Defence Contract' may give the impression that single source subcontracts were not covered by SSCS requirements.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

Reviewers were aware that MOD spent a great deal of time and effort ensuring the Regulations did not duplicate information that was in the Act. Industry supports this approach as it minimises the likelihood of inconsistencies, ambiguities and uncertainty. It recognised that this was a specialist subject and on balance, felt that the SSCSs should adopt the same approach on grounds of consistency, and avoid repeating information already present in the Act or Regulations. On this basis, sections 1-6 become unnecessary and all that is required by way of introduction is a simple statement to the effect that the SSCSs are issued in accordance with S20 of the Act. This would shorten the document and improve readability.

A number of inconsistencies and inaccuracies were noted between the SSCSs and the Act/Regulations which would be eliminated by this approach.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

The Reviewing Group agreed that the SSCRs should be principles based rather than rules based. It noted the principles must be:

1. Sufficiently comprehensive to convey to the parties what the SSRO's position on an issue would be in the event of a dispute.
2. Robust and be able to be used as the basis of legal argument.

It was felt that it would be helpful if the SSCSs established a number of additional principles. These are identified in Annex A to this document.

Whilst welcoming the principles based approach to the SSCSs, reviewers noted that over time they were likely to evolve into rules as precedents were set as a result of opinions and determinations made by the SSRO. This was already happening in Sections 10 and 11 which listed 'rules' for types of cost that would generally be allowed/disallowed. It is suggested that the SSRO should allow for this transition in its forward thinking and planning.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

The reviewing group was uncertain about what was meant by 'procedures for determining costs' and clarification is required in order to enable the group to comment effectively. It was felt that provided the principles were clear and the guidance on their application comprehensive, the procedure for their application would be self-evident.

It was felt that calculation of the costs themselves was a matter for the parties to the negotiation or contract as applicable.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Reviewers felt the current draft contained too many uncertainties and ambiguities given the quasi-statutory status of the document. There were many areas where the drafting was 'too loose' and lacked the precision to create the certainty required for the parties to agree Allowable Costs. Greater precision in the drafting and clarity of intent was required in a number of areas before the SSCs could be used effectively for pricing contracts. Details of the instances where reviewers felt the drafting required attention are available and can be supplied on request.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

See response to Question 5.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

See response to Question 5.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

See response to Question 5

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

This is what is required by the Act, Section 20(2).

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

Reviewers were cautious about including checklists in the SSCSs. The types, range and values of single source contracts placed by MOD is wide and so large that it was felt the parties would inevitably find themselves manipulating situations in order to squeeze a cost into a box that could be 'ticked' in the checklist. For example, it was felt it was likely different checklists would be required for supply contracts and support contracts; those involving works or availability contracts would also need to consider different criteria.

On balance, it was felt the value of checklists in this situation was too uncertain and should be omitted from the SSCRs.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes

No

Please add comments to support your answer:

Cost contingencies and cost risks are an everyday feature of estimating and pricing contracts. The SSCRs clearly anticipate their inclusion in Allowable Costs as it requires them to be identified in the Contract Pricing Statement and reported in the Contract Notification Report, the Quarterly Contract Report and numerous other occasions. They are also a feature of Earned Value Reporting that is a requirement of all MOD Category C and above contracts and it would risk causing confusion if there was a discrepancy in the two reporting processes.

Reviewers felt that on balance it was preferable for contingencies to be visible to MOD and the SSRO so that they could be recognised and managed accordingly. This would be difficult to achieve if Contractors buried contingencies in estimates.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

Opinions and determinations will create precedents and these should be made available to contractors at the earliest possible time so that they can be recognised in their pricing activities and nugatory effort avoided. This would have the knock-on effects of reducing the scope for disagreement and the number disputes referred to the SSRO for determination or opinion.

Reviewers felt that updating annually was too long an interval and that a supplement containing the outcomes of opinions and determinations should be published, say, monthly.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

Value for money can only be assessed on outputs i.e. against the contract price (rather than against elements of cost). Subject to other comments in this response, the process of assessing each cost element against Attributable, Appropriate and Reasonable criteria to determine its allowability will provide reassurance that value for money was being obtained and that the Contractor was receiving a fair and reasonable price.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

Reviewers felt that on balance the (graphical) illustrations added little, if anything, to the SSCs as they only repeated the principles. Similarly, the examples (textual illustrations) repeated information that was already available without adding clarity or further understanding to the subject under consideration. On this basis it was felt the SSCs would be improved if were omitted.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

The Contractor's obligations to disclose information and to keep and make records available are laid down in the Act S23-27, 38. Any other information requiring disclosure in order to apply the SSCs will be contained in the contractor's QMAC.

The reviewing group suggests the SSRO may wish to consider taking ownership of the format of the QMAC document as this may promote consistent application. The group will be pleased to discuss with the SSRO how this can be achieved.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

The reviewing group felt the role of the SSRO was described adequately in the Act S13 and Schedule 4 and it was unnecessary to repeat or interpret it in the SSCs. To do so risked introducing inconsistencies and uncertainty. On balance, it was preferable for those seeking this information to consult the Act.

Reviewers did, however, consider that contractors would find a matrix cross referring each principle and the other statements in the SSCs to the relevant section(s) of the Act very helpful. This would enable them to see from which part of the Act the authority in the principle or statement was being derived, which in turn would help understanding of what had to be done or achieved in demonstrating that a cost was 'Attributable', 'Appropriate', and 'Reasonable'.

Single Source Cost Standards

Response to (Draft) Statutory Guidance on Allowable Costs

Annex A - Principles

1. The group that reviewed the Draft Statutory Guidance on Allowable Costs felt that it would be improved if the following principles were included either within the body of the text or as a separate list of Principles for determining Allowable Costs. The Group would welcome an opportunity for a technical level discussion of the points raised so that the thinking behind the suggestions can be explained.
 - 1.1. Assessments should be made at the time of pricing and be made by a person(s) suitably qualified and experienced in making assessments of the type under consideration.
 - 1.2. Assessments should be made on the basis of verifiable objective evidence. Facts, and judgements made on facts, should be used wherever possible to determine a cost. Judgements may include estimates, extrapolations or other as appropriate.
 - 1.3. The value of the cost should be the mean expected outturn cost negotiated by the parties.
 - 1.4. Cost should be allocated in accordance with the Contractor's GAAP appropriate to the circumstances and applied via the Contractor's QMAC.
 - 1.5. A Price which is the aggregate of Allowable Costs to which Profit has been added in accordance with the Act will be 'Fair and Reasonable' and 'Value For Money'.
 - 1.6. Value For Money can only be assessed on outputs i.e. the Price, and not cost elements.
 - 1.7. Costs incurred solely as a result of a MOD requirement should fall to be recovered in full in MOD prices. Costs incurred that benefit all customers should be proportioned on an equitable basis.
2. Reviewers also felt that there were gaps in the requirements and it would be helpful if the SSCs could establish principles on the following:
 - 2.1. Determining the Allowable Costs for commercial, proprietary and non-developmental items.
 - 2.2. Recovery of investment made during performance of a contract awarded on the basis of competition during performance of a follow-on single source contract.
 - 2.3. Determining the circumstances when the whole contract is to be re-priced under S14 of the Act.
 - 2.4. The treatment of negotiated reductions in the Price in the Allowable Cost, Reporting and Defined Pricing Structure.
 - 2.5. The treatment of gain-sharing, spend-to-save and other incentive mechanisms in the Allowable Cost structure.
 - 2.6. Determining Allowable Costs in contracts containing shared cost research.

- 2.7. Determining Allowable Costs for anonymised procurements, and common stock and fungible items.
- 2.8. Identifying who is responsible for agreeing the Price of Qualifying Subcontracts and their amendments.
- 2.9. The treatment of changes in Subcontract values in the pricing structure when the Price of the prime contract is unaffected by the change.

Single Source Cost Standards

Response to (Draft) Statutory Guidance on Allowable Costs

Annex B - Overreaches

Reviewers felt the SSCSs had overreached the provisions in the Act in the following areas:

SSCS Ref	SSCS Description	Comment
2.4	The purpose of the Single Source Procurement Framework is to ensure a fair and reasonable price is paid for goods, works and services in the absence of competition. Alongside this, there is also the fundamental principle to assure the taxpayer that single source procurement delivers value for money and can withstand public scrutiny.	The highlighted text does not appear in the Act and introduces a new requirement.
3.4	Non-compliance with the guidance is in breach of the Act and any breach allows for penalties and fines to be applied.	The Act requires that parties must 'have regard to' guidance issued by the SSRO S20(3). It does not contain provisions for fines to be levied for non-compliance.
7.4	Section 20(4) of the Act states that the onus is upon the Primary Contractor of a Qualifying Defence Contract, to evidence that costs, whether by reference to this guidance or otherwise, meet those requirements set out in this guidance as being <i>Allowable</i> . Whilst the burden of proof clearly rests with the Contractor 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> .	Section 20(4) requires the contractor to demonstrate that the requirements of 20(2)(a) to (c) are 'Appropriate', 'Attributable' and 'Reasonable'. The expression 'burden of proof' introduces a new requirement.

9.5	<p>Checklist to determine whether a cost is <i>Reasonable</i></p> <ul style="list-style-type: none"> - Is it congruent with meeting the contract performance requirements? - - Would the cost withstand public scrutiny? - Are cost estimates based on empirical evidence? - Is the cost consistent with sector / market benchmarks? - Is the quantum of the cost consistent with good business practice? 	<p>Suggest '<i>Is it necessary to incur the cost in order to fulfil contract performance requirements?</i></p> <p>This is a new requirement and does not appear in the DRA.</p> <p>Empirical evidence may not be available for costs derived by inference, extrapolation or judgement. This point might be better expressed as: <i>'Is there objective evidence to support that the costs are facts or judgements based on facts?'</i></p> <p>This is a new requirement and does not appear in the DRA.</p> <p>This is a new requirement and does not appear in the DRA. 'Good business practice' requires definition.</p>
10.9 (Bullet 7)	<p>'...no discernible benefit provided to MOD or the public sector as a whole....'</p>	<p>This is a new requirement and does not appear in the DRA.</p>
12.10	<p>'.....the SSRO will be permitted to re-open this calculation.....'</p>	<p>The DRA does not allow the SSRO to re-open negotiations.</p>

Single Source Cost Standards

Response to (Draft) Statutory Guidance on Allowable Costs

Annex C - Other Issues For Consideration

SSCS Ref	SSCS Description	Comment
5.1	This guidance replaces the existing Government Accounting Conventions, a part of the 'Yellow Book'.	This could be misleading as the existing Government Accounting Conventions will continue to apply for extant contracts let under the 'Yellow Book' arrangement. Suggest re-phrasing.
6.4	The assessment and agreement of the costing methodology used by the Contractor is delivered through completion and sign off of the Questionnaire on Method of Allocation of Costs.	The attribution of costs will be in accordance with GAAP and applied via the contractor's QMAC. The QMAC is statement of how a contractor attributes costs, it is not 'signed-off' by MOD and the contractor.
7.2	It is essential to the establishment of <i>Allowable Costs</i> , both at pricing and contract delivery stages, that <i>Allowable Costs</i> are auditable from resources employed through activities undertaken (using those resources) to the outputs and benefits required by the Qualifying Defence Contract. An audit trail is achieved through a transparent understanding of the causal link between the final outputs and benefits and the resources/ activities employed to deliver them.	An audit trail is unlikely to be available at the tender stage as the costs will not have been incurred. During the contract performance stage the origin of the cost will be visible from the contractor's accounts where its attribution can be verified by reference to the QMAC. Suggest adjusting so that that the requirement becomes one for the contractor to provide objective evidence that a claim for an Allowable Cost is 'Appropriate', 'Attributable' and Reasonable'.
7.3	It is expected that any costing system and costing methodology used by Contractors will allow the identification of costs as they are allocated from resources to activities to outputs and benefits. Presentation of costs in this manner supports a degree of standardisation of cost information which in turn supports testing of costs to ensure that they meet the criteria for <i>Allowable Costs</i> .	Each QMAC will be unique as it will be tailored to reflect the contractor's business. Suggest the wording is adjusted to reflect the individual nature of QMACs.

10.5 General stock losses and obsolescence should be charged directly to the contracts to which they relate. In circumstances where it is not possible to identify general stock losses or obsolescence costs that specifically apply to contracts then they may be accepted for inclusion as

General stock losses will be dealt with in accordance with GAAP and the contractor's QMAC.

SSCS Ref	SSCS Description	Comment
10.9 (Bullet 3)	<p data-bbox="325 188 826 421"><i>Allowable Costs.</i> This will only apply when the Contractor's costing system is able to isolate these stock losses as an indirect overhead. Contractors will be requested to provide evidence to support any claimed obsolescent stock write-offs.</p> <p data-bbox="325 439 826 739">It is a condition of admitting private venture research and development expenditure for recovery on MOD contracts that the MOD be satisfied that, having regard to all the circumstances, the classification, allocation and apportionment of costs adopted by the Contractor is fair and equitable.</p>	Highlighted text - this should be a matter for the SSRO to decide.

Response 2

Single Source Cost Standards

Statutory Guidance on Allowable Costs - Consultation

By email to

10 December 2014

Dear Sir

The purpose of this email is to set out our principal concerns in relation to the draft Statutory Guidance on Allowable Costs issued 26 November 2014.

For ease of reference the remainder of this email is set out in numbered paragraphs.

1. Whilst we appreciate the fact that the Guidance has been made available before the Regulations come into force, it is not unsurprising given the short timescales that the Guidance is general in nature and principle based. We are very disappointed with the quality of the draft. We look forward to working with the SSRO to develop more detailed Guidance to be published in due course.
2. Additionally whilst we appreciate the opportunity to make representations on the Guidance we note the consultation period is exceptionally short (two weeks) with the Guidance being issued on 26 November 2014 and representations due by 10 December 2014. We are certain interested parties including ourselves would appreciate more time to allow full and proper consideration of the proposals and to enable a more considered and complete response to be provided, followed as appropriate by direct engagement with the defence industry and/or the Authority's representatives.
3. We support the work of ADS in commenting on the Guidance. The comments set out below are therefore not exhaustive and are intended to supplement ADS's position both in relation to the overall adequacy of the draft Guidance and the multiple points of both principle and detail which require correction or further engagement with industry and/or the Authority .
4. References are to paragraphs in the draft Guidance.
5. As we move into the SSPR regime, we will still be operating a number of large contracts under the old Yellow Book pricing regime. Therefore we will see for a number of years the need to produce cost rates under both SSPR and Yellow Book rules. Industry will need to engage with the SSRO to understand how these will work and the arrangements for transition.
6. Detailed comments:

Paragraph 4.2 (3) (a) the commencement date for the Single Source Contract Regulations will be "the day after the day on which they are made" per the draft Statutory Instrument Para 1. This date is critical in determining whether a contract is a Qualifying Defence Contract. There is a lack of clarity on the exact date although the draft Guidance mentions the date "is expected to be December 2014" in footnote 2. Given the importance of this date for the Qualifying Defence Contract definition, and the compliance burden associated with the Regulations more generally, we would recommend that Paragraph 4.2 (3) (a) is amended to say "the contract is entered into on or after [6] months after the commencement of the Regulations" in order provide certainty and to allow contractors sufficient time to prepare systems and put the right processes in place in order to implement the regulations satisfactorily.

Paragraph 4.2 (2) This provision states a contract is a Qualifying Defence Contract if it is above the amount specified in Regulations Part 2, Regulation 6. Regulation 6 only appears to deal with contracts which are amended contracts and does not deal with new contracts. Clarification on the threshold value for new Qualifying Defence Contracts is requested.

Paragraph 4.3 – We have assumed that the test is cumulative. However, we believe that there should be greater clarity about thresholds and suggest the inclusion of a worked example.

Paragraph 7.2 and 7.3 – This provision is unworkable in practice because costs are collated and consequently it is not always possible to attribute a specific benefit to each cost.

Paragraph 8.3 – Not all systems distinguish between direct and indirect costs so this paragraph should be qualified by the words "as applicable".

Paragraph 9 heading and Paragraphs 9.2 and 9.3 – The SSRO is not tasked with providing a 'Definition' of AAR. AAR is not defined by the Act or the SSPR and it is not the place of the Guidance to do so. The SSRO is tasked with providing guidance in establishing an Allowable Cost in accordance with the Act.

Paragraph 9.2 – If a cost is fair and reasonable in the normal course of business it should qualify as appropriate. The test of "withstanding public scrutiny" is not appropriate and is undefined.

Paragraph 9.3 – An attributable cost should be one incurred in complying with the overall specification agreed with the Authority for the particular contract.

Paragraph 9.4 – A reasonable cost cannot be tested against what is value for money to the UK taxpayer. This is idealistic and unworkable. Expectation should not play a part in whether the cost is reasonable. The cost is either necessary to carry out the contract or it is not. The word "congruent" should be replaced with "consistent". A test of "withstanding public scrutiny" is too vague and idealistic.

Paragraph 10.7 – The contractor should be free to reward employees with shares as a benefit for genuine contribution. Such awards should be made on merit and will not necessarily be awarded to all parts of the workforce.

Paragraph 10.13 Pension Costs – We believe that the current accounting standard for defined benefit pension is volatile and not representative of the underlying cost of the scheme. Therefore we would prefer to use the funding cost of the defined benefit scheme, as defined by the scheme actuary on a triennial basis, to form the basis of costing and pricing under the SSPR regime.

Paragraph 11.1 – Entertainment expenses (to employees or third parties other than the Authority) are a legitimate business expense provided they are reasonable and proportionate and should be allowable.

Paragraph 11.1 – Insurance premia which relate to policies which are required by the Authority (or from which the Authority benefits) or the agreed contract specification should be allowable.

Paragraph 11.1 – The bullet point regarding treatment of cost contingency and cost risk is unacceptable. The section is both confused and based on a fundamental misconception regarding the use of cost contingencies.

Paragraph 11.2 – The circumstances in which costs are disallowed needs to be explored further.

Paragraph 12.7 – These provisions cannot lawfully override existing arrangements (including indemnities) between the Authority and the contractor relating to liabilities which the Authority has contractually agreed to bear, for example in relation to the closure, maintenance, clean up or rationalisation of assets.

Paragraph 12.19 - 22 These provisions create a significant disincentive for companies wishing to carry out

research and development ("R&D") in the UK. This is disheartening given R&D is one of the corner stones for rebuilding the UK economy. Only last week, in the Autumn Statement, George Osborne said "*we also want to help British businesses do more research and development – this is crucial to our productivity*". If the R&D credit/relief is set against Allowable Cost the likely consequence is that there is a complete loss of the R&D tax benefit by the contractor on Qualifying Defence Contracts. As such contractors will be less motivated to carry out R&D and are likely to choose not to make R&D claims for any R&D they do carry out. This would ultimately end up with the Authority spending more than they would if the contractor had carried out R&D and had claimed R&D tax credit/relief .

If a contractor is requested by the Authority to make an R&D claim knowing it would retain none of the R&D tax benefit the contractor should be compensated for the cost of making the claim, for example by way of an allowable cost.

Kindly acknowledge safe receipt. Yours faithfully

Response 3

10th December 2014

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Dear Marcine

CONSULTATION ON STATUTORY GUIDANCE ON ALLOWABLE COSTS

Many thanks for your e-mail of 26th November 2014 inviting responses to the consultation on the draft SSRO Statutory Guidance on Allowable Costs. As discussed in our e-mail exchanges, we have completed the Consultation Response Form to assist you in your analysis of all responses. However, in order to provide what we feel is a more comprehensive and full response on this important part of the overall Single Source framework, we also submit this letter as supplementary information.

General observations

We welcome the overall structure of the document and the intent to focus on principles rather than try to provide detailed, rules-based guidance. A number of historically contentious topics are specifically covered and there are subtle differences on these between the Yellow Book and the proposed Statutory Guidance. We would welcome further clarification and engagement on these differences to aid our understanding. A number of areas of the guidance look to replicate information already contained within either the Defence Reform Act (DRA) or the associated Single Source Contract Regulations (SSCRs) and removal of these sections would simplify the guidance document.

Specific Comments

Although mentioned in the introduction (Section 2.2) rather than the main body of the guidance, we believe there is an important principle which would be useful if it were reinforced throughout the document, which is that if non-competitive contracts must emulate competitive conditions, and given that companies in a competitive environment recover all of their costs and still make a reasonable profit (-10% across UK industry at present per the 2014 Annual Review), any normal cost present in a competitive environment ought to be considered to be allowable in a non-competitive environment.

In a number of areas, the guidance raises the test of "withstanding public scrutiny". This is not contained within either the ORA or the SSCRs and hence appears to add to the legislation rather than provide guidance. We believe that aspects of the definitions of Appropriate and Reasonable when applied to the question of allowability adequately cover the need for an Allowable Cost to withstand public scrutiny. As such, any separate reference to a test of public scrutiny ought to be removed from the guidance.

We agree that in order for a cost to be considered Allowable, all of the three

requirements of Appropriate, Attributable and Reasonable need to be satisfied. A number of sections of the guidance (for example section 7.2) describe a need to be able to trace costs incurred through to activities and outputs, however this can only be fully applied to direct costs. Indirect costs, by their very nature, do not have such a strong association between inputs, activities and outputs. We feel it would be helpful if there were separate sections for direct and indirect costs or a stronger emphasis on the use and purpose of the Questionnaire on the Method of Allocation of Costs (QMAC) and the definitions used for direct and overhead / indirect costs contained in the guidance.

In sections 9.2 – 9.4, the checklists are held out to be a set of tests to be used to determine whether a cost is Appropriate, Attributable and Reasonable. We suggest that the checklists should highlight factors which would indicate whether a cost met the criteria, rather than provide a definitive determination, as we believe that the tests in each checklist, even if modified by the comments below, cannot cover all eventualities.

With respect to section 9.2, we would reiterate the point made earlier concerning the public scrutiny test and also feel that a narrow reading of the first bullet point in the checklist could lead to the exclusion of all indirect costs from being Appropriate, which we are sure is not the intention. Our view remains that in order for a cost to be considered Appropriate, its nature must be that it is normal in the proper conduct of business in the defence sector. We believe the adoption of this simple principle in lieu of the proposed checklist would provide clearer guidance.

