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## Decisions

### ¶ 8

#### COFC Adopts Narrow View Of Development Costs Requiring Direct Allocation

*ATK Thiokol, Inc. v. U.S.*, 68 Fed. Cl. 612 (2005)

A contractor properly classified development costs as Independent Research and Development (IR&D) and treated them as indirect costs under Cost Accounting Standard 420 because the parties' contract did not specifically require the development work, the U.S. Court of Federal Claims has held. The Court rejected the Government's broad interpretation of CAS 420 that would preclude indirect cost allocation for any development work necessary for performance, even if the work is not expressly part of the contract. Such a broad reading, the Court concluded, conflicts with the emphasis CAS 402 gives to the parties' contract terms in deciding the proper accounting treatment of costs that are direct or indirect, depending on the circumstances. The Court also held that the company properly capitalized its production equipment and allocated the depreciation as an indirect cost.

ATK Thiokol Inc. manufactures rocket motors for the U.S. Government, foreign governments and commercial customers. To stay competitive, ATK continually conducts research and development projects, including, for example, redesign of its "Castor" rocket motor to promote commercial sales.

After marketing a version of its Castor rocket motor to Government and commercial sources, ATK entered into a contract to provide Mitsubishi Heavy Industries with Castor rocket motors adapted for use as boosters for Japan's H-IIA launch vehicle. Mitsubishi refused to pay for non-

recurring costs that would benefit the Castor motor in the commercial market, and ATK omitted them from its proposals. The contract statement of work recited that ATK developed the Castor motor and was updating the design to support the general requirements of the booster market.

As part of a reorganization that occurred before the Mitsubishi contract, ATK moved its rocket-motor production to Utah. The move required ATK to modify the Utah facility and acquire or fabricate production equipment.

ATK is required to file a CAS disclosure statement detailing the company's accounting practices. Costs for design work can be direct or indirect costs, depending on criteria set out in the disclosure statement. ATK's statement disclosed its practices for classifying design costs as direct or indirect, and its practice of including depreciation, IR&D, and bid and proposal costs in indirect cost pools. The Court found that ATK consistently followed these practices, and the Government previously determined that they complied with the CAS.

The Government disallowed costs for the Castor motor development effort (\$3.1 million) and the production equipment (\$5 million), which ATK had treated as indirect costs. The Government contended that these costs should be charged directly to the Mitsubishi contract. ATK challenged this decision at the COFC.

**Interpreting Cost Principles and Cost Accounting Standards**—Before addressing ATK's claims, the Court described the two principal regulations governing cost recovery and accounting. Quoting *Boeing N. Amer., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002) (en banc) (44 GC ¶ 112 and 44 GC ¶ 308), the Court explained that the CAS govern the accounting concept of cost allocability, which addresses the "relationship between incurred costs and the activities or cost objectives (e.g., contracts) to which those costs are charged." The cost principles in Federal Acquisition Regulation pt. 31 address cost allowability: whether contractors can recover a particular type of cost.

On allocability issues, the CAS preempt conflicting FAR provisions. And, though the FAR may limit the allowability of costs properly allocated under the CAS, the FAR cannot condition allowability on use of allocation methods that conflict with the CAS, the Court said. In interpreting the CAS, courts should ascertain the CAS Board's intent when it promulgated the standard and should rely on the text of the standard and guidance, such as illustrations accompanying each standard. If the CAS do not define a term, courts rely on dictionaries or definitions in related regulations.

**Treatment of Castor Motor Development Effort as an Indirect Cost**—To qualify for indirect-cost treatment, the Castor motor development work must come within the definition of IR&D costs in CAS 420. Under that regulation, IR&D costs are “(i) Basic and applied research, (ii) Development, and (iii) Systems and other concept formulation” studies that are *“neither sponsored by a grant, nor required in the performance of a contract ....”* (emphasis added). The cost principles also contain a parallel definition governing the allowability of IR&D. See FAR 31.205-18.

