There are a lot of hard things about compliant cost accounting in a Federal government environment. Preparing a cost impact analysis pursuant to the CAS Administration clause is hard. Preparing a segment closing pension adjustment pursuant to CAS 413 is **hard** .
And up until recently, accounting for Independent Research and Development (IR&D) expenses has been hard. However, a recent case in the U.S. Court of Appeals,
Federal Circuit
, has clarified the rules quite a bit.

The case, known as **ATK Thiokol, Inc. vs. United States** , has wound its way through the courts over a period of years. In 2005, the U.S. Court of Federal Claims issued an **opinion**
in favor of the contractor, and the United States appealed.

By way of background, in 1990 ATK moved design of a new rocket motor, the Castor® IVA-XL. ATK marketed the motor and, in 1995, applied for an export license, identifying Mitsubishi Heavy Industries as a potential buyer. At about that same time, ATK moved production of Castor ® motors to its Utah facility, which necessitated facility enhancements (including new capital assets); ATK also undertook technical changes and testing of its Castor ® motors at the new Utah facility.

In 1999, ATK conducted a "first article acceptance test firing" that was attended by ten potential buyers, including Lockheed Martin, Orbital Sciences Corporation, and the Japanese Government.

As of 2004, however, ATK had only sold the improved rocket motors to Mitsubishi.

As part of its agreement with Mitsubishi, ATK agreed not to charge for its nonrecurring efforts where those efforts would also benefit other Castor® customers. In its proposal, ATK identified contract-unique nonrecurring efforts for adapting the motor to Mitsubishi's needs, and other nonrecurring efforts that would be benefit all Castor ® customers, which ATK would self-fund.

ATK notified its Defense Contract Management Agency (DCMA) Divisional Administrative Contracting Officer (DACO) that it would begin to incur nonrecurring development costs and agreed that such costs would not be "specifically identified" in the Statement of Work for the

Castor
®
motor." And indeed, while the final contract with Mitsubishi called for Adaptation efforts, it expressly excluded all other nonrecurring costs.

During the period in question, DCAA continuously reviewed ATK's cost accounting practices and found them to be compliant with applicable requirements, including the Cost Accounting Standards (CAS). ATK maintained a CAS Disclosure Statement that clearly discussed how it distinguished direct costs from indirect costs.
Importantly,
ATK disclosed that it
"classified a cost that is normally an indirect cost as a direct cost only when: a) a contract specifically required that
[ATK]
incur the cost; b) the contract paid for the cost; or c) at the time
[ATK]
incurred the cost, the cost had no reasonably foreseeable benefit to more than one cost objective."
The Disclosure Statement also addressed capitalization versus expensing of various assets.
Although DCAA from time to time objected to ATK's capitalization practices, the DACO overruled the auditors' concerns and consistently found that ATK's cost accounting practices were appropriate.

In 1999, however, the DACO notified ATK that it intended to disallow nonrecurring development costs and certain capital assets (tooling costs) because the costs ""required by and specifically benefit the [Mitsubishi] Contract, and [that] these costs should be charged to the Castor® IVA-XL program." Following the process outlined in the Contract Disputes Act, ATK filed suit in the U.S. Court of Federal Claims after the DACO denied its claim.

The Court had to interpret the FAR 31.205-18 cost principle, CAS 402, and CAS 420 in arriving at its decision. The parties' contentions turned on the meaning of the phrase "required in the performance of a contract." Allowable IR&D costs are those that are not required in the performance of a contract, but the issue was whether the words meant "specifically" or "expressly" required, or whether they meant "implicitly" required. The Government argued for "implicitly" required, which would mean that all of ATK's costs should have been charged as direct costs of the Mitsubishi contract. ATK, on the other hand, argued for an "expressly" required standard, which would permit costs not expressly required by the contract to be treated as IR&D expenses.