Again with reference to indirect costs, two of the checklist tests (bullet points four and six) in section 9.3 would be difficult to apply if a narrow reading were to be applied. Again, we are sure this is not the intention. The approach we favour, as set out in our Chief Executive Officer's letter of 30th September 2014 to the SSRO Chair, is that a cost is Attributable to a single source contract if it:

- a) (i) is incurred specifically for the contract; or
- (ii) benefits both the contract and other work, and may be distributed to both in reasonable proportion to the benefits received; or
- (ii) it is necessary to the overall operation of the business, although a direct relationship to any particular contract item cannot be shown; and

- b) is allocated to MoD single source contracts on a basis consistent with the contractor's cost accounting practices as applied to all contracts, whether MoD single source, MoD competitive or other, non-MoD contracts.

We feel this would be a more suitable checklist when considering the definition of Attributable Cost.

The public scrutiny test referenced earlier again appears in the checklist in section 9.5. Additionally when considering that section, there may be occasions when empirical evidence simply does not exist to support a cost estimate. We support the point on benchmarking and feel that expanding the final bullet point to describe costs as incurred by a prudent person in the conduct of business (for example by the use of competitive tendering for subcontracts, robust challenge and approvals processes and costs being established with reference to market forces) would be a more useful checklist.

In a number of areas, there is a requirement to obtain MoD approval prior to undertaking action. For example, in section 10.6 there is a requirement to obtain MoD approval for redundancy costs in excess of the statutory minimum. As a general point, pre-approval by MoD is not appropriate as this gives the MoD a veto on the allowability of certain cost classes without contractors having the chance to present any valid case to the SSRO for its determination.

With reference to redundancy payments, a contractor must be free to determine what he feels are the most appropriate severance terms for his business. If MoD and the contractor cannot agree as to the reasonableness or otherwise of redundancy payments, the SSRO should arbitrate as it would for any other disputed cost.

Section 10.7 refers to staff bonuses "...employed across all parts of the workforce" being Allowable. A strict interpretation could mean that bonus schemes for different sections of the workforce that have different aspects and are based on different factors would not be considered Allowable. We do not believe this is the intention given that many companies have more than one bonus scheme applying to different sections of the workforce and feel greater clarity is required on this matter.

With regards to marketing and sales costs, the majority of these would be incurred for domestic competitive and export campaigns and may not be related to a QDC. However, in the event that a contractor is successful in winning export or domestic competitive contracts, the throughput from that activity gives rise to lower costs being attributable to any non-competitive MoD work going through the same business. It would be inequitable for the MoD to benefit from this export or domestic competitive work being undertaken if the costs of undertaking the associated sales and marketing are not allowable.

Clarification is requested on the disallowance of entertainment expenses of any sort as this is a new arrangement. We do not consider this unreasonable but the benefits of this blanket disallowance need to be balanced against the cost of administering the process of capturing disallowable expenses.

Particular attention is drawn to the twelfth bullet point in section 11.1 which states that provisions for cost contingencies and cost risk are not Allowable. In any contract with a transfer of risk to industry, a suitable level of contingencies and risk must form part of the cost estimate in order for the estimate to have validity. Were this not to be the case, industry would not be willing to accept anything other than cost reimbursement type contracts. With this in mind, we would welcome clarification as to the intent of this particular bullet point.

We assume that the last bullet point in section 11.1 is related to insurance, however it could be read as a more general point which would potentially make warranty costs disallowable and we believe this would be inappropriate. We suggest that a separate, self-contained insurance section would serve to clarify and to highlight this complex subject.

Assuming the last three bullets of 11.1 are all insurance related, they are in line with recent agreements reached with the Review Board other than the last sentence of the last bullet which calls for premiums related to the costs for remedy of faulty workmanship *or the consequences that result to be disallowed*. The words in italics are new and represent a significant broadening of any disallowance. The purpose of product liability insurance is to protect the company from a wide range of losses associated with our products regardless of underlying cause and it is very common for manufacturing companies to take up this type of insurance.

When considering the guidance on rationalisation or plant closure costs, contractors may not be in a position to be innovative with regards to reducing costs. Again we feel that any discussions regarding this type of cost should be subject to a test of reasonableness rather than introducing other criteria.

Similarly, step 2 of the boxed text in section 12.8 is very proscriptive and is rule-based rather than principle-based. It should be for MoD and the contractor to agree the most suitable method to apportion costs of rationalisation, with the SSRO acting as arbitrator in any cases where agreement cannot be reached.

Section 12.20 appears to be in conflict with the earlier section (10.9) on research expenditure and both sections 12.19 and 12.20 do not address R&D Tax Credits which is the heading for these and subsequent sections. We suggest these two paragraphs are deleted.

Finally, the principles contained in sections 12.21 and 12.22 are agreed and accepted. However, the nature of the tax rules in relation to R&D expenditure is such that it would be very difficult, as well as commercially costly for both contractors and MoD, to match and offset any tax credits against specific relevant expenditure. Whether R&D expenditure qualifies for enhanced tax treatment can involve complex analysis and consideration by both contractors and HMRC and can take several years to agree the position. The guidance is silent on transition arrangements and thus contrary to verbal MoD and industry agreements. We suggest that the guidance is amended to state that transitional arrangements from current practice to full compliance and the detailed mechanisms employed to ensure MoD benefit from R&D Tax Credits on QDCs is a matter for negotiation between MoD and each Contractor.

I trust you find this informative and useful. As always, we stand ready to assist the SSRO in the implementation and operation of the new framework and would welcome any dialogue on the subject. I would be happy to provide any further points of clarification relating to the above should you require.

Yours sincerely,

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

We welcome the overall structure of the document with the separation of the principles of Appropriate, Attributable and Reasonable from the specific guidance on costs generally allowable, not allowable and exceptional. It would be helpful if the guidance was clearer when considering direct and indirect costs due to the differing nature of these costs (e.g. direct are clearly attributable whereas indirect less clearly). A number of areas of the guidance look to replicate information already contained within either the Defence Reform Act (DRA) or the associated Single Source Contract Regulations (SSCRs) and removal of these sections would simplify the guidance document.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The guidance introduces points not referenced in either the DRA or SSCRs (e.g. the withstanding public scrutiny test) and its reference to being mandatory is at odds with its standing as guidance (i.e. able to be deviated from if there are clear and compelling reasons to do so). In areas where the guidance looks to replicate the DRA or SSCRs and it is considered essential, this should either be done verbatim or using clear cross-references to the legislation.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

BAE Systems have consistently advocated a principles-based approach. Some areas of the guidance have drifted towards a rules-based approach (such as the methodology by which the proportion of rationalisation costs allowable is calculated) and this feels contrary to the intent of a principles-based approach

Single Source Cost Standards
{Draft} Statutory Guidance on Allowable Costs

Consultation Response Form

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

It is clear from the guidance that all three of the AAR principles need to be met for a cost to be allowable. However, when discussing the linkage of a cost to the output, the guidance should be clearer when considering indirect costs as a narrow reading of the current document could lead to a conclusion that indirect costs are disallowed.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

Referencing an earlier point raised concerning public scrutiny, we believe that aspects of the definitions of Appropriate and Reasonable when applied to the question of allowability adequately cover the need for an Allowable Cost to withstand public scrutiny. Additionally, a narrow reading of the first bullet point in the checklist could lead to the exclusion of all indirect costs from being appropriate which we are sure is not the intention. Our view remains that in order for a cost to be considered Appropriate, its nature must be that it is normal in the proper conduct of business in the defence sector. We believe the adoption of this simple principle in lieu of the proposed checklist would reduce confusion.

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes

No

Please add comments to support your answer:

Two of the checklist tests (bullet points four and six in section 9.3) would be difficult to apply to indirect costs if a narrow reading were to be applied. The approach we favour is that a cost is Attributable to a single source contract if it:

- a) (i) is incurred specifically for the contract; or
 - (ii)) benefits both the contract and other work, and may be distributed to both in reasonable proportion to the benefits received; or
 - (iii)) it is necessary to the overall operation of the business, although a direct relationship to any particular contract item cannot be shown; and
- b) is allocated to MoD single source contracts on a basis consistent with the contractor's cost accounting practices as applied to all contracts, whether MoD single source, MoD competitive or other, non-MoD contracts.

We feel this would be a more suitable checklist when considering the definition of Attributable Cost

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

The public scrutiny test referenced earlier again appears and there may be times when empirical evidence simply does not exist to support a cost estimate. We support the point on benchmarking and feel that expanding the final bullet point to describe costs as incurred by a prudent person in the conduct of business (for example by the use of competitive tendering for subcontracts, robust challenge and approvals processes and costs being established with reference to market forces) would be a more useful checklist.

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes X

No

Please add comments to support your answer:

No additional comment

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No X

Please add comments to support your answer:

We suggest that the checklists should highlight factors which would indicate whether a cost met the criteria, rather than provide a definitive determination, as we believe that the tests in each checklist, even if modified by the comments above, cannot cover all eventualities.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes

No X

Please add comments to support your answer:

In any contract with a transfer of risk to industry, a suitable level of contingencies and risk must form part of the cost estimate in order for the estimate to have validity. Were this not to be the case, industry would not be willing to accept anything other than cost reimbursement type contracts.

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

It would be helpful in pricing of other contracts if the opinions and determinations of the SSRO were published as soon as is practicable rather than waiting for an annual update. This would also serve to be more cost effective for the taxpayer as it may reduce the number of referrals where disagreements over similar issues between MoD and contractors are encountered.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

Not per se. The application of the Reasonable test should be the vehicle by which value for money is achieved.

**Single Source Cost Standards
(Draft) Statutory Guidance on Allowable Costs**

Consultation Response Form

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

generally Allowable Costs?

Yes No

generally not Allowable Costs?

Yes No

exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

Although the illustrations provided substantially cover the relevant areas, the responses above do have a number of caveats:

As a general point, pre-approval by MoD is not appropriate as this gives the MoD a veto on the allowability of certain cost classes without contractors having the chance to present any valid case to the SSRO for its determination;

A contractor must be free to determine what he feels are the most appropriate severance terms for his business. If MoD and the contractor cannot agree as to their reasonableness or otherwise, the SSRO should arbitrate as for any other disputed cost;

Clarity is required on the phrase "employed across all parts of the workforce" in relation to staff bonuses as a strict interpretation could mean that bonus schemes for different sections of the workforce that have different aspects and are based on different factors would not be considered Allowable;

The majority of marketing and sales costs are incurred for domestic competitive and export campaigns. However, in the event that a contractor is successful in winning export or domestic competitive contracts, the through put from that activity gives rise to lower costs being Attributable to any non-competitive MoD work going through the same business. It would be inequitable for the MoD to benefit from this if the costs of undertaking the associated sales and marketing are not Allowable;

The point in respect of the disallowance of cost contingencies and risk has been made in our response to question 11; Clarity is required over the final bullet point in section 11.1 as we believe it relates to insurance but it is not clear and could be interpreted as disallowing warranty costs; Contractors may not be in a position to be innovative with regards to reducing rationalisation costs and any discussions regarding this type of cost should be subject to a test of reasonableness rather than introducing other criteria.

Additionally, the guidance drifts towards being rules-based in the description of how to apportion costs of rationalisation. This should be for MoD to agree with the relevant contractor with the SSRO acting as arbitrator in any cases where agreement cannot be reached; The principles in sections 12.21 and 12.22 are agreed and accepted, however, the nature of tax rules in relation to R&D expenditure is such that it would be very difficult, as well as commercially costly for both contractors and MoD, to match and offset any tax credits against specific relevant expenditure. The guidance is silent on transition arrangements.

**Single Source Cost Standards
(Draft) Statutory Guidance on**

Allowable Costs Consultation

Response Form

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

Submission of the QJMC, the following of its normal accounting systems, practices, processes etc and the continued use of its systems of classification and cost collection will allow contractors to follow the guidance in the most cost effective manner. Any departure from contractor's normal practices and systems will potentially lead to increased cost.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes No

Please add comments to support your answer:

This aspect of the role of the SSRO has been well publicised and communicated via the ORA and SSCRs. It would be helpful if any inclusion in this document cross-referenced to the relevant sections of the ORA or SSCRs

Response 4

Sent: 09 December 2014 13:51

To: Allowable Costs Consultation

Subject: Single Source Cost Standards (Draft) Statutory Guidance on Allowable Costs - Consultation Response Form

I am responding to the Consultation. I have completed the questionnaire but I trust that you will also find the following commentary reasonably helpful?

1. Throughout the draft document, the Act has been unnecessarily restated, but incorrectly, and over-elaborated. New concepts have been introduced that are not criteria in the Act, such as “public interest”, “public scrutiny”, “benefit to MoD”, which are essentially concepts on which the SSRO will form an opinion.
2. There is unnecessary and misguided detail in the Introduction. All that is required of this document is statutory guidance on Allowable Costs that is clear and legally robust.
3. The continued reference to a QDC is unhelpful in not capturing QSCs, it would be simpler to refer to “regulated contracts”. Furthermore, guidance appears in many places to be product based without encompassing services. In addition, it would be more helpful to make a distinction between guidance on direct costs and guidance on overhead costs - some guidance given only relates to overheads but doesn’t say that. Where examples are given, they need to clearly highlight which principle of the three they are addressing, otherwise it isn’t clear which of the principles is being clarified.
4. Cross-references to the Act and the Regulations should be made wherever possible to direct the reader to the source of the authority.
5. There should be a presumption that if Allowable Costs and Profit have been computed in accordance with the Act then the outcome price is value for money.
6. Value for money assessments should apply to prices only and not to individual costs.
7. There needs to be a clear distinction between the “principles” to be applied and the “guidance” on those principles - some places they flow into each other. There are some principles missing, particularly the treatment of commercial items such as market price items and non-developmental items. Guidance is also needed on when costs are allocated to this regime when a contractor is using MRP systems, and the treatment of common, fungible and anonymous stock in relation to reporting and POCO. Guidance is needed on Capital Employed, which is covered in the GACs but not in the current guidance. Guidance is needed on the effect of prior agreements with MoD that might affect the pricing of regulated contracts.
8. The document is poorly drafted:
 - a. Inconsistent use of capitalised terms (the same words have an initial capital in some places but not in others).
 - b. Over-use of capitalised terms that are not defined or distinctive enough.
 - c. Text and ideas are repeated unnecessarily.
9. The document is poorly laid out:
 - a. Use of bullets instead of discrete identification of each paragraph and subparagraph for future reference; the worst example being para 11.1.
 - b. Paragraphs are split across columns and pages making it difficult for the reader to follow.
 - c. Legalistic words and phrases are used instead of plain language.

I personally think that it would be enormously beneficial if the SSRO drafters and representatives from industry sat down together to discuss matters arising from the consultation in order to formulate a really good, robust and helpful set of guidance documents that will stand the test of time.

If in the meantime I, or my Company, may be of any assistance then we should be delighted to support the SSRO in common endeavours.

Best regards,

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

We believe that this document requires significant revision to provide users with the appropriate clarity required. It is often unclear and confusing in its content and in places appears to misrepresent the Act. Consequently, it is inadequate for the purpose of Statutory Guidance.

It would be helpful if the next iteration of the document could cross-reference the Act or the Regulations in such a way as to point to the source material.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The document improperly and incorrectly tries to restate elements of the Act. It introduces new criteria that are not in the Act. It states that compliance with the document is mandatory and that non-compliance is a breach resulting in fines and penalties, which is wholly inconsistent with the terms of Act. It would be better not to attempt to restate the Act or Regulations but just provide required Guidance where necessary.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

Yes, so long as the principles are clear, understandable and robust enough to withstand legal scrutiny - the current draft does not meet these standards. However, the "guidance" on those "principles" has the effect of becoming rules-based, particularly for those costs that are to be disallowed.

There are potentially more principles that should be stated to cover the range of contracts and pricing characteristics contemplated by MoD and the relationship between the parties in the negotiation of costs.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

It's not clear what is meant by "procedures for determining costs", but the calculation of costs should be left to the parties to the contract. What is required is a clear statement of principles and guidance on them as to how they might be applied.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

It is inadequate and unhelpful in that the 'principles' contain no principles. BDUK considers that Allowable = Appropriate and that these allowable / appropriate costs should be determined in accordance with the QMAC and be consistent with IFRS. Additionally, study of US FARs may assist here.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

See answer to Question 5.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

It is inadequate, creates legal uncertainty and is unhelpful. We consider that all that is required is a statement to the effect that GAAP and QMAC should be followed.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

It is inadequate, creates legal uncertainty and is unhelpful. This section introduces new criteria not in the Act and requires a burden of proof from the party least able to discharge it.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

But, the question does not need to be asked, since section 20(2) of the Act requires the parties to be satisfied that the cost is appropriate, attributable to the contract and reasonable in the circumstances. There is a requirement only to “have regard to” the Statutory Guidance in determining whether those requirements are met (it is not mandatory). Furthermore, the MoD may require the contractor to show (whether by reference to the Statutory Guidance or otherwise) that those requirements are met - so the Statutory Guidance is not necessarily the absolute determinant.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

The checklists are unhelpful. They introduce new criteria that are not in the definitions. It should be necessary only to meet the definitions.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Evaluated Cost contingency and cost risk are an essential part of the cost baseline and therefore the price. Contractors make a choice when costing, to include unknowns/risks within the core delegated numbers, or retain control, visibility and challenge by segregating the costs in contingency. The cost contingency should be properly evaluated at the amount that on balance will be incurred by the contractor. MoD recognises this in internal guidance on pricing and on the Earned Value Management of projects. It would be wholly inconsistent with the comparability principles established for the calculation of the baseline profit rate to exclude these items.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

If opinions and determinations are made by the SSRO these should be published promptly and not delayed for an annual publication.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

The Act and Regulations are there to achieve transparency to determine a fair and reasonable cost / price not necessarily VfM, therefore the Guidance alone cannot provide that which cannot be provided.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

The graphical illustrations do not help because they merely repeat the principles stated in the Act. The textual “illustrations” are inconsistent and unbalanced and often at odds with generally accepted practice (GACs) and QMACs. Also new requirements are unacceptably introduced, e.g. 12.4 and 12.10.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

There is mostly unnecessary; the only requirement should be disclosure in a completed QMAC. Access requirements and availability of records are covered by the Act. The SSRO should own the form of the QMAC so that it is under impartial control - although there is an interface with the US where the QMAC (with the QMAC supplement) has to satisfy the US Cost Accounting Standard Board’s Regulations as an acceptable alternative to the filing of a US Disclosure Statement-1. This has been managed by MoD to date.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

There should be a simple listing of the SSRO's role by reference to the particular sections of the Act and the paragraphs of the Regulations that govern that role.

Response 5

Sent: 09 December 2014 13:40
To: Allowable Costs Consultation
Subject: Statutory Guidance on Allowable Cost comments

Dear Marcine

Please find attached my response questionnaire on the above draft guidance. The response form did not allow me to provide all responses required, so I also attach a marked up copy of the guidance with specific issues, comments and suggested amendments.

This guidance is a key plank of the new Regulated regime, and it exists in a diverse and complex contractor base. As such there is considerable complexity, and much care in the definitions is required. I apologise for the length and quantity of issues raised, I appreciate that the SSRO has been left with very little time to produce this guidance, to allow contracts pricing now to use the document. The MoD have struggled to address this guidance, with all the background and detailed real issues experience that they have.

In addition to the questionnaire, and marked-document, I would also make the following observations:

1. I have already noted the difficult position the SSRO has been left in with regards to the timetable, however 10 working days for responses on this key document is not sufficient, and should all who are affected respond adequately, 10 days for the SSRO to finalise the document is also not adequate. The issues are complex and in many cases will require further exploration, discussion and investigation. There is no time to properly complete this feedback loop.
2. The document is long hand, restating the act in places, which is not required, whilst the core of the definitions/principles (if any) and illustrations are brief.
3. The document does not properly state the requirements of the Defence Reform Act (DRA) and Regulations. It states that the guidance must be followed. Users must have 'due regard' for the guidance, and have sound reasons for deviating from it.
4. New tests have been added which I believe are inappropriate, such as 'public scrutiny'. The public understand little of the defence contractor environment and existing agreements, the guidance should stand suitably qualified and experienced scrutiny.
5. Existing agreements indeed must be taken into account, particularly those relating to the sales of assets/sites from the MoD to industry.
6. There should be an overriding starting principle, that:
 - a. Primary cost recording is in GAAP (IFRS/FRS/Other). The MoD/SSRO has no jurisdiction in this.
 - b. Costs are presumed to comply with AAR in their primary GAAP reporting.
 - c. There needs to be clarity there is restatement from the primary cost recording to MoD costing through the GAAP and application of the allowable cost principles.
 - d. The guidance needs to make clear the step from a to c, and that the guidance only deals with c
7. The issue of market priced items/commercial items/non-developmental items has been discussed at length with the MoD, however there is no solution to the allowable cost here. Please see attached paper. This is a significant omission and requires to be addressed in the first issue of the guidance. Otherwise contractors making composite supplies (commercial and single source), or overseas contractors (for example being unwilling to sell a platform that the MoD has not invested in at marginal cost) will not be willing to supply the MoD.
8. The guidance needs to be modified to recognise the issues that ERP systems will have on allowable cost. Most contractors use anonymous stock (where costs are moving average actuals). For example contractors can price using POCO, but the costing system will average that stock out with all other stock. The alternative is to use project stock. However this is most inefficient, increasing inventory levels, slowing production efficiencies, altering MoQs and in practice impossible to control (robbing stock). The issues here are numerous and complex. I would be happy to discuss them with the SSRO should this help in their understanding.
9. Although not an allowable cost issue per se, the GACs define the Capital Employed for the Capital Servicing Allowance computation. As the GACs are not relevant for Regulated contract there is no guidance. The SSRO needs to either include it in this guidance or add a separate piece

of guidance.

10. Overall I would summarise:

- a. Appropriate, this is not a principle, but should be a list/series of 'inappropriate' items that are in bad taste, types of expenditure that the MoD should not be paying for.
- b. Attributable, it is impossible to link some infrastructure/business overhead to contract specification/benefit. The test should be satisfied by use of the company disclosed QMAC. I also would suggest that the QMAC format, should be owned and maintained by the SSRO. At the moment it is agreed between the MoD and industry, which is a very difficult process within MoD as their separate users (CAAS accountants and CAAS cost engineers) frequently disagree
- c. Reasonable, this is the most difficult test, but should be considered prospectively (never retrospectively), with a presumption of reasonableness unless the quantum is significantly at deviation from norms, otherwise spurious challenges will arise.

11. The private venture section does not include treatment of part funded development programmes

12. Indeed there are sometimes part funded contracts, consideration of these is required

13. PPP/PFI programmes will usually depart from the QMAC with good reason, this set aside should be permitted.

14. The allowability of some direct and significantly indirect costs on contract break has not been considered. FAR Part 31.205-42 gives good guidance.

15. The recovery of indirect costs of rationalisation/idle capacity is not considered in detail

- a. There may be no direct base to recover these costs over
- b. The recovery base may be inappropriate (export, or all priced)
- c. As stated, profit would have to be added to allowable costs, it has been accepted, that in these cases industry does not add profit.
- d. A new class of cost for this circumstance, to which no profit is required (or if it conflicts with the act, then these payments must be exempted, or in later Regulations taken out of scope.

16. Items in the GACs not brought into this guidance:

- a. Bid and proposal costs have not been addressed (partially excluded or deferred)
- b. No mention that some contractor groups may use a separate company for PV development, but this does not preclude recovery.

Again, I apologise for the length of my response, but this is a key document, and I think the SSRO has had a timing 'hospital-pass'. I am available, and would be delighted to explain further any of the issues that I raise, by telephone, email or meeting.

Kind regards

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

This document requires some significant revision to provide users with the appropriate clarity required. Please see attached mark-up.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The document does not need to provide any description of its status and purpose, it only needs to reference the Defence Reform Act and the Single-Source Contract Regulations.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

I am not sure principles always work for AAR:
Appropriate, it is really a statement of what is inappropriate - a list/rules
Attributable, should follow the disclosed QMAC
Reasonable may permit a principle based approach

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

The calculation of costs should be for the contractor to conduct and the MoD to verify.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Please see mark-up, and email, and attachment.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

Please see mark-up, and email, and attachment.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

Please see mark-up, and email, and attachment.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

Please see mark-up, and email, and attachment.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

Yes, the DRA requires (section 20(2))
There is a requirement to 'have regard to' the Guidance in determining whether those requirements are met (not mandatory). The MoD may require the contractor to show (whether by reference to the Guidance or otherwise) that those requirements are met.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

The checklists create new criteria that are not in the definitions.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Evaluated Cost contingency and cost risk are an essential part of the cost baseline and therefore the price. Contractors make a choice when costing, to include unknowns/risks within the core delegated numbers, or retain control, visibility and challenge by segregating the costs in contingency. The cost contingency should be properly evaluated at the amount that on average will be incurred by the contractor. MoD recognises this in internal guidance on pricing and. It would be wholly inconsistent with the comparability principles established for the calculation of the baseline profit rate to exclude these items.
The draft Contract Reports set out the price buildup, cost, then contingency then profit. It is essential that the contingency is properly evaluated on an average outturn basis.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

Annual publications would be useful, together with timely updates when determinations and opinions are made.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

Please see mark-up, and email, and attachment.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

The illustrations are a restatement, and bring no new understanding.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

Presentation of a completed QMAC only should be required. The SSRO should own the form of the QMAC so that it is under impartial control (subject to management of the US MoA). Any rights of access and open book are contained in the DRA. Again see mark-up, and email, and attachment.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

This is not required in the guidance, only reference to the toe DRA/Regulations where appropriate.

Allowable costs for commercial items, market priced items and non-developmental items priced within a Regulated Contract

1. Introduction

- 1.1. The definition of the allowable cost for commercial items, market priced items and non-developmental items was discussed during the development of the Defence Reform Act (DRA) and Single Source Pricing Regulations (Regs), between the MoD and industry during the consultation process.
- 1.2. The DRA allows one pricing methodology:
Price = (Contract Profit Rate(CPR) x Allowable Cost (AC)) + AC
The DRA does not permit a composite/hybrid contract, under which some (single-source) items are priced in accordance with the formula and some are priced on another basis
- 1.3. The Single Source Regulations Office (SSRO) has now published the draft *Statutory Guidance on Allowable Costs* (SGAC), which does not address the issue.
- 1.4. These items have a market price, which is efficient, and fair and reasonable to be paid, therefore defining their allowable cost appropriately is critical to both industry and the MoD.

2. Supply types that require definition of appropriate AC

- 2.1. Contracts with the MoD have grown in range and scale of supply over the years in line with procurement policy. This has been primarily to ensure that risk of output performance and integration rest with the contractor and are mitigated from the MoD's portfolio. Contracts therefore often supply single-source items and items which have a market price within the same contract.
- 2.2. The Regs require that deliverables under a contract are not separated out if they fulfil a single requirement (Regulation 5 (5), (9), (10) and (11)). These items must therefore be included (and priced i.a.w the DRA) in the Regulated contract.
- 2.3. Non-developmental items are supplies in which the MoD has not invested in the development of the item. Suppliers must be able to recover this investment. Pricing on a pure cost (marginal cost) basis is inappropriate and may trigger Most Favoured Nation clauses, or destabilise pricing norms. Many suppliers will choose not to supply if this were the case. For example an overseas aircraft supplier would not supply the UK MoD at its marginal cost of another aircraft when either that supplier or its government has invested in its development and IPR.
- 2.4. Commercial, market priced or non-developmental items, are supplies that are sold, in a competitive environment, where pricing norms are available from price lists or other evidence.

3. Solution

- 3.1. An appropriate solution to this issue would be to specify within the SGAC a different value to the AC for the supply of these types of item. MoD and industry have previously discussed and broadly agreed a solution to this definition to AC, which defines the AC as the market price less the contract baseline profit rate. The MoD commercial guidance on the MoD's Acquisition Operating Framework (Single Source Contract Regulations Guidance, Chapter 3, Pricing a Qualifying Defence Contract: The Cost Element) addresses this issue: Para 17 states 'You must follow the [Statutory Guidance on Allowable Costs] SGAC in all circumstances, unless you have clear and convincing reasons to deviate from them. *For example where you can use market rates to assess that a cost for a particular item is reasonable.*' (Emphasis added).
- 3.2. The AC in this circumstance would be $AC = \text{Market Price} / (1 + \text{CPR})$. This would be a deemed AC for these types of supply.
- 3.3. This pricing would require exclusion from contract reporting, or reporting with the AC being the AC as priced for these items.

Response 6

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

This guidance is being issued under s.20(1) of the DRA, which states:

“(1) The SSRO must issue guidance about determining whether costs are allowable costs under qualifying defence contracts.”

Hence, the guidance should be limited to that this subject. We see no need to revisit the background, restate the definition of a QDC or include sections on Reporting, Monitoring and authority. A reference to the relevant authority and supporting clauses would be sufficient.

Should you feel that such background has to be included then the draft would need to be considerably re-worked to address a number of imperfections. The current ambiguity in the text undermines the clarity of the guidance and would render its use in making binding directions difficult. We would cite best practice in this area as being the US approach within their Cost Accounting Standards Board Regulations (notably CFR 9904.402-60), not losing sight of IFRS/UK GAAP accounting standards. We would also stress the importance of the QMAC. In our view, it might assist the SSRO, if after defining the framework against which contractors are required to report, the result were to be submitted to MoD/CAAS for audit and agreement.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The current draft lacks focus and thus obscures the actual status and purpose of the guidance. In expressing these aspects with precision, you may wish to revert to Section 20 sub-section (2) of the Act which states that in determining whether a particular cost is an allowable cost, the MOD and the contractor must have regard to guidance issued by the SSRO. MOD 's view during the consultation stage was clear that 'must have regard to' is to mean that guidance issued by the SSRO can be set aside where there is good, documented and agreed reasons for so doing. In addition, our understanding of the baseline is that statutory guidance is only applicable to qualifying contracts and qualifying sub-contracts. The guidance may be adopted for use on contracts that are outside the scope of the law and regulations but this will be 'agreed' guidance rather than statutory guidance. Statutory guidance is not applicable to pre-existing contracts' price in accordance with the Government Profit Formula and Associated Arrangements. The precision of these boundaries has been obscured in the current text.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes

No

Please add comments to support your answer:

The principles need to be defined with clarity so as to enable the parties to understand the tests and considerations that the SSRO will apply. While a rule-based definition of 'appropriate' costs may be attainable, the more intangible aspect of 'reasonable' costs may be harder to define. Again, we would cite best practice on the way in which these concepts are expressed in the US cost accounting principles of 'consistency in estimating, accumulating and reporting costs' (CFR 9904.401) and 'consistency in allocating costs incurred for the same purpose' (CFR 9904.402).

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes

No

Please add comments to support your answer:

We are puzzled by the introduction of a seemingly novel concept of 'Single Source Cost Standards'. Section 20 of the Act requires the SSRO to issue statutory guidance on 'Allowable Costs' and there is no empowerment to define 'Cost Standards'. These are covered by QMAC and other regulatory guidance and thus the document title itself is erroneous.

In terms of procedures, the table at 7.7 served little if any purpose given that it refers solely to 7.6. In addition, the order in which the tests set out within 9.2 to 9.4 make no difference to the end result. It is therefore arguable that the flow-chart is redundant and does not represent a 'procedure'.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes

No

Please add comments to support your answer:

The principles are not clear because they lack clarity of definition either because they have not been defined at all, are not presented in a logical order or lack consistency.

An example of the lack of a definition would be Section 10.9, on Private Venture Research and Development where the second bullet states:

' in the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs should be recovered by a charge to the current total output of the product group'

What does 'charge to the current total output of the product group' actually mean and where is it defined?

In terms of the lack of structural logic, the last bullet in Section 10.9 states:

"research and development costs will not be allowed where there has been no discernible benefit provided to MOD..."

This seemingly is the compelling criteria and logically should be placed first.

As for inherent contradiction and thus a lack of consistency, bullet six in the same section states:

'any costs relating to projects where the research and development activity has already been funded will not be an Allowable Cost'

In order for Research and Development to be funded, it must be chargeable to a customer and therefore is not Private Venture hence the definition is not consistent.

As a general point, if it is considered necessary and appropriate to explain the difference between Direct Costs and Indirect Costs then the wording at FAR 31.202 (Direct Costs) and 31.203 (indirect Costs) provide a better foundation.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

The definition is seemingly founded on the premise that the costs should be able to withstand public scrutiny. This is a highly subjective test and as such very likely lead to an inappropriate approach. Equally, the checklist is inadequate in that it is not clear as to the meaning of:

'Is it a cost that would be expected to be incurred in the delivery of the Qualifying Defence Contract?'

It is not clear whether the test is restricted to direct costs or whether apportioned cost might also be considered. If the latter applies, it is also not clear as how cost segmentation should be applied.

Again, the approach taken in the US FAR Part 31.205 is instructive in pplying the 'public scrutiny' test.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Pease add comments to support your answer:

The definition lacks sufficient detail in the checklist by which to make a judgement on the 'Attributable' test. There is a range of sets of circumstances where application of the checklist tests would lead to different conclusions. Equally, we judge that it would not be possible to apply the final item:

'Can it be evidenced that the cost has not been recovered elsewhere'

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

Reasonableness cannot be demonstrated by *'delivering value to the UK taxpayer'*. It can only be reviewed against the facts and circumstances know at the time decisions were made and the judgements made giving rise to those decisions.

The US FAR definition at 31.205-3 is normally considered as sound. It addresses 'business at large' rather than defence contractor compared with other defence contractors. It also includes sound discussion on the factors that need to be considered.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

We are puzzled by this question as Section 20(2) of the Act requires the parties to be satisfied that the cost is appropriate, attributable and reasonable. However, there are plausible circumstances where the cost may be allowed in part if only a proportion is agreed as not allowable. Sharper, more detailed definitions for all three tests are required.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

This is covered in the responses to the preceding questions.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Cost estimates should be based upon verifiable facts and judgements applied to those facts. The basis of estimates should be disclosed. Equally, the cost estimate should be prepared and negotiated whereby the value agreed is the mean expected cost outturn (the sum of the product of the cost at each point on the probability distribution multiplied by the probability at that point). Again, the US FAR fully and soundly addresses this issue and consideration should be given to utilising the approach within this Guidance.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

Such an approach would aid the understanding of the parties and reduce the scope for disagreement with subsequent referral to the SSRO. However, in the first two years of application of the Guidance, updates should be published promptly and not delayed to meet an annual publication cycle.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

A definition of allowable cost cannot on its own promote value for money, without some reference to the quality of the final product. This balance is a matter of growing concern across the broader range of public procurement.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

The examples given are generally all found within the Yellow Book, yet seem to lack the same level of detail within the draft Guidance. While apologising for the level of detail, we offer the following by way of illustration using para 10 to illuminate the 'generally Allowable costs' point but could apply similar analysis to the subsequent two sub-questions:

- 10.4 Depreciation (together with any impairment to the carrying value) of property, plant, and equipment represents the value of the usage consumed and is calculated in accordance with the applicable accounting standards board regulations and confirmed by external independent audit. The values written down in the period should be taken from the accounts as published. Changes to valuation should be taken from the accounts and not subject to agreement by MOD or scrutiny by the SSRO.
- 10.4 Amortisation of certain intangible assets (say business software) is similar in nature to depreciation of property, plant and equipment and should be treated in the same way. R&D capitalised as an intangible asset in accordance with IAS 38 needs further consideration. The recovery of R&D into contract prices relates to the use of the know how in the performance of a contract rather than the diminution of the carrying value of the long term asset due to the passage of time. The US FAR treats R&D (regardless of treatment as a long term asset or a period expense) as relating to the period when the cost was incurred and not when the cost is amortised/impaird.
- 10.5 Where the costs of goods held in stores are allocated to a contract at their point of acquisition rather than point of consumption then stock losses and obsolescence should be a contract charge. Where inventory is held as fungible inventory and the allocation of cost of deferred to the point of consumption then the costs of stock losses and stock obsolescence should be treated as a business expense. The dialog also needs to address the timing of the allocation of the cost, it should be when the carrying value of inventory is reduced to its net realisable value rather than when the items are disposed of i.e. the period in which the value of inventory is reduced rather than when confirmed as lost or disposed as obsolete.

- 10.6 Redundancy payments (see arrangements made by government departments for its own employees) are seldom at the statutory minimum. They are negotiated settlements made either on a case by case basis or as part of a collective agreement. Surely SSRO does not require being informed of each and every occurrence and negotiated settlement! Is SSRO requiring MOD to participate in each negotiation and settlement or is it sufficient for the company to evidence that the quantum of the cost is both reasonable under the circumstances? MOD has a history of accepting expenditures that are reasonable (Would have been incurred by a prudent contractor undertaking commercial work).
- 10.7 Staff bonuses are not necessarily employed across all parts of the workforce. Just like overtime incentives, they are focused to stimulate and reward the behaviours and performance sought by the contractor. The wording should be revised to address reasonableness.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

Disclosure requirements are covered elsewhere in the regulations.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes No

Please add comments to support your answer:

It would be helpful if a clear listing were provided of the rights to seek an opinion of the SSRO by both (primary) QDC contractors and (sub-contractor) QSC contractors; particularly with reference to failures to agree when pricing QSC sub-contract changes where the contract statement of work between the MOD and the prime contractor is unchanged.

Response 7

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

As responded above I do believe that the introduction is clear however I do want to comment and ask a question regarding paragraph 4.2 (3) (i):

On the assumption that the Secretary of State will wish to agree that the contract amendment is to be a QDC and the Primary or Sub-Contractor may prefer for it not to be a QDC. Can you confirm that without mutual agreement that the amendment will NOT be a QDC. Furthermore, is it possible for the Secretary of State and Primary Contractor to agree a QDC but that the Sub-Contractor does not agree and its component of the amendment is classified as NOT QDC?

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Paragraph 8.3 states that the “attribution of costs between indirect and direct recovery must be agreed between the MOD and individual contractors”.

It is understood that clarity needs to exist on which costs will be direct and indirect however the paragraph implies that the MOD can disagree with the cost attribution put forward by the Contractor. The cost attribution proposed by the Contractor is most likely to be driven by the Contractor’s methods of accounting for costs across QDCs, non QDCs and contracts with non MOD customers and as such it’s likely to be impractical to attribute costs to QDCs in a way that is inconsistent with non QDC / non-Defence contracts.

Furthermore, it is likely that the attribution of costs between direct and indirect will differ significantly between Contractors.

Can SSRO confirm that this paragraph is not intended to drive consistency between Contractors nor for the MOD to require a particular attribution but that it is simply to ensure that the attribution is understood at the outset of an amendment?

Paragraph 8.5 contains a definition for Overhead / Indirect Costs.

A list of costs that may be included in this category is provided.

These costs are often allocated to a contract using the Questionnaire on the Method of Allocation of Costs. Is it the intention that the audit and review of the allocation methods will be used will be similar to that experienced in the past or are the SSRO expecting to introduce a more detailed audit of the already existing allocation methods.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes

No

Please add comments to support your answer:

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes

No

Please add comments to support your answer:

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

The checklist to determine whether a cost is Reasonable is very far reaching with little detail.
For example: "Is the cost consistent with sector / marker benchmarks?"
Benchmarking are costly exercises, who is expected to bear the cost of this?
And: "Is the quantum of the cost consistent with good business practice?"
Can the SSRO provide examples of how this can be demonstrated?

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

No answer as a result of feedback in relation to Q8

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes

No

Please add comments to support your answer:

As part of MoD / Contractor negotiations, the agreement on who is best placed to hold risks associated with the contract deliverables will be something that forms part of the negotiations. The output may well be that both parties agree that the Contractor is best placed to manage said risk and as such the cost of the risk will by default be required to be built into the cost base.

This can be demonstrated by the cost variances experienced on some MOD contracts. These cost variances are not just incurred as a result of Contractor variances in estimation but also MOD inaccuracies and contract ambiguities over contractual deliverables.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

A yes with two caveats:

Cost of funding the SSRO is as yet undefined and will impact contract margins from 2017. The scope of questions, investigations and audits will need to be controlled to ensure the value for money formula is adhered to.

A contractor might be hesitant entering into a contract of more than one year given the potential change to the Contract Profit Rate and might prefer to contract on an annual basis to avoid contract uncertainties.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

Examples given do not cover the entire Profit and Loss spectrum of costs and therefore it is considered that more examples could be given.
E.g. Maritime costs rather than salary costs.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

The document states "Determine whether the price payable under the QDC is to be adjusted, and by what amount".

Can SSRO please confirm that, subject to a Contractor being non compliant with the cost standards, the price cannot be changed once is contract amendment has been signed?

Can the SSRO clarify the requirements placed upon the Primary Contractor to ensure that the Sub-Contractors is compliant with the standard? It needs to be clear that the Primary Contractor has no right to audit nor require commercial sensitive financial data from the Sub-contractor.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

The role of the SSRO is understood however the degree to which they will interrogate and audit costs is uncertain.

Response 8

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

We feel the structure could be improved by referring to sections of the Act that introduce the SSRO and charge the SSRO with providing this guidance. Adding the background data risks introducing opinions rather than hard facts, which can be distracting.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The concern we have is that the introductory sections can be seen to be critical of single source contracting per se and that the sense of balance between the SSRO's two objectives could be stronger. For example, in 2.5 the last bullet could end with the words "for all stakeholders" to make it clear that the SSRO's role is to act as an independent party for the good of all involved in single source contracting. In 2.6 (a) a change to state "to address shortcomings that *may* arise" would make it clearer that not all single source procurement has shortcomings today.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

It might be possible to improve this by referring to the items generally disallowed as this might add depth to the types of items that would not be deemed appropriate.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

Whilst concise, we have a concern over two of the details contained within the checklist.

The first is causality as that would seem to point the user towards direct costs and might leave overhead costs as unattributable and unrecoverable. Without these costs, companies are unable to operate but they often will not have a causal link to a specific contract.

The second is the last bullet as this would require the Contractor, having the burden of proof, to prove a negative, which is impossible. The principle of not recovering cost twice is absolutely proper and correct and the clause could be reworded to remove the concern.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

Whilst concise, we have one concern over one detail contained within the checklist. One question is whether the cost estimates are based on empirical evidence. Where a novel service or new product is being developed and contracted, there may be no empirical evidence for some or all of the estimated costs. This needs to be considered.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

Provided that the detail in each of the checklists is appropriate and possible (see earlier comments on questions 7 & 8).

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

This would seem to question the whole basis of risk contracting, whereby the risk in contracts is split between Industry and the MoD. If you are unable to allocate some estimated costs for these unknowns, which are today fully accepted as being necessary by both Industry and the MoD, then the logical conclusion is that the MoD wishes to accept all of the risks in these contracts and in the worst case would possibly need to contract on a cost plus basis.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

We believe that this should happen routinely on an annual basis but that special supplementary guidance should be issued on an urgent basis if it would have a significant effect on single source contracts, where waiting for an annual update would limit the SSRO's ability to achieve its objectives as listed in the Act.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

The increased awareness within all parties that this is now scrutinised to a much finer level of detail than ever before should promote this.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

Much of the disclosure that takes place does so as part of the routine engagement related to the QMAC applicable to each organisation. The QMAC is mentioned but could be relied upon more in this guidance to show what the parties have agreed fits the definitions of AAR.

Whilst we have no objections to sharing with the SSRO a decision not to account in accordance with our normal accounting system if that were ever to happen, we could not immediately see to what purpose we would be sharing this as we believe that such explanations would be made and shared between the contracting parties and would have expected them to be referred to the SSRO solely if a determination were needed to address a lack of agreement between the contracting parties.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes No

Please add comments to support your answer:

We believe that communication of the role of the SSRO as an independent body could be made more effective by emphasising its role working on behalf of all stakeholders to fulfil both of the objectives it has been given by the Act.