The Court looked at Interpretation No. 1 of CAS 402 (which deals with direct versus indirect charging of B&P costs) and found what it was looking for. In the language of CAS 402 Interpretation No. 1—

Under 9904.402, costs incurred in preparing, submitting, and supporting proposals pursuant to a *specific requirement of an existing contract* are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirement.
The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.
[Emphasis added by the Court.]

As the Court discussed, "Accordingly, under CAS 402, the definitions of 'direct cost' and 'indirect cost' and Interpretation No. 1, a contractor may, but is not required to, distinguish B&P costs that are 'Sometimes direct/Sometimes indirect,' on the basis of whether those costs are 'specifically required by the provisions of an existing contract.'" The Court used that finding to interpret the requirements of CAS 420 and the cost principle at FAR 31.205-18. The Court found the parties intended to exclude certain development efforts from the contract, so that those efforts were clearly "not required"—

… the court has determined that whether IR&D costs are 'required in the performance of a contract,
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within the meaning of CAS 420, is determined by the contracting parties' intent. Accordingly, the court declines to interpret
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required in the performance of a contract
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in the manner advocated by the Government, because doing so would undermine CAS 402, eliminating the primacy that the CAS Board intended the contracting parties intent to serve in the allocation of
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Sometimes direct/Sometimes indirect
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costs. Nor will the court interpret
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required in the performance of a contract
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in that manner for IR&D alone, because doing so would conflict with the identical phrase in the definition of B&P costs, required by the CAS Board's retention of CAS 402 and Interpretation No. 1, when CAS 420 was promulgated.

In addition, ATK's tooling costs were properly treated as capital assets whose depreciation was an allowable cost of its indirect cost pools. Such costs were not required to be treated as direct costs of the Mitsubishi contract.

The Government appealed, but only to the extent of the IR&D costs. It chose not to appeal the Court of Federal Claims decision regarding capital assets.

On appeal, the Federal Circuit affirmed the Court of Federal Claims decision. According to the appellate decision—

In light of the language and interpretation of CAS 402, it was appropriate for ATK to treat the Development Effort costs at issue in this case as indirect costs. First, those costs were not specifically required by the Mitsubishi contract. Second, as the trial court found, ATK had a disclosed and established cost accounting practice of charging as indirect costs those costs that were not paid for or required by a particular contract and that had a reasonably foreseeable benefit to more than one contract. … we agree with the trial court and ATK that the meaning of that phrase in the definition of IR&D must be the same as the

meaning of the identical phrase in the definition of bid and proposal ('B&P') costs. B&P costs are defined to mean costs incurred in preparing, submitting, and supporting bids and proposals, but not to include the costs of effort 'required in the performance of a contract.' FAR 31.205-18(a); CAS 420-30(a)(2). B&P costs are addressed in the same regulations that govern IR&D costs and are treated similarly to IR&D costs in all pertinent respects.
See generally
FAR 31.205-18; CAS 420-30. B&P costs 'benefit all business of a contractor rather than a specific existing contract [and thus] treating all such costs as indirect overhead is logical.' … There is no support anywhere in the text or history of the regulations for treating that identical regulatory formulation differently. We therefore construe the reference to costs 'required in the performance of a contract' to mean, in both contexts, costs that are specifically required by the contract. … Because the research and development costs at issue in this case were related to the Mitsubishi contract but were not specifically required by that contract, we uphold the trial court's decision that those costs were indirect IR&D costs within the meaning of the pertinent regulatory provisions.

For the past seven years, contractors have had to manage a certain amount of ambiguity in their cost accounting practices, as they struggled to comply with an ambiguous set of regulations. This important decision clarifies the proper cost accounting for IR&D expense, and contractors are advised to study it closely.

We believe that one of the lessons to be learned is that a contractor's Disclosure Statement is a key tool to establishing its cost accounting practices. In our experience, contractors too often fail to take advantage of the Disclosure Statement to declare which costs will be direct and which will be indirect, and under what circumstances. The second lesson is that the drafting of the contract language matters. As the ATK decisions demonstrated, the combination of clear Disclosure Statement language with clear contract language is difficult to beat.