Response 9

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The guidance states that the Single Source Procurement Framework, of which the SSCs form a part, is the statutory framework for all single source defence procurements - it does not limit itself to QDCs and QSCs. We would question this.

Within Sections 4.3 and 4.4 of the Introduction, reference is made to the total cost of acquisition (TCA). As we would understand TCA, this would translate to the consideration of all costs related to a programme - both industry and government - throughout the whole of the CADMID cycle. As a method for evaluating whether, or not, an individual prime contract within a part of that overall cycle is a QDC we do not believe this is appropriate.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

One overriding principle that has been continued through into the Defence Reform Act is that contractors should receive a fair and reasonable price for the work that they do. We appreciate that this is repeated in the guidance but would also note that one measure of this has been comparability with other, non-defence companies. Given what may now be disallowed, and the potential treatment of a number of areas of cost, we do not believe that this comparability will ever be attainable in future.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Generally the section covering allowable cost is both clear and concise. However, section 7.6 does raise a concern where it becomes possible, because an “opinion” can be binding and a “determination” is binding, that an agreement between MoD and a contractor reached pre-contract could be challenged post contract, even if an SSRO opinion was sought at the time of any such agreement.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

Whilst we would not criticise the general approach, there are areas that might fall under this heading which give us concern.

The treatment of R&D tax credits and the limitation suggested on redundancy payments need some exploration. On the former, it would appear that the planned transitional period for the treatment of R&D Tax Credits has not been allowed for. We understand that this is an MoD responsibility, rather than one that rests with the SSRO, nonetheless this guidance should allow for that period before mandating any final proposition. On redundancy payments, the current statutory minimums are in place to provide a basic level of protection for employees - it would appear here that they might also be imposed to limit employee compensation in the unfortunate event that a company finds it necessary to release some of its employees. Aside from the pure financial implications, there is also a psychological impact to be considered - employees may frequently find themselves working through a period leading to a release date, in the expectation of a minimum payment, can an employer anticipate exemplary performance in that period?

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

We do not believe this is appropriate for either industry or MoD, indeed MoD's own processes currently require that they carry out a thorough, costed assessment of risk at every stage of their approvals. The examination, and quantification of risk, jointly between contractors and MoD/CAAS has developed over many years into a transparent process which gives both parties a full and supportable insight into the potential risks that may arise during the execution of defence contracts and the methodologies for assessing and modelling those risks gives both parties a robust basis for price agreement. To abandon this now would be a retrograde step.

Further, we do not understand what is meant by "contractors are expected to manage price fluctuations" - identifying and mitigating a risk is not "a price fluctuation".

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

Any process is capable of development through taking lessons on board from experience
- this guidance should be no different.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Areas of this guidance will promote the development of differential costing systems for domestic and export business. Whilst the actual impact of such a move will vary between contractors and indeed between individual accounting periods, it is highly probable that this will, at times, cause costs to the UK to rise.
In addition, whilst specific elements of the guidance may reduce costs on individual contracts, the overall impact of the apparent intended treatment of R&D expenditure will cause delay to some research programmes (MoD agreement is required before they are commenced), the curtailment of others and, in certain cases, mean that contractors will not be able to recover costs incurred even where actions are being undertaken at the direction of MoD. This has potential implications for contractors in the export market, which will restrict growth and deny both industry and the MoD the benefits that could accrue from that growth.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

There are areas where a greater definition is required. For example - entertainment is stated to be a cost that would never be allowable. Of course we appreciate the general principle behind this position, that MoD should not be expected to permit costs that are extravagant or unreasonable and, indeed, our own internal policies fully support that stance. Equally however, we would seek to ensure that this guidance promotes consistency as it seeks to ensure value for money and a fair and reasonable price and, in the absence of a definition of "entertainment", that consistency may be lost. A further example relates to the costs of faulty workmanship - does this extend to the cost a contractor might incur as a consequence of being supplied with defective government furnished equipment, does it extend to the future disallowance of all forms of scrap and rectification, does it mean that, in future, MoD will cease to seek benefit from "the learning curve"?

Against 10.14 we would observe that a marketing and sales organisation is likely to form an element of the overall construct of any reasonably sized business - the non-MoD attributable business that such teams can bring benefit the UK by allowing companies to spread their recovery of overheads over a larger cost base than the domestic market would sustain, allowing lower costs to the UK. And, we would also note that it is unlikely, in the extreme, that UK MoD would base future procurement decisions - currently underpinned by a complete understanding and assessment of future operational requirements - on trade fair style promotions - that being so, all such costs would cease to be "allowable".

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

Response 10

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

See attached word document for reasons why Appropriate should be rule based but Reasonable should be principle based

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes

No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes

No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

The cost may be allowed in part if only a proportion is agreed as not allowable.
The definitions as currently drafted within the draft statutory guidance lack sufficient clarity

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

See attached word document for reasons I've set out within my answers to questions 7, 8 and 9

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes

No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

It will aid the understanding of the parties and reduce the scope for disagreeing and referral to the SSRO.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

I do not believe that it will reduce the net overall quantum of costs

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

See attached word document for reasons

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

See attached word document for reasons

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

The Act and regulations set out the scope of the SSRO's terms of reference and limits of its authority.
It would be helpful if a clear listing were provided of the rights to seek an opinion of the SSRO by both (primary) QDC contractors and (sub-contractor) QSC contractors; particularly with reference to failures to agree when pricing QSC sub-contract changes where the contract statement of work between the MOD and the prime contractor is unchanged.

Question 1

- The introduction at 8 pages is largely unnecessary and is wholly disproportionate to the 1.5 pages given to Appropriate, Attributable and Reasonable. The introduction also (1) contains substantially inaccuracies; (2) is poorly drafted; (3) is inconsistent with the Act and the draft regulations with Parliament for approval; and (4) addresses issues outside of the scope of statutory guidance on allowable costs. I have included within each of the answers details of where these failings occur.
- Much of the accounting language used, business and accounting concepts referenced within allowable costs are often very outdated and therefore lack the necessary precision appropriate to use within statutory guidance.
- Some of the content, as resembling chatty dialog, is inconsistent for inclusion with statutory guidance as other than guidance based illustrations. Guidance based illustrative examples can be effectively used; I suggest that the SSRO look to the US 'Cost Accounting Standards Board Regulations' to see how this can be delivered effectively e.g. at CFR 9904.402-60
- The section on reporting, monitoring and authority is inadequate. Contractors in completing their statutory accounts are required to comply with applicable accounting standards i.e. IASB, FASB, and FRS. The application of the accounting framework needs to be acknowledged as the bedrock upon which MOD's requirements are built.
- The SSRO does not appear to understand the objectives of the QMAC. The QMAC is to provide a framework whereby contractors can disclose certain of their cost accounting practices to MOD; an essential part of equality of information that is required to support fair and reasonable pricing; it is not (1) a disclosure of the estimating methodology employed; (2) a disclosure of the basis upon which indirect costs are allocated to the various rate pools; (3) it is not the outcome of an agreement between the MOD and the contractor as to how it values its inventory or contract costs. Once an accounting practice is disclosed by the contractor to MOD, the contractor is required to apply that methodology consistently across his business.
- The US (QMAC) form is owned by the Cost Accounting Standards Board (see CFR 9903) and thresholds for completion are included within the Cost Accounting Standard Board's regulations (also at CFR 9903). SSRO should give urgent attention to understanding the purpose of the QMAC and then giving full and urgent consideration to owning the UK equivalent (the QMAC) of the US CASB DS1 form. For the avoidance of doubt, is it a certified declaration by the contractor (for the whole of its business) of (1) which costs types and in which circumstances it treats as either direct or indirect, the criteria it uses in making those decisions, the controls it has in place to ensure consistent application; (2) the costing rate structure used for production of management and financial accounts; (3) the costing rate structure used for pricing of MOD single source work and its relationship to the rate structure used for management and financial accounts; (4) valuation basis of fungible and contract specific inventory held in each accountable store location; and (5) various other matters that are addressed (either as contractor specific issues or as contractor wide issues).

Question 2

- Section 20 sub-section (2) of the Act only requires that in determining whether a particular cost is an allowable cost, that the MOD and the contractor, must have regard to guidance issued by the SSRO. References included within the draft statutory guidance are inconsistent with the above requirement. MOD during the extended consultation made clear that 'must have regard to' is to mean that guidance issued by the SSRO can be set aside where there is good, documented and agreed reasons for so doing. In paragraph 17 of Chapter 3 on the recently published Commercial Guidance on the AOF MOD states 'You must follow the SGAC in all circumstances, unless you have clear and convincing reasons to deviate from them. For example where you can use market rates to assess that a cost for a particular item is reasonable.' Statutory guidance may need to be set aside e.g. be required to cover the requirements of DEFCON 656, non-developmental items, or mass redundancy. The US FAR sets out reasonable considerations for these items e.g. at 31.205-42 Contract Break where costs otherwise treated as indirect may be allocated to contract and incorporated within the price settlement (not dissimilar to the framework of DEFCON 656)
- The following are inconsistent with the Act:
 - 'must be used' in paragraph 1.1
 - 'is mandatory in determining' in paragraph 1.2
 - Paragraph 4.2 (2) is missing reference to regulation 58
 - Paragraph 5.1. SSRO have no authority to state that this guidance replaces the existing Government Accounting Conventions. New contracts that are not qualifying contracts are outside the scope of the SSRO. Pre-existing contracts the deal was struck using the Government Accounting Conventions in place at the time as modified and recorded within the agreed EIPS; it should not be for the SSRO to frustrate the basis of the commercial deal struck; transitional arrangements for new GACs introduced up to 2014 should apply as agreed by MOD and JRBAC with the Review Board for Government Contracts.
- Statutory guidance is only applicable to qualifying contracts and qualifying sub-contracts. The guidance may be adopted for use on contracts that are outside the scope of the law and regulations but this will be agreed guidance and not statutory guidance. Statutory guidance is not applicable to pre-existing contracts price in accordance with the Government Profit Formula and Associated Arrangements. The EIPS agreed at that records the basis of the price agreement and is subject to the arrangements in place at the time of the price (or arrangement) agreement as varied within the EIPS. Accordingly the following are inconsistent with the Act or the commercial deal agreed.
 - 'under single source contracts' in 1.2 needs to be restricted in scope
- Some paragraphs and dialog serve no purpose as they are better explained or scoped within the Act or the regulations. Accordingly the following should be deleted:
 - Paragraph 1.1 is erroneous and unnecessary
 - Paragraphs 2.1, 2.2, 2.3, 2.4, 2.5, 2.6, 3.1, 4.2, 5.1 and 5.2 are inappropriate for inclusion within statutory guidance as they have have been either better or more accurately expressed elsewhere within the legal framework (Act or regulations) or supporting parliamentary papers.
 - Paragraph 4.3 second sentence is unnecessary as it is expressed fully and accurately within the regulations. The examples should also be deleted as they serve only to cause confusion with the actual requirements set out within the regulations.
 - Paragraph 4.4 has similar but extended failings to those included within paragraph 4.3 above and should be similarly deleted. E.g. the reference to primary equipment when MOD contracts for, 'goods, services or works'.
- Some wording is just unnecessary and as it adds no discernible value should be deleted;
 - Paragraphs 6.1, 6.2 and 6.3 serve no purpose

- Some wording is misleading and should be further considered:
 - The Single Source Cost Standards do not deal with the treatment of costs but rather if they may be included within contract allowable costs. Paragraph 1.2
 - the basis upon which a Contractor determines and calculates.... Paragraph 3.3. The Act requires statutory guidance to be issued to address whether costs are allowable under qualifying defence contracts rather than how the contractor calculates the allowable cost. Paragraph 3.3 should be revised to limit scope to that contained within the Act. This restriction is properly addressed within paragraph 6.4.
 - Paragraph 3.4 looks to be wholly wrong. Non-compliance with the guidance (without MOD and the contractor having adequately good reason to have the guidance set aside at the time of pricing) may result in the contract price being corrected and even damages being addressed but it is not an event that can lead to penalties and fines being applied as the topic is outside the scope of schedule 31. Fines or penalties applied against the MOD are outside the scope of the SSRO's powers within the Act.
 - In paragraph 6.4 it is clear that the SSRO has little effective understanding of the purpose of the QMAC. It, similar to the US Cost Accounting Disclosure Statement, is a declaration by the contractor as to how it accounts for certain costs. It does not set out how each of the rates are calculated but rather enables the contractor to declare its cost allocation basis, the criteria and controls it has adopted and the consequences for certain transactions.
 - Paragraph 6.5 'ability' should be replaced by 'authority'

Question 3

- The principles need to be sufficiently clear so as to enable the parties to understand the tests and considerations that the SSRO will apply when considering an expert opinion. Where this objective is not, in my opinion met, I have included within the answers below.
- Sense needs to prevail. Appropriate may often be easier to express as a rule 'entertainment is not an allowable cost' rather than the principle 'anything a contractor may gain enjoyment from is unallowable'. Whereas reasonable is harder to express as a rule 'pay awards of more than 1% over the UK average as published by the Office of National Statistics' than a principle based 'pay awards in excess of those that would be met by a prudent contractor undertaking commercial work'
- SSRO should also give consideration to a requirement based on the US cost accounting principles of 'consistency in estimating, accumulating and reporting costs' (CFR 9904.401) and 'consistency in allocating costs incurred for the same purpose' CFR 9904.402
- Allowable costs do not address the use of market prices where MOD has not contributed to the development cost (COTS, commercial items, non-developmental items). There was much discussion with MOD about pricing mechanisms in circumstances where such items were supplied within the scope of a qualifying single source contracts. MOD said they would allow the allowable cost of such market priced items to be defined as 'the price less the agreed contract profit rate' and support the adoption of the same by the SSRO. The commercial guidance at paragraph 17 of Chapter 3 acknowledges these discussions. The existing AOF guidance, which is consistent with the above discussion, is set out in <http://aof.uwh.dii.f.r.mil.uk> or <https://www.gov.uk/acquisition-operating-framework>. This is particularly an issue for overseas sub-contractors supplying products where MOD has not contributed to the cost of the development and for which a market price exists. Papers, as discussed with MOD, are available if required.

Question 4

- I did not see any evidence within the document of effective use of procedures. The table at 7.7 served little if any purpose as the order that the tests set out within 9.2 through 9.4 made no difference to the end result. If there is a purpose to be served by setting out a procedure then it should be incorporated but not otherwise.
- The QMAC requires the contractor to disclose how he calculates certain costs (e.g. issues from fungible inventory; FIFO, weighted average actual). This disclosure document should be retained, maintained as relevant and language consistent with current accounting standards.
- Method used by the contractor for apportioning of overheads to cost recovery rates should be agreed as reasonable with MOD and then consistently applied

Question 5

- See also comments provided at question 4
- The wording of 7.2 and 7.3 is overly flamboyant and consequently unclear. If there is anything that is being expressed it should be delivered in plain and simple English.
- At 7.3 the costing system and costing methodology used by Contractors to evaluate end and intermediate cost objects for the production of their statutory financial accounts and monthly management information is not the same as that used for pricing and reporting of single source MOD contracts. The base information is reconfigured to be evaluated in accordance with the MOD requirements. There are key differences, which should be disclosed in the QMAC. These differences may include, but are not restricted to, any (or all) of the following:
 - MOD overhead rates include period expenses (overheads that do not pass through the inventory account) whilst company accounts exclude such costs from cost recovery rates
 - MOD costs exclude unallowable costs whilst company accounts include such costs within the valuation and costing of contract work performed
 - MOD costs fully adjust (true up) for manufacturing cost variances and over/under recovery of labour and overhead costs whilst in the financial and management accounts any correction is done on a whole businesses basis and not allocated to contract
 - MOD labour and overhead recovery rates are often a consolidated structure and have less denominators than are used for production of financial and management accounts
- The wording at 7.4 differs from that contained within section 20 of the Act. The Contractor may be required to show that the requirements are met in relation to a cost as an allowable cost under a qualifying contract. This dialog has necessarily always taken place, this is not new other than it is codified for the first time.
- Wording at 7.5 should recognise that any of the parties to a qualifying contract are able to refer the disagreement to the SSRO for an expert opinion (including sub-contractors with a qualifying sub-contract)
- If it is considered necessary and appropriate to explain the difference between Direct Costs and Indirect Costs then the wording at FAR 31.202 (Direct Costs) and 31.203 (indirect Costs) provide a better foundation for setting out such dialog. For the majority of UK contractors all employed labour is treated as an indirect cost (not direct) and hours are used as the basis for cost allocation. The listing provided as examples of indirect cost are both trite and simultaneously awkward, if specific reference needs to be made to any of the items listed they should be incorporated into the appropriate section.
- At 8.3 the treatment must be disclosed by contractors using the proscribed QMAC form. MOD will then view if they find the attribution reasonable and may test to ensure that it is consistently applied. I believe that MOD will concur that no purpose is achieved by MOD signing the QMAC as approved.

Question 6 - Why I view the principle of Appropriate as set out in the draft is neither clear nor concise

- The costs a contractor incurs are not subject to public scrutiny beyond that required to be disclosed in its Statutory Accounts.
- The check list is inadequate.
 - What does 'Is it a cost that would be expected to be incurred in the delivery of the Qualifying Defence Contract' mean? Is the test restricted to direct costs or is apportioned cost also to be considered. If the test is about the extent of a causal relationship between the primary cost and the cost object to which the costs is allocated or apportioned? If yes how then how is the unallowable inappropriate quantum to be established? Is it that the costs should be segregated between and rates calculated on the basis of:
 - (1) those costs that are only necessary for the performance or capture of a qualifying contract (e.g. contract reporting) are to be wholly recovered over such contracts; and
 - (2) costs that are incurred that are only necessary for the performance on non-qualifying defence contracts are to be wholly recovered over such contracts; and
 - (3) costs that are incurred that are only necessary for the performance of UK Government defence contracts are to be wholly recovered over such contracts; and
 - (4) costs that are incurred that the benefit unequally falls to revenues is the cost to be proportionately allocated; and
 - (5) costs that are incurred for the performance and capture of all contracts are to be recovered over all activity.
 - What does 'Is the cost suitable for the purpose of a QDC mean? Question is similar to that addressed above?
 - The costs a contractor incurs are not subject to public scrutiny beyond that required to be disclosed in its Statutory Accounts.
 - Do you mean is the basis of apportionment (or allocation) of the cost fair and reasonable? If not what is intended as the test?
- Definition is ill considered. For example; costs incurred in negotiating or acquiring qualifying defence contracts would not fit within the scope of necessary to fulfil the requirements of the contract; 'recovered in any way from existing or future contracts' needs to be better considered (under or over recovery of indirect costs through application of overhead recovery rates).
- Within Section 10 there is no linkage to the principle of Appropriate to show how the criteria referred to in this section is met to make costs of a type unallowable.
- If items are to be excluded on the grounds of public taste then these items and criteria should be scheduled (as they are within the US FAR Part 31.205)
- Costs only incurred for the benefit of a proportion of customers or contracts should be borne by those contracts (e.g. MOD single source, MOD competitive, Export/commercial). Costs incurred for the benefit of all customers should be borne by all customers in proportion to the benefit (those contracts or customers benefiting less should be allocated less cost).

Question 7

- The definition at 9.3 looks to be superficial and only differs from Appropriate in that the cost 'is necessary to fulfil the requirements of the contract' whereas the Attributable 'is expected to be incurred in the conduct of a QDC'. If the difference between Appropriate and Attributable is that the former requires public taste to be addressed whilst the later requires 'like costs incurred for similar purposes to be treated in the same way and indirect costs to be apportioned in proportion to the benefit derived' then this is should be addressed in plain and simple English.
- The Checklist needs further development to make the requirements clear.
 - Bullets 1 and 2 look to address matters that are covered within the QMAC
 - Bullet point 3 needs to consider treatment of foreign exchange translation, fair value hedging, and pension costs
 - Bullet 4, see comments under checklist above
 - Bullet 5 the requirement is not clear
 - Bullet 6 looks to duplicate bullet 4
 - Bullet 7 looks to be impossible. A contractor can assert or certify that the costs will not be double recovered but I don't know how a contractor could evidence that he has not.
- If the requirement is largely addressed by the QMAC then SSRO should consider owning its contents to ensure that the form remains appropriate to the decade.

Question 8

- The US definition at 31.205-3 is normally considered as sound. It addresses 'business at large' rather than defence contractor compared with other defence contractors. It also includes sound discussion on the factors that need to be considered. It should be recognised that one cannot define reasonableness any more than one can define beauty (both are terms of art).
- Reasonableness cannot be demonstrated by 'delivering value for money to the UK taxpayer'. It can only be reviewed against the facts and circumstances known at the time decisions were made and the judgements made giving rise to those decisions.
- The dialog at 9.5 adds very little to the decision as to if a cost is wholly or partially reasonable and the proportion, if any, that is considered as unreasonable.
- The checklist is banal:
 - Bullet 1 looks to cover the same ground as attributable
 - Bullet 2 looks to cover the same ground as appropriate
 - Bullet 3 looks to the estimating methodology rather than the quantum
 - Bullet 4 is only of use if there are meaningful benchmarks available to the contractor and they are in sufficient detail to enable effective dialog to ensue
 - Bullet 5 is just to put the question that is being addressed within the criteria for review.
This is a circular reference!
- It should be recalled that for many contractors the proportion of work that is represented MOD single source is neither dominant nor likely to drive overall business behaviour.

Question 11

- Cost estimates should be based upon verifiable facts and judgements applied to those facts. The basis of estimates should be disclosed
- The cost estimate should be prepared and negotiated whereby the value agreed is the mean expected cost outturn (the sum of the product of the cost at each point on the probability distribution multiplied by the probability at that point)
- The US FAR fully and soundly addresses this issue (see below) and consideration should be given to anglicising its contents.
 - a) “Contingency,” as used in this subpart, means a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at the present time.
 - (b) Costs for contingencies are generally unallowable for historical costing purposes because such costing deals with costs incurred and recorded on the contractor’s books. However, in some cases, as for example, terminations, a contingency factor may be recognized when it is applicable to a past period to give recognition to minor unsettled factors in the interest of expediting settlement.
 - (c) In connection with estimates of future costs, contingencies fall into two categories:
 - (1) Those that may arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy; e.g., anticipated costs of rejects and defective work. Contingencies of this category are to be included in the estimates of future costs so as to provide the best estimate of performance cost.
 - (2) Those that may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately (including the basis upon which the contingency is computed) to facilitate the negotiation of appropriate contractual coverage.

Question 14a

- 10.4 Depreciation (together with any impairment to the carrying value) of property, plant, and equipment represents the value of the usage consumed and is calculated in accordance with the applicable accounting standards board regulations and confirmed by external independent audit. The values written down in the period should be taken from the accounts as published. Changes to valuation should be taken from the accounts and not subject to agreement by MOD or scrutiny by the SSRO.
- 10.4 Amortisation of certain intangible assets (say business software) is similar in nature to depreciation of property, plant and equipment and should be treated in the same way. R&D capitalised as an intangible asset in accordance with IAS 38 needs further consideration. The recovery of R&D into contract prices relates to the use of the know how in the performance of a contract rather than the diminution of the carrying value of the long term asset due to the passage of time. The US FAR treats R&D (regardless of treatment as a long term asset or a period expense) as relating to the period when the cost was incurred and not when the cost is amortised/impaird.
- 10.5 Where the costs of goods held in stores are allocated to a contract at their point of acquisition rather than point of consumption then stock losses and obsolescence should be a contract charge. Where inventory is held as fungible inventory and the allocation of cost of deferred to the point of consumption then the costs of stock losses and stock obsolescence should be treated as a business expense. The dialog also needs to address the timing of the allocation of the cost, it should be when the carrying value of inventory is reduced to its net realisable value rather than when the items are disposed of i.e. the period in which the value of inventory is reduced rather than when confirmed as lost or disposed as obsolete.
- 10.6 Redundancy payments (see arrangements made by government departments for its own employees) are seldom at the statutory minimum. They are negotiated settlements made either on a case by case basis or as part of a collective agreement. Surely SSRO does not require being informed of each and every occurrence and negotiated settlement! Is SSRO requiring MOD to participate in each negotiation and settlement or is it sufficient for the company to evidence that the quantum of the cost is both reasonable under the circumstances? MOD has a history of accepting expenditures that are reasonable (Would have been incurred by a prudent contractor undertaking commercial work).
- 10.7 Staff bonuses are not necessarily employed across all parts of the workforce. They just like overtime incentives are focused to stimulate and reward the behaviours and performance sought by the contractor. The wording should be revised to address reasonableness.
- 10.9 The 5th bullet should be more clearly worded. Does it give option to decide when costs are to be included within cost of production i.e. when the cost is incurred or when the cost is amortised? Contractors adopting IASB will be required to capitalise and amortise product development as an intangible asset.
- 10.11 MOD's agreement to the research or development being undertaken was not a pre-existing requirement. Transitional arrangements are required.
- 10.15 Surely only reduce costs if the costs to which the credits relate would otherwise have been fully allowable.

Question 14b

- State the criteria used to make unallowable (AAR)
- 11.1 First bullet needs to address the various classes of intangible assets. Use modern terminology i.e. property, plant and equipment rather than the now ambiguous capital nature.
- 2nd bullet. If dividends then say dividends if not they say what is addressed. Used IASB terminology
- 5th bullet Dialog is unhelpful unless it points to why unallowable. Use IASB terms throughout
- 6th bullet This is for calculation of the capital servicing allowances and is not part of allowable costs
- 7th bullet Only early settlement discounts
- 8th bullet. Surely it is an appropriate exclusion basis
- 9th bullet. Goodwill is not amortised, it can only be impaired.
- 10th bullet consideration needs to be given to (1) defined benefit pension costs (2) foreign exchange translation and settlement variances and (3) transactions resulting from fair value hedging. The first 2 were addressed with the GPFAA and the latter is not connected with the cash payments made into the scheme.
- 13th bullet. Say why (AAR) for each.
- 16th (final) bullet. Only for purchased insurance costs. For other rectification costs the costs should be allowable. Arguments are well set out within FAR 31.205-39 'Service and warranty costs include those arising from fulfilment of any contractual obligation of a contractor to provide services such as installation, training, correcting defects in the products, replacing defective parts, and making refunds in the case of inadequate performance. When not inconsistent with the terms of the contract, service and warranty costs are allowable. However, care should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.' This is logical and sound. The proposal contained within the draft is not.

Question 14c

- The existing arrangements are that MOD will settle major restructuring and re-organisation costs that it has caused, by contract settlement outside of the rates used for pricing or reporting of single source contracts. Much of the language contained within this section is taken from existing GACs but the framework under which claims are made has altered. MOD has historically not agreed to single source contract prices where the cost estimates include an allowance for or forecast of mass redundancy and/or restructuring. These costs are expected to be addressed on an equitable basis once they are incurred or plans are advanced for their expenditure. Spreading the cost of the restructuring across future unpriced contracts and rendering the costs allowable for profit is currently seen as something that MOD would wish to support in the public press. Similarly contractors with contracts priced for the next few years will not see the additional income necessary to offset the harm caused by MOD's procurement swings. The statutory guidance offers no solution to this issue.
- The costs that are incurred in a major restructuring are indirect in nature and an equitable solution needs to be found and incorporated within the statutory guidance so that the joint aims and arrangements are either continued (extra-contractual or contract or new single source contract settlement) or new arrangements need to apply and transitional arrangements established by MOD on a contractor by contractor basis (would probably require exemption from regulations to be granted by MOD).
- The guidance on mass redundancy, as drafted, is wholly inadequate
- Pensions. Consideration should be given to early retirement inducements are part of a redundancy or settlement package. IASB require such costs to be shown in the statutory accounts as Past Service Costs as they grant additional benefits; they are never the less a cost incurred in the day to day running of the business.
- R&D tax credits. The Review Board recommended transitional arrangements be agreed with MOD for new contracts awarded over the next few years.

Question 15

- The disclosure requirements of the QMAC need to be improved (Industry has worked with MOD for a new and modernised form and content) and rolled out across contractors without further delay or prevarication.
- 13.4 The Contractor's costing system as used for the production of statutory and management accounts will always be the same regardless of customer. This will form the basis for, but not be the same as, MOD rate agreements, Single source pricing and QDC/Supplier Reporting.
- 14.1 Qualifying sub-contractors are not required to disclose any information to its customer. It is only obligated to provide information and access to MOD
- The final page of the guidance is duplicated

Response 11

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

On the whole we believe the guidance has been well structured, however our view is that Section 5 is confusing, particularly lying as it does in the middle of the document. If included, we suggest that it is moved to the Background in Section 2.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

Section 1

Paragraph 1.1 suggests that it applies to “any contract where lack of competition could impact on delivering value for money”. This is misleading, as it only applies to Qualifying Defence Contracts (QDCs) and Qualifying Sub-contracts (QSCs), not any single source contract. For example any contract less than £5m will not be covered, and nor will any exclusions under regulation 7 of the Single Source Contract Regulations 2014. The same point applies to paragraphs 2.2, 2.3 (which suggests that it applies to “all single source defence procurements”), and para 12.1.

Section 2

The framework has three components, the Act, the regulations and the SSRO (para 2.5). We believe that the Defence Reform Act 2014 should be mentioned. This is because the regulations cannot be read without the Act - any repetition of the Act in the regulations was removed for legal reasons, so many of the powers and duties are only set out in the Act.

Section 3

We propose that the guidance should be clearer in terms of its application to QSCs. The point is made, for example in paragraphs 4.2(1), 4.3(c) and 4.6, however we consider it should be more prominent.

Para 3.3 sets out that the guidance is for the purposes of pricing. We consider that it should also be used during contract delivery, for example when reporting actual and estimated costs (these should be actual and estimated allowable costs).

We propose that the guidance explains how you can determine if a procurement is “single source” or not. This is done in Regulations 8, 9, 59 and 60 of the SSCRs, and a plain English version might be helpful.

(question 2 continued)

Section 4

Paragraphs 4.3 and 4.4 describe how the “value” of the contract should be determined. This is set out in considerable detail in Regulation 5 of the SSCRs, and we consider that it would be clearer and more accurate to refer to this regulation (or repeat its content) rather than set out an alternative methodology. The value of the contract is used in many places throughout the SSCRs, for example different reporting requirements exist for different values, maximum civil penalties depend upon contract value etc. In all cases the value is determined in line with Regulation 5. This point also applies to the second box of the flowchart (e.g. “For an acquisition of primary equipment it is the total cost of that acquisition...”).

Paragraph 4.4 introduces the term primary equipment. We are not sure what this means.

Flowchart

We consider that use of a flowchart is very helpful to users. However, we consider that there need to be two flowcharts, as the process is different for QSCs than it is for QDCs. For a QSC, the flowchart would need to include the fact that the Primary contractor makes an assessment of whether or not the sub-contract is a QSC, and if so notifies the MOD and the sub-contractor. So the starting point for a sub-contractor is being notified that they are a QSC. If they wish to challenge this, they may do so by going to the SSRO (as set out in Section 29(4) of the Act, and Regulations 62 and 63 of the SSCRs).

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes

No

Please add comments to support your answer:

Yes, we believe that principles, as supplemented by more detailed guidance as set out in sections 10-12, is the best approach.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes

No

Please add comments to support your answer:

Yes, we believe that guidance on *how* to calculate costs should not be included as this will depend entirely on the specifics of the case. However we consider that the guidance should set out examples of evidence that supports the case for a cost being AAR, such as has been done in para 9.5 (indicators of whether costs are reasonable) which we consider to be very helpful.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes

No

Please add comments to support your answer:

Section 6

Paragraph 6.3 could be read as meaning that the objective of the AAR principles only applies to suppliers who are 'undertaking similar types of work'.

Paragraph 6.4 suggests that the Questionnaire on Method of Allocation of Costs (QMAC) sets out the costing methodology used in pricing QDCs and QSCs. This is not generally the case. The QMAC describes the mapping between indirect cost items and the units used for apportioning those costs (it does not apply to direct costs). For example the QMAC may indicate that IT costs are spread according to direct hours. The full methodology for determining a price is effectively set out in the contractor's pricing model, any feeder models, the QMAC and the inputs are set out in the Contract Pricing Statement (see Regulation 23 of the SSCRs). We suggest that the guidance should acknowledge this point. This also applies to paragraph 13.1.

Section 7

We are not entirely sure of the intent behind paragraphs 7.2 and 7.3. One reading implies that the SSRO expects suppliers with QDCs or QSCs to have accounting systems that allow them to map each element of cost against three different dimensions: resource type, activity, and contract output. If this is indeed the SSRO's intention, we are concerned that this may result in suppliers having to make very substantial changes to their accounting systems (e.g. introduce activity based costing). This could result in very substantial costs, which suppliers would seek to recover, which we believe would warrant considerable further consultation. Furthermore, we believe that this kind of mapping is not possible for some indirect cost types. For example for pure and applied research and development it may be impossible to map this cost onto a specific contract.

There are a number of principles that we believe the SSRO share (most of them appear in other places in the guidance), that we consider would be beneficial to set out clearly in section 7. These include:

- Costs are not allowable unless supported by adequate and sufficient evidence
- Actual costs should be assigned to contracts "once, and only once" (no double counting)
- A given estimated costs should also be assigned only once
- Actual costs must have been recorded and incurred in the books of account

On a more general point, the guidance does not make it clear that sometimes it applies to estimated costs (for example for the firm, fixed, target, and volume-driven pricing methods under Regulation 10 of the SSCRs) and sometimes to actual costs (as in the cost plus and estimate-based fee pricing methods). This sometimes leads to confusion in the tenses used in the guidance, and is perhaps worth making explicit.

Section 8

Some overhead costs are directly attributed to a contract rather than spread over a number of contracts. The term 'overhead/indirect costs' does not make this distinction, which may lead to confusion.

In the list of example overhead costs, we believe that the inclusion of 'general expenses' runs the risk of being interpreted too widely. Perhaps 'low value miscellaneous costs' might be better?

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes

No

Please add comments to support your answer:

We consider that the SSRO's definition of appropriate is very helpful.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes

No

Please add comments to support your answer:

We consider that the definition of attributable is primarily focussed on direct costs. There appears to be very little guidance on the principles around a fair method of apportionment of indirect costs or subcontract costs (where these support a number of QDCs), other than that it is "consistent with the firm's normal accounting practices". Given that many single source suppliers are predominantly engaged in single source work, they may have accounting practices that are consistent but not fair and reasonable.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

We consider that the SSRO's definition of reasonable is very helpful. We would like the SSRO to include a section on Key Performance Indicators (KPIs) in this guidance. We would welcome further engagement with the SSRO on this issue.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

As per Section 20(2) of the Defence Reform Act 2014.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

We consider the checklists to be very helpful.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

We believe that the allowability of such costs should be debated.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

Yes, and it may also be worth re-issuing the statutory guidance on allowable costs, if these should be amended based on experience.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

We consider that there is much in the draft guidance that will support agreeing prices on QDCs and QSCs that provide value for money.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

Section 10

Depreciation and amortisation - We consider that suppliers should not charge the MOD for any depreciation on assets where we have paid directly for the capital costs (otherwise they get paid twice), or on assets which we have given then. We also would like to suggest that a supplier should not be able to recover depreciation on new facilities and buildings, where these are primarily to support the delivery of QDCs and QSCs, unless they have previously sought our approval.

Stock losses and obsolescence - We are not convinced that any stock losses and obsolescent should be generally allowable. In particular, we consider that stock losses resulting from poor storage, handling, or control should not be allowable. We also consider that the word 'general' should be removed as 'general' costs are not usually able to be directly apportioned.

Redundancy payments - We welcome the SSRO's view that suppliers must seek MOD approval if they plan to pay redundancy costs above statutory rates (as a pre-requisite for allowability).

Marketing and sales - We would prefer that these costs were included under the generally not allowable category, unless they could be demonstrably linked to a QDC or QSC. The example of "trade fairs to market new equipment" could be read as giving permission to charge for all such marketing, which we do not consider to be fair and reasonable.

Refunds - We consider that paragraph 10.15 could be read such that reimbursements, credits, grants or refunds only offset costs if they cannot be identified to a particular contract. We consider that these should also offset direct costs.

EU emissions - We consider that it would be clearer to separate this out as a separate paragraph.

Section 11

In the list of costs which are generally not allowable, we welcome the increased clarity on these costs that the SSRO guidance provides. We consider that, as well as subscriptions and donations of a political nature, sponsorship should also be generally not allowable. We also propose that liquidated damages and other penalties for poor performance should not be allowable.

Section 12

We welcome the inclusion of guidance on idle facilities.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

We are not entirely sure what the SSRO means by “disclosure requirements”. If this refers to the requirements for MOD and/or industry to disclose certain matters to the SSRO, which are dotted about the draft guidance, then please refer to our response to question 16.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

On the issue of the SSRO's role in determining Allowable Costs, our view, based on legal advice, is that there are a number of instances in the draft statutory guidance where the SSRO is exceeding its powers under the Defence Reform Act. Examples are provided below.

Para 1.2. Our view is that application of the guidance is not mandatory; rather the mandatory requirement is to "have regard to" the guidance (Section 20(3) of the DRA). In practical terms, this means that the MOD and suppliers will have to follow it unless there is a good reason not to. Given the very wide range of contracts, there may be cases where there is good reason to deviate from aspects of the guidance, such as guidance on costs which are generally not allowable.

Para 3.4. Firstly, for the reasons stated at Para 1.2, our view is that non-compliance with the guidance is not a breach; it is not having regard to the guidance that is a breach. Secondly, we consider that the compliance regime for not following the pricing formula (incl. having regard to the guidance) is via a referral to the SSRO, who may change the price; there is no ability to levy penalties or fines (which only apply to compliance of the transparency provisions, not pricing provisions).

Para 7.6. Our view is that SSRO opinions are not binding. The impact of not following an opinion provided by the SSRO is that, in any future referral to the SSRO once on contract, the SSRO is likely to follow their previous opinion. Not following an SSRO opinion thus creates a substantial risk to either MOD or the supplier, but it is not binding.

Para 10.4. Our view is that the SSRO will only have the ability to scrutinise such matters if either party seeks an opinion or determination from the SSRO.

Para 10.6, 12.4, 12.9, and 12.15. Our view is that the SSRO is notified of new QDCs, but that there is no legal requirement to notify them separately of agreements on individual elements of allowable costs.

Para 11.2 and 12.10. We consider that this may be read as the SSRO having the power to make a binding determination without have been referred to by either MOD or industry, which we believe is not the case.

Para 13.6. Unresolved disputes do not have to be raised with the SSRO. In legal terms, either MOD or the supplier have the power to raise them (via a determination or opinion), but do not have a duty to do so.

Para 14.1. Our view is that the power to write statutory guidance under Section 20(1) only empowers the SSRO to issue guidance which MOD and suppliers must have regard to when agreeing allowable costs under Section 20(3). Regarding bullet (1) - The Act requires supplier to keep records, and grants the MOD the power to issue compliance and penalty notices if this is not done. The SSRO's role is to consider any appeals from industry in this regard, and to publish an annual compliance report. Regarding bullet (2) The MOD has the right under section 20(2) to require a supplier to show that the costs are Appropriate, Attributable and Reasonable. The SSRO will only have this power if either party have referred to them for an opinion or determination, which also applies to bullets (3) and (4).

Annex B - Supplementary return on drafting issues

This list below summarises areas where we identified what we considered to be minor drafting issues. They are offered in the spirit of ensuring the guidance is as clear as possible.

- a) Paragraph 2.1, 1st bullet - suggest change “specification” to “requirement” as not all contracts have a specification, whereas they all have a requirement.
- b) Paragraph 2.3 - It may worth clarifying that Lord Currie’s Review was the basis of Part 2 of the Defence Reform Act rather than its entirety.
- c) Paragraph 2.6 suggests that the Act identifies the objectives of the framework, whereas the Act itself is silent on this. The policy objectives of the framework were set out in the White Paper¹.
- d) Paragraph 4.2 - the more correct legal term is “coming into force of the Regulations”, rather than “commencement of the Regulations” (also appears in the flowchart).
- e) Paragraph 4.5 - we think it may be helpful to draw a distinction between exclusions (Section 14(2)(c)) and SofS exemptions (Section 14(7)) and to explain both.
- f) Paragraph 7.1 - we suggest the deletion of all the wording after “... all three criteria” to avoid any confusion - it might be read that only two of the three are required.
- g) Paragraph 7.5 - “sole arbiter” - we believe it may be better to use the phrase “sole adjudicator” as arbitration has a specific legal meaning (which is not the case here);
- h) Paragraph 7.5 - delete “... either the Secretary of State” and “... or an authorised person”. Note that the term “authorised person” was included in Part 2 in the event that DE&S became a GOCO. As this was not done, there is no ‘authorised person’.
- i) Paragraph 8.1 - please clarify what is meant by “standard costs”.
- j) Paragraph 8.5 - please clarify what is meant by a “cost object”.
- k) Paragraph 9.3 1st sub Paragraph - we suggest that “... incurred in regards to...” is deleted and replaced by “...incurred directly or indirectly...” as we believe this to be clearer.
- l) Paragraph 9.3 2nd sub Paragraph - we suggest that “...met...” is deleted and replaced by “...incurred...” as we believe this to be clearer.

¹ Better Defence Acquisition, June 2013, MOD

- m) Paragraph 9.5 - we suggest that 'indicators of whether a cost is reasonable' could more clearly state the requirement to justify decisions as to whether to subcontract or undertake work in-house.
- n) Paragraph 11.1, bullet 15 - comment; we believe it would be helpful to provide specific examples of the types of insurance covered here, for example we believe that Product Liability Insurance should not be allowed.
- o) Paragraph 12.3 - we understand and support the theme expressed here. We suggest the following wording may explain the theme more clearly; "these generally relate to exceptional or abnormal costs which would have a major impact on allowable costs and require specific additional analysis and evidence to arrive at an agreement on suitable treatment".
- p) Paragraph 12.4 - We are not entirely sure what is meant by "costing model". If this refers to the "regulated pricing method" as per Regulation 10 of the SSCRs, perhaps it would be clearer to use this term.
- q) Paragraph 12.8 - We understand and supports the theme expressed here. We suggest the following wording may explain the theme more clearly "Where a contractor proposes to rationalise or close a facility on economic grounds and can demonstrate that the resultant costs are related to the delivery of single source contracts to MOD then....".

Response 12

Jeremy Newman
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10th December 2014

Your ref. Consultation dd 26th

Nov 2014 Dear Jeremy,

Draft Statutory Guidance on Allowable Cost

We are responding today to the consultation on Allowable Costs issued on 26th November 2014. This follows our previous letter to you on 1st October outlining our thoughts on an approach that would be a practical solution to the difficulties of issuing Statutory Guidance in such a short time frame.

In the draft Statutory Guidance, the stated intention is for the Guidance to be based on principles rather than rules: we support this approach. However, in our view some areas of the Guidance go beyond what is needed to establish and reinforce the overarching principles.

On the basis that 'Allowable Costs' is the fundamental concept for pricing Single Source Contracts, the Guidance should provide a clear interpretation of the principles that are supported by the Regulations. The current draft, which in some areas diverges from previously agreed positions with MoD and Industry, introduces detail which could lead to inconsistent interpretation and unintended consequences. This is also likely to result in many referrals to the SSRO for judgement with which the organisation may be unable to cope.

Given the very short period for this consultation, we suggest that the Statutory Guidance be slimmed down to the principles, followed by further consultation over detailed working practices where these diverge from the current Government Accounting Conventions. We believe that the further development of the Single Source Cost Standards is best achieved through collaborative working with the SSRO, MoD and Industry. Done well, this will result in a set of standards that are recognised by the parties as the agreed rules for 'Allowable Costs'. Investment in this process will avoid Contractors defaulting to seeking pre-clearance from the SSRO.

It is in our mutual interest to make the new system as efficient as possible. We hope that our response is taken as constructive, and we will dedicate the necessary resources to collaborative working on these important concepts.

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

The documentation as issued is extensive and in some areas detailed and to that extent seems to go beyond establishing a 'principles rather than a rules based' guidance document. In our view this mixture of principles and rules could result in a large number of referrals to the SSRO for judgment of individual cases.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

In the introduction it is implied that the SSCS 'must be used' for any single source contract. Our understanding is that the Regulations require the SSCS for QDCs and QDSs only. It is important that the Guidance is consistent with the Act and Regulations.

The guiding principle for non-competitive contracts is only portrayed as 'obtaining value for money to the UK tax payer'. An equally important guiding principle in Part 2 of the Act 13(2) (b) is to pay the Contractor a 'Fair and Reasonable' price. The SSRO, as an independent body, must demonstrate that the interests of both parties are taken in to consideration in the publication of a balanced Guidance document.

Para 2.4 requires that 'procurement delivers value for money and can withstand public scrutiny'. The public scrutiny criterion is highly subjective and not capable of clear definition or measurement .Given the consequences this requirement is likely to result in referrals to the SSRO.

Para 3.4 allows for the supplier to be fined for not following Guidance. This again is likely to result in referrals to the SSRO, where subjective criteria are included.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

The Draft Guidance seems to have drifted from the principles basis that was intended. We suggest that the statutory guidance is limited to Principles and supplemented, after due consultation, with Working Practice Statements in relevant areas.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

Whilst agreeing with the principle the Guidance introduces further detail e.g. para. 8.5 attempts to list items which may or may not be included.

The QMAC should remain the mechanism for Contractors to agree the cost calculation methodology.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

The principle of Allowable Costs as defined by the Act is clear. The Statutory Guidance appears to be less concise and introduces some confusion to the understanding of its application. E.g. Overhead and Indirect Costs are defined as being 'incurred during the performance of the QDC'. There are many instances when Allowable costs may be incurred prior to the start of a QDC, but are still relevant to the contract.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

The Guidance for Appropriate is a mixture of principle and a checklist. This seems contrary to the intention expressed in the introduction. Both criteria make reference to the 'public scrutiny' test. As noted above, this is a subjective judgement and likely to result in referrals to the SSRO.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

The Guidance for Attributable is a mixture of principle and a checklist. This seems contrary to the intention expressed in the introduction. This should be governed by the established methodology in the QMAC to avoid referrals to the SSRO.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

There appears to be some overlap with the Appropriate and Attributable sections.

The Guidance states that 'Reasonableness must be demonstrated by delivering value for money to the UK Taxpayer'. The VFM criterion is subjective and is likely to result in submissions to the SSRO for clarifications.

Para 9.5 refers specifically to uncertainty involved in determining reasonableness. This effectively refers to risk which under para. 11.1 is not allowable. There therefore appears to be a contradiction between the two sections.

The checklist introduces sector market benchmarks which, without definition remains subjective. Likewise, the public scrutiny criterion is also judgmental and both will result in referrals to the SSRO.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

The principle is sound, but the Guidance and the three definitions as drafted have the potential to be judgmental, as noted above.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

The Guidance has drifted from principles to rules without adding clarity. See responses provided in questions 6, 7, and 8

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Cost contingency and risk should sit with the party responsible for managing the risk of delivery. In Fixed / Firm priced contracts this is invariably the contractor. Therefore costs associated with managing that risk should remain with the contractor. In a cost plus or time and materials contract however, where the risks associated with the delivery remain with the MoD, it would be appropriate to disallow risk and contingency.

All risk and contingency should be fully supported by detailed and transparent supporting evidence at the time of contract commitment.

As noted in Question 8 there appears to be contradiction between this section and para 9.5.

Under section 17 of the Act there is a requirement to adjust the baseline profit to reflect the risk element. Furthermore the Contract Pricing Statement requires a risk register to be included. Both these strongly suggest there is an intention for risk to be an allowable cost.

The Guidance, as written, may well result in significant risk transfer back to MoD with contractors forced to go down the cost plus or time and materials contract form.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

Given the complexity of contracts supplementary guidance is appropriate to clarify contentious areas. Important determinations made by the SSRO should be communicated as soon as possible.

Where possible, industry wide determinations should be made in a collaborative forum, to promote the desired transparency and consistency of interpretation, for both Mod and Industry.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

The Guidance should promote VFM in single source contracts, but it is imperative that the Principles are clear, and that any detailed rules are unambiguous and objective to avoid the time and cost and potential delays involved with referrals to the SSRO.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

The illustrations largely cover most areas, but are not exhaustive. There are inconsistencies with current practices which have not been subject to consultation. For example in the following areas;

10.4 Depreciation & Amortisation

Guidance requires any change in 'valuation of assets to be agreed by the MoD and scrutiny by the SSRO'. This is governed by GAAP and is the responsibility for the Company to determine.

10.6 Redundancy Payments

Guidance requires MoD approval of payments in excess of statutory rates. Redundancy conditions that are TUPE transfers should only require notification not approval as with current practice.

10.7 Employee Benefits

Guidance requires that staff bonuses must be in line with company policies and employed across all parts of the workforce.

Incentive schemes for certain sections of the workforce (e.g. sales staff) are considered to be a normal employment cost. This again is currently allowable.

10.14 Marketing and Sales

The Guidance requires allowable Marketing & Sales costs to be demonstrably linked to a QDC. The majority of costs under this category are currently proportionately allocated in accordance with the QMAC. This would therefore be a change from current practice.

The Guidance should provide some clarity on the acceptability of proportional allocation of generic Sales & Marketing type costs.

QUESTION 14 (cont'd)

11.1 Costs which are generally not allowable

The major concern in this area is as noted in Question 11 concerning the ownership of risk and contingency. The other areas covered in this section may not be that material to QinetiQ but have not been subject to consultation and are a change to current practice. Our comments are as follows;

- non allowance of 'entertainment expenses of any sort -' we can envisage circumstances where there would be a benefit to MoD, in respect of both customer entertainment and staff welfare.
- 'notional transactions' are not understood
- charitable donations are not a major concern, but this does impact on corporate responsibility

Further Observations and Comments

Section 12.16 Pensions

The Guidance in this section is a duplication of parts of the Pension section 10.13
The Guidance would be improved if the Pension sections were combined and simplified to avoid the duplication of established principles

QUESTION 14 (cont'd)

Section 12.19 – 12.22 Research and Development Tax Credits

The heading of the section “Research and Development Tax Credits” should be changed to “Research and Development expenditure and R&D expenditure credits”. Tax credits do not apply to paragraphs 12.19 and 12.20.

Paragraph 12.20

The requirement to generate “probable” future economic benefit for the MOD is too subjective. The principle should be that research expenditure that is directed at future benefits specific to non-MOD customers should be excluded from Allowable Costs.

Paragraph 12.21

The paragraph should be reworded:

“The net benefit from R&D expenditure credits (or equivalent overseas credits) gained by Contractors must be offset against Allowable Costs. The net benefit is the amount gained after deducting related costs and taxes.”

R&D expenditure credits (“RDEC”) are the focus of this section and should be the subject of this paragraph. They are a payable credit used to settle a cash tax liability. They are not a corporate tax item. Corporate tax items have historically never been offset against Allowable Costs and this treatment should continue. Equivalent credit regimes in overseas territories should be brought within the definition of RDEC. It is important to be specific in the Guidance.

Where RDEC is offset against Allowable Costs, the offset should be the net RDEC benefit that is obtained by the Contractor, not the gross amount claimed.

RDEC should only be offset against Allowable Costs with effect from the point at which implementation of RDEC becomes mandatory i.e. from 1 April 2016, in line with the discussions with MoD on transitional provisions following the Review Board recommendations.

We would highlight that the flow down of these provisions through the supply chain will have a significant effect on the businesses of Small and Medium Sized (SME) companies which should be considered in the application of the Guidance.

Paragraph 12.22

This section is unnecessary and should be removed. The Guidance should not direct accounting treatment and should only concern calculations of Allowable Costs. Tax credits need to be accounted for in line with applicable accounting standards (e.g. IFRS or new UK GAAP) and Contractors’ normal accounting practices.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

On the basis that the QMAC is the recognised practice for documenting and agreeing the Contractors cost allocations and accounting procedures, the Guidance seems to be overly expansive in content.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

The role of the SSRO is determined by the Act which is clear; therefore we would not expect this to be further expanded upon in the Guidance. To this extent, the Guidance should be shortened to make the communication more effective and cross reference the Act where relevant.

It is important to reinforce that where the issue / inconsistencies noted above are not clarified in the final Guidance, then the SSRO will have a very important role in answering referrals or providing clarity ahead of contract award.

Response 13

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

The actual structure of the document appears generally ok. However the guidance would be further improved if there was more clarity and consistency between the various sections. The attached document provides further detail on the specific points.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

It attempts to give some general introduction to the subject which is good to put the SSCS into context and for those less familiar with the Act. However we would recommend that where the Act is referenced the precise cross references are made. Eg. 2.6 we could not cross reference exactly to the Act. Where an interpretation is made then we recommend this is clearly stated. This would aid consistency and clarity given the legal status of the guidelines. We recommend it should just state facts as far as practicable. Eg. 5.2 suggests that no significant updates to the 1968 agreement have not been made, whereas a significant change for instance was introduced in 2003(details below for your convenience). We do accept the point that it took a long time to agree between MOD and Industry (CBI). Hansard reference:

2003 General Review of the Profit Formula meets Defence Industrial Policy

DEFENCE

Government Contracts

The Minister of State, Ministry of Defence (Mr. Adam Ingram): I am pleased to announce that the Government have accepted the recommendations in the Review Board for Government Contracts' 2003 general review of the profit formula for non-competitive Government contracts.

This package of measures, to be implemented from 1 July 2004, represents a significant modernising of the current profit formula arrangements, and is consistent with the Department's defence industrial policy.

The measures that will be introduced include an alternative profit calculation methodology, a recognition that there are varying degrees of risk associated with defence non-competitive contracts, arrangements for addressing "profit on profit", a formula for sharing excess profits and unconscionable losses, and incentives to encourage timely submission of post-costing certificates.

A copy of the report has been placed in the Libraries of both Houses.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

This seems very appropriate as the many different types of cost, contracts and circumstances mean that these can be applied as appropriate to the circumstances.

However, where we think that these have strayed into 'rules', then we have identified these in the attached document.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

We assume the SSRO is referring to how the cost is allocated and apportioned to different cost objectives in a causal/beneficial way when it talks of 'how to calculate cost'.

This is a complex area and whilst we agree the SSRO should only provide principles we would welcome the SSRO opinion on matters where the overall MOD work represents a relatively small proportion of the output of a unit, attached document refers.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

See attached document. In our opinion the guidance would be improved if it made clear that all types of cost are included, both direct as well as indirect / overheads in part 7. In addition that costs that have no causal/beneficial relationship but are necessary to meet legal, statutory or regulatory requirements are explicitly covered.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

Please see attached pdf document.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

Please see attached pdf document.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

Please see attached pdf document.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

As long as the criteria are clear, unambiguous and consistent between the three criteria.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

We agree that checklists or indicators (as the SSRO have previously requested) are an excellent way of getting MOD and Contractors to understand the reasoning behind the three tests and importantly the real differences between appropriate, attributable and reasonable. However an expansion of the checklists (see letter sent to the SSRO on the 6th June 2014) would be helpful. We would request for these to contain just indicators and not any new criteria.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

We believe this fundamentally undermines the Government's ability to contract in innovative ways. Please see attached pdf document.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

It is helpful to have an annual update. However we strongly urge that all key opinions and/or determinations are published as they occur and an overall consolidation completed annually. The rationale is that this would allow all parties to build up a body of knowledge as to how the rules are being implemented and interpreted in practice, which could be applied quickly. This would lead to ever improving submissions and minimise potential disputes.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

We understand and appreciate the intent. Whether the rules can accommodate some of the more complex military projects as well as issues such as the pricing of proprietary items will only become clear over time.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

We fully support the use of visual aids to facilitate the understanding of complex financial and commercial issues. We would welcome the opportunity to work with the SSRO and MOD to improve these illustrations.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

Recommend that clear references are made to the Act where applicable.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

We would appreciate a simple listing of the SSRO's role including reference to the particular sections of the Act and the paragraphs of the Regulations that govern that role.

Single Source Cost Standards

Statutory Guidance on Allowable Costs (Consultation:

close date 10th Dec) Comments

Introduction

1. In the timescales available we have reviewed the document at top level only and provides its initial key comments below.

It is recognised that the clear definition of Allowable Costs is a very important aspect of pricing single source contracts under the DRA and we welcome the opportunity to give its thoughts and have dialogue with the SSRO. A concern for us is the magnitude of the changes to areas such as risk as well as allowable cost (note the distinction); when until recently we had been advised the existing Government Accounting Conventions (GACs) would be transferred into SSPR and refined when the SSRO was fully staffed. From a practical perspective this creates several problems during both the period between now and the effective date and also with respect to long-term contracts which span 'old' and 'new' regimes . A solution will need to be found for these transitional issues (new contracts in the process of being priced as principles are being developed and also for discharge of existing contracts on the old Government Accounting Conventions (GAC) basis). As with any arrangement regarding 'principles', we appreciate that there may be differences of interpretation between the MoD and Industry and also, inevitably, some scenarios which are not adequately addressed. We therefore believe it is vital for the smooth introduction of these regulations over the coming years that all SSRO decisions are published (whilst respecting commercial confidentiality) thereby allowing both MOD and Industry to grow their understanding of how the rules work in practice and ensuring that mistakes, errors and differences are not replicated across different programmes.

Key Points on the Document Issued by the SSRO

General

2. The SSRO guidance says that it "*provides **principles and procedures** to determine whether or not costs meet the criteria for Allowable Costs. It does not provide guidance with regard to the methodology employed to calculate those costs.*"(6.4)

We agree with the general approach but notes that in several places the guidelines then provide specific guidance on methodologies eg site closure costs are to be apportioned based on turnover, rather than, for instance, say apportion on a suitable activity base(12.8 step 2)).

3. There appear to be some principles missing, particularly the treatment of proprietary items (so-called 'commercial items'), non-developmental items and foreign subcontractors whose prices are subject to national audit rules (which may be different or even contradictory to the SSPR principles.)
4. Guidance would also be welcome when costs reported using standard costing/variance system in an MRP environment, including the treatment of common stock in relation to reporting.

The Principles of Allowable Costs (7)

5. The SSRO key principle is that Allowable costs are those that are *“auditable from resources employed through activities undertaken (using those resources) to the outputs and benefits required by the Qualifying Defence Contract. An audit trail is achieved through a transparent understanding of the causal link between the final outputs and benefits and the resources/ activities employed to deliver them.”*

This is the case for many contract costs, but not always for residual central or home office costs. The US DoD has addressed this issue under their own regulations (CAS 9904-403) and we would welcome the SSRO reviewing the USA approach with the purpose of evaluating whether a similar approach could be adapted.

Types of Costs (8)

6. Explicitly talks about *“Overhead and Indirect Costs ... of the Contractor's business in general, cannot be identified and measured as directly applicable to the performance of that Contract.”*

However in the above principles (point 7 above) they appear only to relate to direct allocated costs. We question whether this is the intention of the SSRO and would ask that the coverage in section 7 explicitly covers all types of cost, both direct and indirect within and outside the relevant pricing unit.

The Three Criteria for Allowable Costs (9)

7. Noted that the 3 criteria are: **Appropriate, Attributable and Reasonable.** Again the guidance appears to cover direct costs only. If this is not the intent), we recommend it explicitly covers indirect costs within the pricing unit and in centralised services and that there is provision for residual costs allocation on a fair and reasonable basis (US DoD regulations cover these types of cost). Noted that the test of ‘public scrutiny’ introduced.

As regards our detailed points on the 3 criteria we would refer the SSRO to our letter dated 6th October 2014, in particular the suggested indicators as to whether the cost is appropriate, attributable and reasonable. Generally we feel that some of the distinctions between the 3 criteria are confusing and overlap: far more clarity is required for MOD and the contracting community.

Guidance on Costs Generally Allowable (10)

8. Depreciation costs (10.4). It is unclear as to why *“changes to the valuation of assets have to be agreed by the MOD, but subject to scrutiny by the SSRO.”*

A referral could be made by either party so we are unsure as to why depreciation appears to have been identified for potential special treatment? In addition, companies such as us have to ensure compliance to IFRS which we still understand is the requirement for the calculation of the baseline profit rate and ensuring the principle of comparability?

9. Contractor redundancy payments (10.6). We are confused why there are not independent guidelines on the allowability of redundancy costs in excess of rates laid down in Statute, rather than just a requirement for *“MOD to approve”*. The need to gain MOD approval is accepted as being important for any cost but all parties would benefit from some clear detailed guidelines to aid our discussions. The scope of redundancy payments will be many and varied dependent on, for instance, local site agreements, business unit agreements, the employment T&Cs under which individual is employed (which could include TUPE arrangements and terms

provided by legacy/acquired organisations, the type of restructuring (eg. site closure or not), the need to maintain skills and continuity of supply.

We are also unsure what is meant by the phrase *"any such agreements over those in Statute are to be notified to the SSRO"* as regards in particular the scale/scope of application. We are unsure as to the practicality and proportionality of such an undertaking given the direct and indirect cost pools this covers in a significant part of our business but in respect of a relatively small level of MOD business (ie, in our Gas Turbine division and associated Home Office and Centralised Services). What we believe is key are the metrics used to determine overall cost pools allocated to MOD and our other Government customers to ensure VFM. A 'one size fits all' set of rules, irrespective of the amount of MOD non- competitive activity, seems disproportionate.

10. Employee Bonus Schemes (10.7). We welcome the confirmation that bonus schemes are an allowable costs whether in *'cash' or 'benefits in kind'*. Bonus payments operate across all parts of the workforce, but that schemes tend to increase with seniority and reflect the normal cost of employing certain grades of staff. This is the cost of doing business and attracting/retaining sometimes rare skills required.

We would however suggest that further guidance is needed on what costs (direct or indirect/overheads) that relate to the requirement that *"Exceptional bonuses payable as part of a sale of a company (or part)" are unallowable*. We are unsure as to the practicality and proportionality of such an undertaking given the direct and indirect cost pools this covers in a significant part of our business but in respect of a relatively small level of MOD business (ie, in our Gas Turbine division and associated Home Office and Centralised Services). What we believe is key are the metrics used to determine overall costs pools allocated to MOD and our other Government customers to ensure VFM. Again, a 'one size fits all' set of rules, irrespective of the amount of MOD non-competitive activity, seems disproportionate.

11. Private Venture R&D on **abortive** product development expenditure (10.11). In accordance with the guidance document this now requires MOD agreement *"in advance of the research being undertaken" (ie all R&D in case this turns out to be abortive)*. We envisage considerable difficulties regarding the practicalities of such a proposal and would welcome further dialogue on this issue.
12. Private Venture R&D on '**undecided**' PVR&D (10.12). We would venture that the concept of *'undecided'* expenditure may generate issues for future overhead or contract specific recoveries. Please note that the existing concept of 'spreading forward' expenditure is not new and we would put this forward as being the first option that should be considered.

Guidance on Costs Generally not Allowable (11)

13. Marketing and Selling (10.14). Noted that *"Marketing and sales costs can only be considered Allowable, if they are demonstrably linked to a Qualifying Defence Contract, for example attendance at trade faresto market new equipment"*.

This is an area where we particularly welcome the chance to explain possible unintended consequences of the guidance as currently written. Whilst we understand the appeal of a process which tries to link MoD benefit to expenditure, this is not easy in a business where programme timescales are measured in years and where considerable tangible and intangible benefits

accrue to existing operators as more customers buy a product e.g. in the sharing of fixed costs, the extension of supply chains and economies of scale (which come not just from military sales but also success in the civil marketplace). As a consequence, the costs of generating business in related areas would normally be considered reasonable where it increased the business in shared supply chains and MOD realised a benefit. eg. by enabling fixed costs to be spread over a larger business base. If this is not the case then contractors may have to construct specific MOD additives on a falling business base, ie MOD would bear the full fixed costs of its business without benefiting from increases in associated Military Commercial and Civil business. This would be an unintended consequence for MOD at a time of falling MOD budgets. We would welcome the SSRO thoughts on this, along with a clear definition of marketing & selling costs (eg. what is included, for instance does it include non MOD business development, bid and proposal costs, etc).

14. Entertainment costs (11.1). *“entertainment expenses of **any sort** can never be determined to meet **Appropriate, Attributable and Reasonable** and would not withstand **public scrutiny**”*

We appreciate that this is an area which should be subject to scrutiny. However there is a danger that too-broad a definition may inadvertently prevent RR conducting its business effectively and could be to the detriment of the MoD. We would appreciate the opportunity to discuss this principle since some pragmatic exemptions could be of recognised benefit to the MoD. We have well-developed policies on ethics, gifts and hospitality etc, which ensures that all such expenditure is properly authorised and controlled with severe penalties for non-compliance. Entertainment is therefore only approved when it is accepted as being good for the company (and compliant with HMR&C rules). The range of ‘entertainment’ is considerable, embracing for instance paying for meals for visiting personnel from joint venture partners [who reciprocate when we visit their facilities], rewarding success where perhaps a staff member might be rewarded for identifying costs savings which are shared with the MoD under TCIF arrangements etc.

An over-riding concern is again to ensure the practicality and proportionality of such a disallowance exercise given the direct and indirect cost pools this covers for a relatively small level of MOD business in our Gas Turbine division and associated Home Office and centralised services. What we believe is key are the metrics used to determine overall costs pools allocated to MOD and our other Government customers to ensure VFM. A ‘one size fits all’ set of rules, irrespective of the amount of MOD non-competitive activity seems disproportionate.

15. Cost contingencies (11.1). *“**provision for cost contingencies and cost risk are not Allowable** as they are **not a true contract cost** and **Contractors are expected to manage potential price fluctuations as part of contract delivery.** Any **exceptional or abnormal costs will be assessed under Section 12 of this guidance**”.*

Us and the MoD have spent the past 10 years jointly developing innovative sustainment contracts under which we have assumed many of the responsibilities formally undertaken by military personnel. With the transfer of responsibility has come a transfer of risk – which is recognised in these contracts through various mechanisms in the contracts including joint weighted and ranked risk registers. Being paid for the assumption of risk is absolutely fundamental to our willingness to take these long term contracts. We struggle to understand the rationale or logic behind such guidance as sound business practices dictate that a contract is priced at a level of confidence agreed between MOD

and us. If such cost contingencies and cost risk are unallowable, contractors will have no option but to reject the transfer of risk. The end result will in many cases be a decision by Industry to contract only for short periods or under low risk arrangements such as 'cost plus'; . This would undoubtedly be a 'backwards' step and preclude innovative contracts which have demonstrably saved the MoD many hundreds of millions of pounds in the recent past. We would recommend that this subject is taken forward separately by the SSRO. A good starting point would

Chapter 3 of the MOD guidance on SSPR – The Cost element: 39 (e) ... a description of the assumptions and calculations relevant to the Allowable Costs under a contract, **including assumptions and calculations relevant to any risk or contingency included in those Allowable Costs.**

See also contract report template and Regulations definition (...the price breakdown includes risk/contingency allowance

Reg 25(3)(c)(i) any risk contingency element included in the allowable costs; etc

The above is also necessary to ensure comparability relative to the calculation of baseline profit.

We would also note a clear distinction between accounting for risk and allowable costs. The former has been subject to management and control as part of contractual negotiations when all appropriate factors can be taken into consideration. We believe this area should be taken forward separately.

16. Charitable Donations (11.1). We note that these are no longer allowable which is in contrast to our US DoD customer which does allow certain elements of these costs. Whilst understanding the underlying intent, this strict rule could unintentionally impact the support that Industry is able to give to charities supporting the Services or MoD-sponsored/endorsed charities.

17. "Costs for the remedy of faulty workmanship or the consequences that result" (11.1) are unallowable. We would request further guidance on this subject as if the wording of this section was applied very literally it raises significant issues and questions, for example:-

- Are internal cost covered, e.g. time spent re-working, re-testing, re-inspecting, scrap, swarf, disposal costs
- Does this extend to the cost of supplying a warranty that is normally included in a new supply contract
- Will this extend to arisings in an availability contract that are within a normal warranty period

The above is part of the normal processes for us, particularly on products and services where we have the design and IP rights. Lower added value such as 'make to print' are generally subcontracted, where the risks are lower.

Guidance on Exceptional or Abnormal Costs (12)

"In all cases of an exceptional nature which result in separate negotiations the SSRO must be informed. MOD must submit the details to the SSRO....."(12.4).

We would welcome further guidance on the definition of exceptional or abnormal costs. In particular how it may relate to accounting standards and also the materiality of the item as regards MOD current and prior years work content.

It is assumed that this relates to directly recovered exceptional items, but we would seek clarification from the SSRO.

We would also appreciate the rationale for why it is just the MOD that has to submit? , and also the reasoning behind why there is automatic submission, rather than a referral by either party?

19. Prescriptive nature of the methodology to be followed in determining a causal/beneficial relationship (12.8 step2). In this principles paper we are unsure as to why a specific 'turnover' allocation methodology has been chosen rather than a generic requirement for a suitable activity base?
20. Requirement that the SSRO can be permitted to reopen the calculations within a limited period (12.10). Noted this new requirement. It would be helpful to have a set of rules of time periods and criteria for reopening, given the uncertainty this will generate.
21. Idle Facilities (12.11 to 12.15). This section seems to be dealing with circumstances where the majority of output at a particular location is currently or has been single source work. We would recommend this is clearly articulated, along with examples of MOD thresholds (and subsequent changes) that would give rise to the rules. This point is related to those above where we articulate :What we believe is key are the metrics used to determine overall costs pools allocated to MOD and our other Government customers to ensure VFM. A 'one size fits all' set of rules, irrespective of the amount of MOD non-competitive activity seems disproportionate.
22. Research and Development Tax Credits. (12.19 to 12.22). We would welcome some transitional rules to April 2016, which take account of the mandated requirement to account 'above the line' tax post this date. We had understood this to be the case as agreed between MOD and Industry, but do recognise the independent views of the SSRO.

Reporting, Monitoring and Authority - Authority (13)

23. "Noted that the Act and this guidance empowers the SSRO to ensure that Primary Contractors keep and require their sub-contractors where applicable to keep relevant records and to report in accordance with the Act"

This appears to be a very significant departure from previous express guidance provided by the MoD to Industry during the consultation process. MoD clearly stated on several occasions that a contractor's obligation was to correctly identify QDS and to notify subcontractors if the rules applied. However any non-compliance and the imposition of any penalties for non-compliance was to be managed by the MoD with the subcontractor directly. As a general principle, it is not reasonable to place the obligation on Contractors for the compliance with the regulations by their subcontractors. We would further note that many of Industry's partnering arrangements, particularly collaborations involving foreign firms, were imposed by the MoD and hence it would be even more inequitable to make Industry responsible for any non-compliance by these parties.

We would appreciate further clarification on this matter noting that all reporting will we understand be between the subcontractor and MOD/SSRO.

Response 14

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

The structure appears logical but frequently strays away from the core objective of providing all parties with sufficient clarity. It currently raises more questions than it provides answers and in our opinion requires significant revision to make it fit for the purpose of Statutory Guidance. The extremely short timescales imposed for such an important consultation are a concern.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

Much of the introduction appears to be unnecessary and if anything results in some ambiguity given it introduces new criteria that are not in the Act and restates certain parts of the Act, but incorrectly. Paragraph 4 could therefore be deleted. It also strays away from the objective by restating the political reasoning used by government to justify the introduction of legislation, which is subjective and unnecessary in the context of this specific guidance. In our opinion, the introduction should restrict itself to a reference to the requirement of the Act for the SSRO to issue guidance as currently shown at para 3.2 of the draft document and then describe how that will be addressed in the rest of the document.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

Yes as long as the principles are sufficiently clear and more tightly drafted.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Much of paragraphs 7.2 - 7.6 do not define allowable costs or accommodate differing QMACs with regard to standardising cost information. Primary recording of costs has to be in accordance with IFRS. Any verification and challenge of costs by MOD should be by suitably qualified and experienced personnel.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

It is inadequate and creates uncertainty. For example the checklists should be aides to assessing whether a cost is appropriate rather than being determinative as the list will develop into a rules based list and it is clearly non-exhaustive. Terms such as `suitable` and `withstand public scrutiny` are ambiguous and appear to go beyond the Act.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes

No

Please add comments to support your answer:

It is inadequate and creates uncertainty. Bona fide overheads do not appear to have been addressed. The treatment of cost should be consistent with the GAC and QMAC.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

It is inadequate and creates uncertainty.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

This is already a requirement of the Act.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

The checklists as written introduce considerable uncertainty. They appear to introduce new criteria that are not in the definitions so should be conformed to those definitions.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes

No

Please add comments to support your answer:

Reasonable provisions for cost risk and contingencies are an essential part of the cost baseline and therefore the price. The level of any cost contingency should be evaluated at the amount that on average will be incurred by the contractor and be commensurate with the risk profile of the contract.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes

No

Please add comments to support your answer:

We would recommend that any opinions and determinations made by the SSRO are issued as and when they arise, certainly in the first 5 years, in order to facilitate early clarity and precedent.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

Not as currently drafted. It will help when the drafting is tighter and is restricted to the specific objective.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

If made comprehensive, the illustrations will help.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

The paragraphs on Authority are unnecessary as it just restates the Act. We would that the SSRO should own the form of the QMAC going forward.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes No

Please add comments to support your answer:

There ought to be much clearer cross referencing of the SSRO's role to specific sections of the Act and the relevant paragraphs of the Single Source Contract Regulations.

Response 14

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes

No

To the extent that the guidance is produced to ensure that users have a broad appreciation of what the MoD expects from Industry when both parties enter into a single source contract, it has, to a reasonable extent, achieved this. However, there are areas where there is a lack of real definition or explanation which needs to be further addressed. These are highlighted in more detail at the appropriate questions.

Given that the SSRO's obligation under s20 (1) of the Defence Reform Act (the "Act") is to issue guidance about determining whether costs are allowable costs under qualifying defence contracts, it would be better if the guidance fulfilled that function and that function alone. Whilst background information, information about how the guidance is to be used and restatements of the Act may be helpful, we suggest that may be more useful in a separate non-statutory guidance document.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes

No

Please add comments to support your answer:

The introduction, brief as it is, outlines by which entity the guidance is issued, the purposes for which it is issued, in relation to what it is issued and that the use of the guidance is mandatory. Assuming that the status of the guidance is still "draft" then we would say a clear but brief description of the status and the purpose of the guidance have been provided?

There are some inaccuracies and areas where clarity could be improved. The guidance is to be used for the purpose of pricing both Qualifying Defence Contracts and Qualifying Sub Contracts as defined in the Single Source Pricing Regulations (the "Regulations"). This is not clear.

Importantly, non-compliance with the guidance is not in breach of the Act, contrary to what is stated in paragraph 3.4. Contractors and MoD must have regard to the guidance, yet if there is good reason there may be scope to diverge from it.

The remedies that may be applied are not clear and if they are to be stated here, reference should also be made to the SSRO's ability to re-price contracts.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes

No

Please add comments to support your answer:

Yes and the principles must be very clear and more extensive than they are currently and be able to cover a range of contracts and circumstances beyond those currently contemplated. Also, there are example checklists of whether costs should be determined as Appropriate, Attributable or Reasonable which are too narrow and may be interpreted as definitive. The parties to a negotiation should understand that circumstances specific to a contract will determine whether costs are Appropriate, Attributable or Reasonable and they should be encouraged always to investigate these further.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

Yes, the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost. The calculation of contract costs should be left to the parties to the contract.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

No, the principles and definitions must be clearer and more extensive than they are currently. The example checklist given to determine whether costs are Allowable is too narrow and should not be interpreted as definitive; the checklists should be considered as an aid to interpretation only. Also, given the nature of the definitions and the checklist, there will inevitably be a degree of doubt whether a cost is allowable or not which in nearly all cases will be subjective. For example, in the definition of "Appropriate" there are references to costs that "would be expected to be incurred", costs which are "suitable" and costs which are "fair and equitable". This language simply creates other potential areas of disagreement on which the SSRO will have to arbitrate. In such circumstances SSRO will struggle to demonstrate how it has applied the available, albeit limited, guidance fairly. Moreover there are some criteria in particular where the Contractor, MoD and SSRO will simply be unable to objectively assess, e.g. whether a cost would withstand public scrutiny.

Given this situation, where SSRO is required to make a determination, but this determination is to be based on undefined criteria such as those mentioned above, there should be a general presumption that a cost is allowable unless evidence can be produced which shows that it is not.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

No, the principles and definitions must be clearer and more extensive than they are currently. Also, the example checklists given to determine whether costs are Appropriate are too narrow and may be interpreted as definitive. The parties to a negotiation should understand that circumstances specific to a contract will determine whether costs are Appropriate and they should be encouraged always to investigate these further.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

No, the principles and definitions must be clearer and more extensive than they are currently. Also, the example checklists given to determine whether costs are Attributable are too narrow and may be interpreted as definitive. The parties to a negotiation should understand that circumstances specific to a contract will determine whether costs are Attributable and they should be encouraged always to investigate these further.

Yes No

Please add comments to support your answer:

No, the principles and definitions must be clearer and more extensive than they are currently. Also, the example checklists given to determine whether costs are Attributable are too narrow and may be interpreted as definitive. The parties to a negotiation should understand that circumstances specific to a contract will determine whether costs are Reasonable and they should be encouraged always to investigate these further.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

Assuming the principles and definitions are suitably amended then yes.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

No. It should be necessary only to meet the principles and definitions. The checklist should be considered merely to be a non-exhaustive list of examples. Please also see answer to Question 5.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Risk is necessarily present within highly complex, technology based programmes; particularly those requiring engineering development with commercial arrangements that may be in place through many years.

Wider MoD literature and indeed, your own Investment Appraisal process, considers Whole Life Cost at 10%, 50% and 90% cost confidence levels; reflecting the related analysis of deterministic costs, uncertainty as well as risk (mitigated).

Equivalent recognition of the need for Industry to consider the same would appear unreasonable.

We believe that this section of the guidance could be considerably improved by providing definitions for cost contingencies and cost risk, and ensuring compliance with MoD's own best practice literature on the subject of Cost Risk analysis. References for these MoD own documents can be supplied if requested.

It is requested that this guidance reflect the principle that risk is present on Defence programmes and that it should be 'carried' by that stakeholder best placed to manage the risk; enabling provision to be made for it, by whomever carries it (whether that by MoD or industry).

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

If opinions and determinations are made by the SSRO they should be published promptly and not delayed for an annual publication. Worked examples, opinions and/or determinations will help all concerned acquire an effective understanding of the working of the SSRO.

single source defence contracts?

Yes No

Please add comments to support your answer:

As it is currently presented, more clarity is required on how this guidance will fairly and co-operatively support the achievement of value for money in single source contracts for **all** parties. This, however, will have to be based on transparent two party engagement and clear tests for what are Allowable, Appropriate and Reasonable costs. See also answer to Question 5.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

No, the principles and definitions must be clearer and more extensive than they are currently. Also, the example checklists given to determine whether costs are Appropriate are too narrow and may be interpreted as definitive. The parties to a negotiation should understand that circumstances specific to a contract will determine whether costs are Appropriate and they should be encouraged always to investigate these further. See also answer to Question 5.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

The only disclosure would normally be contained within a completed QMAC. Disclosure outwith this would be on a case-by-case basis.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes No

Please add comments to support your answer:

There should be a simple listing of the SSRO's role by reference to the particular sections of the Act and the paragraphs of the Regulations that govern that role. Guidelines for Industry, published on the AOF may have been helpful.

Response 16

10th December 2014

Marcine Waterman Interim Chief Executive SSRO
Finlaison House
15-17 Furnival Street
London
EC4A 1AB

Dear Marcine

SSRO - Single Source Cost Standards Consultation

Thank you for giving us the opportunity to respond to the SSRO consultation on Single Source Cost Standards.

We wholeheartedly support the principle of delivering Value for Money whilst ensuring that a fair and reasonable price is paid. We therefore welcome the opportunity to input to the guidelines that will deliver this objective.

Please find enclosed our response on the consultation form as requested. Please note that in many cases rather than a yes/no response, we have opted to add comments which we hope will be constructive.

If you have any queries or clarifications, please do not hesitate to contact me.

Yours sincerely

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

Whilst the structure of the guidance is clear, some areas of the guidance go into details that could be seen to extend beyond the establishing of overarching principles.

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

It would be helpful to clarify whether the guidance is for all Single Source contracts or purely Qualifying Defence Contracts.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes No

Please add comments to support your answer:

This should be seen in the context of question 1 above.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

concise?

Yes No

Please add comments to support your answer:

The items in the checklist could appear to be somewhat subjective eg. in the requirement to 'withstand public scrutiny'.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

It would be helpful to confirm that indirect costs that are necessarily incurred and attributable across the business as a whole but not directly required for contract fulfilment can be included.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes No

Please add comments to support your answer:

Please see response to 7 above.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes No

Please add comments to support your answer:

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes No

Please add comments to support your answer:

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

This proposal would seem to risk a move back to a more cost-plus contracting approach, with significant programme risk transferring back to the MOD. We believe that the concept of the bearing of risk by the Contractor enhances Value for Money.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes

No

Please add comments to support your answer:

substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes

No

- generally not Allowable Costs?

Yes

No

- exceptional and abnormal Costs?

Yes

No

Please add comments to support your answer:

We would appreciate further review in the following areas:

1. The guidance requires that staff bonuses must be applied across all parts of the workforce. Bonus schemes for senior management and also sales teams are normal employment practice in the commercial world and benefit MOD in terms of ensuring the relevant skills for execution of contracts.
2. Clarity on the extent to which sales and marketing costs can be proportionately allocated and on the definition of notional transactions.
3. Where Research and Development Expenditure Credit is offset against allowable costs, it should be the net rather than gross benefit. In addition, we propose that the offset should only take place from the point of mandatory RDEC implementation ie in April 2016 as previously proposed in the HMT RDEC consultation response and also following the Review Board recommendations.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes

No

Please add comments to support your answer:

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

Response 17

Introduction

QUESTION 1 - Do you agree the guidance has been structured effectively?

Yes No

Please add comments to support your answer:

QUESTION 2 - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes No

Please add comments to support your answer:

The document unnecessarily, and incorrectly restates elements of the Act. It introduces new criteria that are not in the Act. It states that compliance with the document is mandatory and that non-compliance is a breach resulting in fines and penalties, which is wholly inconsistent with the Act. It restates the political reasoning used by MoD to justify the introduction of legislation, which is disingenuous, and inconsistent with the facts.

QUESTION 3 - Do you agree that this guidance should be principles rather than rules based?

Yes

No

Please add comments to support your answer:

Yes, so long as the principles are clear, understandable and robust enough to withstand legal scrutiny - the current draft does not meet these standards. However, the "guidance" on those "principles" has the effect of becoming rules-based, particularly for those costs that are to be disallowed; this should lead to the development of a rules-based system over time for all allowable and disallowed costs. There are more principles that should be stated to cover the range of contracts and pricing characteristics contemplated by MoD and the relationship between the parties in the negotiation of costs, such as Commercial Off The Shelf (COTS) items, commercial/market priced items and non-developmental items.

Allowable Costs

QUESTION 4 - Do you agree that the Single Source Cost Standards should only provide principles and procedures for determining Allowable Cost? (not guidance on how to calculate cost)

Yes No

Please add comments to support your answer:

It's not clear what is meant by "procedures for determining costs", but the calculation of costs should be left to the parties to the contract. The document does not appear to include any procedures. What is required is a clear statement of principles and guidance on them as to how they might be applied.

QUESTION 5 - Do you agree that the principle of Allowable Costs is clear and concise?

Yes No

Please add comments to support your answer:

Allowable costs are defined by the Act. It is not clear why any further "principle" should be applied, which creates legal uncertainty and is unhelpful.

QUESTION 6 - Do you agree that the definition of Appropriate is clear and concise?

Yes No

Please add comments to support your answer:

A "definition" may not be appropriate. The Act calls only for the SSRO to provide "guidance". What is provided is inadequate, creates legal uncertainty and is unhelpful.

QUESTION 7 - Do you agree that the definition of Attributable is clear and concise?

Yes No

Please add comments to support your answer:

A "definition" may not be appropriate. The Act calls only for the SSRO to provide "guidance". What is provided is inadequate, creates legal uncertainty and is unhelpful.

QUESTION 8 - Do you agree that the definition of Reasonable is clear and concise?

Yes

No

Please add comments to support your answer:

A “definition” may not be appropriate. The Act calls only for the SSRO to provide “guidance”. What is provided is inadequate, creates legal uncertainty and is unhelpful.

QUESTION 9 - Do you agree with the principle that all three definitions of Appropriate, Attributable and Reasonable have to be met to enable a Qualifying Defence Contract cost to be Allowable?

Yes

No

Please add comments to support your answer:

But, the question does not need to be asked, since section 20(2) of the Act requires the parties to be satisfied that the cost is appropriate, attributable to the contract and reasonable in the circumstances. There is a requirement only to “have regard to” the Statutory Guidance in determining whether those requirements are met (it is not mandatory). Furthermore, the MoD may require the contractor to show (whether by reference to the Statutory Guidance or otherwise) that those requirements are met - so the Statutory Guidance is not necessarily determinative.

QUESTION 10 - Do you agree that the checklist of questions under the Appropriate, Attributable and Reasonable definitions must be met before a cost is determined as Allowable?

Yes

No

Please add comments to support your answer:

No. The checklists are unhelpful. They introduce new criteria that are not in the definitions. It should be necessary only to satisfy the Act “having regard” to the guidance or otherwise.

QUESTION 11 - Do you agree that it is appropriate for cost contingency and cost risk to be generally disallowed?

Yes No

Please add comments to support your answer:

Evaluated cost contingency and cost risk are an essential part of the cost baseline and therefore the price. Contractors make a choice when costing, to include unknowns/risks within the core delegated numbers, or retain control, visibility and challenge by segregating the costs in contingency. The cost contingency should be properly evaluated at the amount that on average will be incurred by the contractor - Para 9.5, second bullet refers to the uncertainty involved in assessing the reasonableness of costs: contingencies and cost risk provisions will reflect that uncertainty. MoD recognises this in internal guidance on pricing and on the Earned Value Management of projects. It would be wholly inconsistent with the comparability principles established for the calculation of the baseline profit rate to exclude these items.

QUESTION 12 - Do you think supplementary guidance should be issued annually, setting out examples of opinions and/or determinations made by the SSRO?

Yes No

Please add comments to support your answer:

If opinions and determinations are made by the SSRO they must be published promptly and not delayed for an annual publication.

QUESTION 13 - Do you agree that this guidance will promote value for money in single source defence contracts?

Yes No

Please add comments to support your answer:

For the reasons given in answer to Question 1 and subsequently.

QUESTION 14 - Do you think that the illustrations provided in the guidance substantially cover the relevant areas with regards to:

- generally Allowable Costs?

Yes No

- generally not Allowable Costs?

Yes No

- exceptional and abnormal Costs?

Yes No

Please add comments to support your answer:

The graphical illustrations do not help because they merely repeat the principles stated in the Act. The textual “illustrations” are often obvious and shed no new light or clarification on the subject matter.

Reporting, Monitoring and Authority

QUESTION 15 - Do you agree that the disclosure requirements are appropriate to support the application of this guidance?

Yes No

Please add comments to support your answer:

There is unnecessary verbiage. The only requirement should be disclosure in a completed QMAC. Access requirements and availability of records are covered by the Act. The SSRO should own the form of the QMAC so that it is under impartial control - although there is an interface with the US where the QMAC (with the QMAC supplement) has to satisfy the US Cost Accounting Standard Board’s Regulations as an acceptable alternative to the filing of a US Disclosure Statement-1 (or the QMAC plus DS-1): this has been managed by MoD to date.

QUESTION 16 - Do you agree that the role of the SSRO with regards to determining Allowable Costs has been effectively communicated?

Yes

No

Please add comments to support your answer:

This is a process that is separate from guidance on allowable costs. The procedures that the SSRO will require for applications to the SSRO, and the processes that the SSRO will adopt, for determinations or opinions under the Act need to be spelt out clearly, but in a separate document. We need to know timescales, evidential requirements, whether it will be a papers only opinion or determination or whether oral submissions can be made, whether there will be an inquisitorial process adopted by the SSRO and, if so, whether legal representation of the applicant will be permitted.

In this guidance, there should be a simple listing of the SSRO's role by reference to the particular sections of the Act and the paragraphs of the Regulations that govern that role.

Equally, the SSRO must use the same "guidance" set out in the Statutory Guidance in reaching any opinion or determination on a matter that is referred to it - so the Statutory Guidance must be fit for that purpose and is just as "binding" on the SSRO as it is on the Contractor and on the MoD.

General Observations on Draft Statutory Guidance on Allowable Costs

dated 26 November 2014

1. The SSRO has not followed the Cabinet Office [Consultation Principles](#). There has not been extensive consultation on the subject of Allowable Costs with stakeholders and experts. The following principles are relevant:
 - a. The impact of the Statutory Guidance has major significance in the pricing of multi-million pound contracts. A consultation period of 10 clear working days (27 November to 10 December) is so short that it is out of proportion to the complexity of the issues and the impact that the Guidance will have. There has been no clear explanation or rationale for shorter timescales than the 12-week norm for significant matters.
 - b. There has been no real discussion with the affected parties and experts who can bring their expertise and alternative perspectives to enable better informed decisions to be taken.
 - c. No evidence has been produced by the SSRO to substantiate the positions taken in the draft Guidance to enable contestability and challenge, particularly where there is a change from the current Government Accounting Conventions.
 - d. The consultation document is not easy to comprehend, navigate or reference.
 - e. The consultation does not say at what stage of development the Guidance has reached, what matters are open to change and what decisions have already been taken.

It is strongly recommended that the SSRO has direct discussions with experts and stakeholders before taking the next steps in developing Statutory Guidance on Allowable Costs.

2. The Act has been unnecessarily restated, but incorrectly, and over-elaborated. New concepts have been introduced that are not criteria in the Act, such as “public interest”, “public scrutiny”, “benefit to MoD”, which is considered *ultra vires* for the SSRO to opine on.
3. There is unnecessary and misguided detail in the Introduction. All that is required of this document is statutory guidance on Allowable Costs that is clear and legally robust. The document will be a legal document to settle disputes on pricing matters and must be fit for that purpose. However, “non-compliance” with the guidance is an inappropriate expression if the parties must only “have regard” to the guidance, which is the standard in the Act.
4. The continued reference to a QDC is unhelpful in not capturing QSCs, it would be simpler to refer to “regulated contracts”. Furthermore, guidance appears in many places to be product based without encompassing services. In addition, it would be more helpful to make a distinction between guidance on direct costs and guidance on overhead costs – some guidance given only relates to overheads but doesn’t say that. Where examples are given, they need to clearly highlight which principle of the three they are addressing, otherwise it isn’t clear which of the principles is being clarified; in some examples a combination of the three principles appears, often in pairs, which is unhelpful.

5. There is a presumption in the draft guidance of a causal beneficial relationship with a cost (perhaps in a single financial year), which is not necessarily the case in practice yet it should still be an allowable cost on an equitable basis. This aspect of the guidance needs to be developed further to reflect practical aspects.
6. There should be a presumption that all costs are allowable unless they do not satisfy the principles of appropriate, attributable and reasonable. There should also be a presumption that if Allowable Costs and Profit have been computed in accordance with the Act then the outcome price is value for money.
7. Value for money considerations should apply to prices only and not to individual costs – it is the outcome that needs to be considered value for money and not individual elements of a price build-up, as many matters will offset each other to arrive at the outcome. Furthermore, as there is no definition of “value for money” in this context it is unclear how any consideration could be made, particularly if the presumption at paragraph 6 above applies.
8. There needs to be a clear distinction between the “principles” to be applied and the “guidance” on those principles – in some places they flow into each other. There are some principles missing, particularly the treatment of commercial items such as market price items and non-developmental items. Guidance is also needed on when costs are allocated² under this regime when a contractor is using Material Requirements Planning or Enterprise Resource Planning systems, and the treatment of common, fungible and anonymous stock in relation to reporting and Profit On Cost Once. Guidance is needed on Capital Employed, which is covered in the Government Accounting Conventions but not in the current guidance. Guidance is needed on the effect of prior agreements with MoD that might affect the pricing of regulated contracts.
9. The guidance must be sufficient to identify the methodology to be used by the SSRO in any matter referred to it by the parties concerning an adjudication³ on allowable costs. This will ensure transparency of the determination process for allowable costs and provide a basis for each party’s conduct (see also paragraph 27 below) in assessing allowable costs when agreeing prices.
10. The extent of allowability of costs applies broadly to many contractor accounting systems in varying contract situations. To avoid possible disallowance or dispute based on inappropriateness, improper attribution or unreasonableness, contracting officers and contractors should seek advance agreement on the treatment of costs or circumstances. However, an advance agreement should not be an absolute requirement and the absence of an advance agreement on any cost should not, in itself, affect the allowability of that cost. Advance agreements should be in writing and cited in relevant contracts.
11. Guidance on “Appropriate” costs should be rules-based, by reference to IFRS and current conventions reflected in the Government Accounting Conventions⁴.

² The current convention for vesting where an inchoate interest may exist (eg under DEFCON 649) is for vesting to occur at the time that stock is allocated to the contract or item in question.

³ The SSRO is acting as an “expert” adjudicator and not as an arbitrator under the Arbitration Act.

⁴ See Appendix D to the Report on the 2014 Annual Review of the Profit Formula for Non-Competitive Contracts, February 2014.

12. The guidance needs to make clear that costs may be allowable in part if only a portion is unallowable. There should not be a requirement to show a negative, such as costs are not recovered elsewhere. The standards should be as objective as possible and avoid expressions such as “expected benefits”.
13. In the guidance on reasonableness, there is a reference to “good business practice” which is undefined. If it is to be retained a possible explanation might be: Using standards, practices, methods and procedures conforming to the law and exercising that degree of skill and care, diligence and prudence which would reasonably and ordinarily be expected from a skilled and experienced person or body engaged in a similar type of undertaking under the same or similar circumstances. What is reasonable depends on a variety of considerations and circumstances, including —
 - a. whether the cost is a type of cost generally recognised as ordinary and necessary for the conduct of the contractor’s business or the contract performance;
 - b. generally accepted sound business practices, arm’s length bargaining, the uncertainty involved, the economic environment and a reflection of statutory provisions;
 - c. the contractor’s responsibilities to customers, the owners of the business, and employees; and
 - d. any significant deviations from the contractor’s established practices.
14. The guidance in 10.14 is inconsistent with the approach to marketing and selling expenses which was established in 1971 and has been consistently applied since that time (with only minor modifications on insurance and transport/carriage), and reflected in the Government Accounting Conventions, see attached Supplementary Report on the Treatment of Marketing and Selling Expenses. There needs to be clear and convincing evidence to move away from the current convention.
15. In the guidance at 11.1, in relation to “entertainment expenses”, there is no definition of “entertainment”. The example is inconsistent with the Government Accounting Conventions and is inconsistent with normal practice and the Reference Group. There needs to be clear and convincing evidence to move away from the current convention.
16. The guidance at 11.1, in relation to cost contingencies and risk, is inconsistent with the Government Accounting Conventions, the requirements for reporting under the Regulations and MoD commercial policy. It suggests that learning curve assumptions and scrap and re-work allowances will not be allowed – this is inconsistent with normal practice and the Reference Group. There needs to be clear and convincing evidence to depart from these conventions.
17. The guidance at 11.2 is said to be incomplete, which leaves uncertainty as to what is allowable.
18. The guidance at 12.7 refers to “normal commercial business risk”, which is undefined. Furthermore, MoD business is not normal commercial business. In the circumstances described “value for money” is not a realistic principle; however, fair and reasonable compensation to the contractor should be a primary consideration, as MoD has had the benefit of these unabsorbed costs in its pricing of prior contracts. Demonstrating innovation and efficiency do not seem to fall into the description of an allowable cost, as provided in the Act, and appear to be artificial requirements.

19. The statement at 12.10 that suggests the “SSRO will be permitted to re-open” a calculation is beyond the powers given to the SSRO in the Act or Regulations.
20. In relation to 12.11 to 12.15 (and elsewhere), regard must be had to existing agreements between the Contractor and the MoD.
21. Cross-references to the Act and the Regulations should be made wherever possible to direct the reader to the source of the authority.
22. In any determination of allowable costs the guidance must apply at the time of pricing or incurring the cost having regard to the particular performance requirement, the usages and practices of the trades or professions involved, the uncertainty involved, the circumstances of the supplier, the economic environment and the statutory provisions applicable at that time.
23. Where a supplier is required to show that the principles for an allowable cost are met in relation to a particular cost that requirement should be satisfied by the supplier providing a credible rationale, on the balance of probability, that the cost is appropriate, attributable and not unreasonable, unnecessary, extravagant or wasteful. The extent of any explanation should be sufficient for a person competent in interpreting management and financial information of that type to understand the relevant information.
24. The assessment of prices or overhead rates on the basis of benchmark comparisons or “should cost” analysis or views of competitiveness are not justifiable, as these criteria do not apply to how allowable costs are described under the Act.
25. The document is poorly drafted:
 - a. Inconsistent use of capitalised terms (the same words have an initial capital in some places but not in others).
 - b. Over-use of capitalised terms that are not defined or distinctive enough.
 - c. Text and ideas are repeated unnecessarily.
 - d. Several editorial, punctuation and grammatical errors.
 - e. Lack of configuration control – the original version put up on the website was taken down and amended before being put up again, but with no indication that it was a changed document.
26. The document is poorly laid out:
 - a. Use of bullets instead of discrete identification of each paragraph and subparagraph for future reference; the worst example is para 11.1.
 - b. Paragraphs are split across columns and pages making it difficult for the reader to follow.
 - c. Arcane and legalistic words and phrases are used instead of plain language.
 - d. More white space is needed between paragraphs and sections to help the reader.

27. While not directly relevant to the guidance on allowable costs, in any reference to the SSRO, the SSRO should have regard to the following behaviours that should be expected of the parties:
- a. There must be a mutuality of frankness by the parties to a price negotiation in disclosing to each other facts and judgments on those facts that are material to that price negotiation.
 - b. While not relieving the party having the information of the primary responsibility for disclosure, there must be a duty to make normal commercial enquiries of the other party. A party cannot simply rely on the other party's duty to make available facts and judgments on those facts.
 - c. The MoD cannot merely superimpose its definitions or judgments in contradiction to those of the contractor who has acted in a reasonable manner when incurring costs. MoD must show why it believes the contractor's actions were not those that a prudent business person undertaking commercial work would have taken in the same or similar circumstances. Nor can MoD override a contractor's policies and substitute its own management judgment for that of the contractor's officials.

SUPPLEMENTARY REPORT ON THE TREATMENT OF MARKETING AND SELLING EXPENSES

1. According to our Terms of Reference contained in the Memorandum of Agreement between the Government and the C.B.I., we are to conduct an Interim Review of the New Profit Formula for non-competitive Government contracts, which came into force on 26th February, 1968. As part of this Review we were asked to decide whether certain costs, which are at present not accepted as charges to Government contracts, should in future be so accepted. In our Report on the Interim Review dated 31st July, 1970 we dealt with practically all the subjects to be covered by the Interim Review but we were not able, within the time limit prescribed, to reach firm conclusions on the complex subject of the treatment of marketing and selling expenses. Accordingly, the Government and the C.B.I. agreed that the Interim Review should be extended for a further year, to 1st August, 1971, so that we might endeavour in consultation with Departments and contractors, to find a more satisfactory way of attributing marketing and selling expenses to Government contracts.

2. The present Government Accounting Convention regarding marketing and selling expenses is that these expenses may be partially excluded from the costs attributable to Government contracts; certain items, such as discounts allowed and bad debts, are normally totally excluded from attributable costs. The Government have given an explanation of their current treatment of these expenses in paragraph 8B of their submission to us dated 6th January, 1970 (Appendix F). Several contractors and trade associations have made submissions to us giving their comments on this Convention and we have also had discussions, both before and after the publication of our Report on the Interim Review, with Government Departments and with the Joint Review Board Advisory Committee (J.R.B.A.C.) representing five trade associations with major interests in Government contracts and the C.B.I. Sixteen contractors have given us a detailed analysis of their marketing and selling expenses and of the treatment of these expenses by Government Departments under the present Convention. We have given careful consideration to all the evidence given to us by companies, trade associations and Government Departments and to the Third Report from the Committee of Public Accounts, Session 1969-1970.

3. In our Report on the Interim Review we said that we were concerned that there should be clearer principles to determine the admissibility of marketing and selling expenses in pricing non-competitive Government contracts; we felt that the present Convention might lead to inconsistencies in treatment and to confusion and time-wasting in price negotiations. We were not then convinced, nor are we now convinced, that the treatment of these expenses has, in aggregate, been unreasonable, or that the Convention should be changed in such a way as to affect materially the aggregate amount of costs admitted. It does not however follow that adoption of the proposals made in this Supplementary Report will not result in changes in the amounts allowed in particular cases, and we do not envisage that future negotiations should involve comparative exercises which would be both time-consuming and relatively meaningless.

4. We referred in paragraph 22 of our Report on the Interim Review to certain types of costs which are commonly classed as marketing and selling expenses but which should, in our view, be charged direct to particular contracts and thus generally excluded from attributable costs. These include bad debts, discounts allowed on sales, insurance (of credit and goods in transit), agents commissions, after sales service costs (where attributable to a specific product) and outward carriage of finished products. For the purposes of this Supplementary Report the

expression "marketing and selling expenses" should therefore be treated as excluding the foregoing types of costs.

5. In making the proposals contained in the following paragraphs of this Supplementary Report we have had especially in mind :

- (a) the desire of all concerned (with which we entirely concur) that the method of dealing with marketing and selling expenses should be simple to administer, *and*
- (b) the need to strike a fair balance which on the one hand acknowledges that the Government benefit from marketing and selling expenses incurred in aid of non-Government work, but which on the other hand affords to the Departments concerned proper protection against the risk of unnecessary, extravagant or wasteful expenses being charged to Government contracts.

In the course of our consultations there emerged a very substantial measure of agreement between those whose views we canvassed on behalf of Government and industry, and this is reflected in our present proposals. They should, we consider, result in a straightforward and consistent treatment of these expenses and eliminate the dissatisfaction which has on occasions been engendered in the past by disallowances which have been felt to be arbitrary and unfair.

6. All contractors should classify their marketing and selling expenses as far as possible, in the same way. The precise degree of analysis required will vary from contractor to contractor and the details should be agreed with the Department concerned, but we recommend the following general classification:

- (a) Market Research and Advertising (of all kinds including Exhibitions, etc.).
- (b) Selling Expenses, analysed under
 - (i) Salaries and Commissions (to staff) and Retainers (to agents)
 - (ii) Overheads (direct and administrative)
 - (iii) Travelling Expenses and Entertainment.
- (c) Technical and Liaison, analysed under
 - (i) Salaries and Commissions (to staff)
 - (ii) Overheads (direct and administrative)
 - (iii) Travelling Expenses and Entertainment.

Where appropriate, expenses should include associated overheads. Where a Group has a separate company or companies for the purpose, inter alia. of marketing products at home or abroad, the relevant marketing and selling expenses of such company or companies should be taken into account in arriving at the total expenses for which analysis is required.

7. As far as possible each of these categories of expenses should be identified to, and allocated to, appropriate product groups, except in those particular cases where it is realistic and appropriate to identify and allocate them to specific products. One or other such method of allocation should be practicable, at least for a substantial proportion of the total expenditure, and any small proportion that cannot be so allocated should be susceptible of apportionment on an appropriate basis. The criteria that will determine the way in which the allocation or apportionment of any particular item of expenses is to be made will depend on the facts of each case. The aim should be to ensure that the share of the total expenses borne by each product group or product fairly reflects the correct incidence of costs falling on the product groups or products which the expenditure was designed to benefit. What will constitute appropriate product groups or products must likewise depend upon the circumstances. Groupings as already established for his own purposes by a particular contractor may not always be found appropriate in the present context, but contractors' established practices should be disturbed only when this is necessary to achieve a fair result.

8. (a) Subject to the Department concerned being satisfied, having regard to all the circumstances, (i) that the method of classification, allocation and apportionment of expenses adopted by the contractor is fair and reasonable, and (ii) that no part of the expenses was unreasonably incurred, the full amount of the marketing and selling expenses charged should be accepted in calculating the overhead rate applicable, for Government pricing purposes, to each product group or product as the case may be.

(b) The Department concerned should normally accept that the relevant expenses were reasonably incurred :

- (i) in the case where only a small proportion of a contractor's turnover in respect of the relevant product group or product is made up of non-competitive Government contracts
- (ii) in any other case, unless it were to consider that the inclusion of any expense would be inconsistent with the Government's existing practice (which is not confined to marketing and selling expenses) of excluding from attributable costs anything that is unnecessary, extravagant or wasteful.

(c) If a Department proposes to disallow any item of expense the contractor should be entitled to a full explanation of the reasons for the proposed disallowance.

9. We consider that the proposals stated above should come into effect for the purpose of calculating overhead rates for each contractor's financial year next commencing after the date of this Supplementary Report. This will avoid any retrospection, which would in our view be both administratively undesirable and potentially unfair. It will moreover take time for the detailed adjustments of procedures to be worked out with the Departments concerned. We strongly urge that Departments and contractors should commence discussions as soon as possible with a view to agreeing the classification of costs, the identification of product groups or products and the methods of allocation and apportionment, since we are anxious that our proposals should not delay the agreement of future overhead rates.

10. We wish to record our appreciation of the continued help given to us by representatives of the Government Departments and of industry.

11. It is with regret that we have to record the death in February of this year of Sir William Lawson. Pending the appointment of a new Chairman, Viscount Caldecote has undertaken the duties of acting Chairman.

29th June, 1971.

CALDECOTE
BASIL ECKERSLEY
ST. JOHN ELSTUB
ROBERTHALL

Response 18

Comments / Observations

There is a need for clear guidance and updating of approaches in accord with current thinking and concepts that are carefully set in the demanding and sometimes contradictory public sector based defence acquisition environment.

It must be borne in mind that this is an environment where the overriding need to ensure Value for Money and public accountability are to the fore. Whilst conceptually there may be a clamour for relaxed contractual working culture, ultimately it is the tax payers money – the public's money that must be seen to be spent carefully and in accord with clear guidelines. Hence this is a move in the right direction and appears to set the right tone.

It is not perfect and must be seen in the context of further approaches (I understand that this is only the first of a number of points that are being produced) For example it be set in the confines of the new Operating Model and recognise that contractors are a key element of the way forward for defence procurement (in a variety of roles and often embedded within the MOD side of the relationship (i.e. they are spending public money and the public must still be assured that the actions and approaches taken stand up to public scrutiny. Again in that sense this provides a good marker (or baseline from which to build)

Response 19

Sent: Tuesday, December 9, 2014 12:41:43 PM (UTC)

To: Marcine Waterman

Subject: Consultation – draft Statutory Guidance on Allowable Costs - Response by 8 Dec please

Sorry it's a bit late, but please see below some queries/comments you may want to take into account

- 1) 1.1 - Not a true statement, not "any contract" its QDC's only.
- 2) 2.5 - General point, clause uses bullet points whereas elsewhere it uses sub clauses.
- 3) 3.4 - Is this true? Doesn't the Act say that we should have regard to the guidance, not that it is a breach of the Act not to comply with the guidance.
- 4) 4.3 - "All revenues pertaining to a contract" - is that clear enough?
- 5) 4.4 - This can' be right. The value isn't based on the "total cost of acquisition to the MoD". That would normally include their own internal cost.
- 6) 7.2 - This is a MAJOR area and is repeated in other sections. A causal link is a big hurdle to jump re overheads. Some costs are the costs of being in business. It is not always possible to provide a direct causal link to the contract!
- 7) 7.3 - I would have thought there should be an over riding principle of IFRS and QMAC here.
- 8) 7.4 - Onus for burden of proof seems to have moved here. I thought it was reciprocal.
- 9) 8.1 - see 7.2.
- 10) 8.3 - This is what the QMAC covers.
- 11) 8.5 - Overhead costs - "incurred during the performance of the QDC". Depreciation costs may continue after completion of the QDC.
- 12) 9.2 - "supported by sufficient justification in line with the Act". Not sure this is covered in the Act.
- 13) 9.2 - The use of the checklists is not helpful since they are not comprehensive. The GAC's work better.
- 14) 9.3 - See 7.2.
- 15) 9.5 - Checklist not helpful - estimates based on empirical evidence? We, for instance have no empirical evidence on turrets.
- 16) 10.2 - "reconcilable" - as any accountant will tell you, anything is reconcilable.
- 17) 10.4 - A MAJOR issue. "changes to the valuation of assets to be agreed by MoD" I don't think so. IFRS lay down the rules on this.
- 18) 10.6 - Redundancy - remove all the words after employees.
- 19) 10.14 - A MAJOR issue. The example they give is preposterous anyway. Demonstrably link a trade fair to a piece of equipment? No mention of B & P. ??
- 20) 11.1 - Would this exclude the cost of a treasury function?
- 21) 11.1 - Eighth bullet point - A MAJOR issue - "entertainment expenses can NEVER meet etc." Really?
- 22) 11.1 - Twelfth bullet point - A MAJOR issue - "provision for cost contingencies and risk are not allowable!" - Nonsense.
- 23) 11.1 - Final bullet point - A MAJOR issue. This means that all remedial work is disallowed. Nonsense
- 24) 12.7 - Not sure what this means.
- 25) 12.8 - Step 2 - Not sure turnover is always the best measure.
- 26) 12.19 - R & D tax credits - no mention of transitional arrangements. This is currently with DG Finance, not an SSRO item.
- 27) 13 - is in twice!!

Kind regards