The Government argued for a broad definition of “required in the performance of a contract” that would include any work necessary to perform the contract. Such an interpretation results in more work charged directly to specific contracts. In contrast, ATK's more restrictive interpretation turned on whether the contract specifically called for the work or contemplated payment of the costs.

Relying on the development of the CAS 420 language and interpretive principles accompanying another standard, CAS 402, the Court adopted ATK's interpretation and held that the development costs were properly charged indirectly. When the CAS Board promulgated CAS 420, it incorporated the definition of IR&D from Armed Services Procurement Regulation 15-205.35. The committee that developed the ASPR definition had rejected a broad description of development work excluded from IR&D in favor of the narrower phrase defining IR&D as “technical effort which is not sponsored by or required in performance of a contract ....” The ASPR committee also rejected language that would have “reduced the role of contract interpretation in determining what is or is not required in the performance of a contract,” the Court said.

The CAS Board incorporated the ASPR language into CAS 420 without further defining “required in the performance of the contract.” Such a definition

was not necessary, the Court said, because the proper interpretation of the phrase can be gleaned from the “regulatory framework in which it was promulgated.”

The part of the regulatory framework that the Court turned to for guidance—CAS 402—prevents double recovery of costs by requiring contractors to use consistent accounting methods. For costs that can sometimes be allocated directly or indirectly, such as costs for research and development, CAS 402 requires contractors to set criteria for determining the proper accounting treatment. The criteria must ensure that “[a]ll costs incurred for the *same purpose, in like circumstances*, are either direct costs only or indirect costs only ....” CAS 402, 48 CFR § 9904.402-40 (emphasis added).

“Interpretation No. 1,” promulgated with CAS 402, provides guidance for determining whether a cost is incurred “for the same purpose, in like circumstances,” and emphasizes the importance of contract terms in determining the proper accounting treatment of costs. The interpretation states that, for cost accounting purposes, costs incurred pursuant to a specific contract term requiring the work are distinct from costs incurred without a specific contract requirement. Although Interpretation No. 1 addresses bid and proposal costs, the Court found the guidance applicable to IR&D costs.

In light of CAS 402's emphasis on the parties' intent as recorded in the contract, the Court concluded that the CAS 420 phrase, “required in the performance of a contract,” does not have a fixed meaning independent of the contract terms. Rather, its meaning depends on the parties' intent “as determined by traditional contract interpretation on a case-by-case basis.”

**Indirect Allocation of Development Costs Was Proper**—The Court found that the Mitsubishi contract terms showed that the “parties did not intend the IR&D costs associated with upgrading [the Castor rocket motor] for the commercial market to be specifically identified with the contract.” Under the SOW, an upgraded rocket motor was a precondition to performing the contract work of converting the motor into a booster for Japan's launch vehicle. In addition, although the contract had a detailed price structure, it contained no price for the development effort.

ATK accounted for the development costs as indirect costs according to its disclosed practices, which required indirect allocation if none of the following conditions existed: (a) a contract specifically required that

ATK incur the cost; (b) a contract paid for the cost; or (c) when the cost was incurred, it had no reasonably foreseeable benefit to more than one cost objective. The Court found this accounting treatment proper because the Mitsubishi contract “did not specifically require or pay for” the development effort, and when ATK incurred the costs, a commercial market for the motor “appeared viable.” Charging the costs indirectly, therefore, complied with the CAS 402 requirement for ATK to adhere to its disclosed accounting practices.

The Court also held that the indirect-cost treatment complied with CAS 420 and rejected the Government’s interpretation of the phrase “required in the performance of a contract” to include any work necessary to perform the contract. Such an interpretation undermines CAS 402 by “eliminating the primacy that the CAS Board intended the contracting parties’ intent to serve in the allocation of ‘Sometimes direct/Sometimes indirect’ costs.” The Court also rejected the Government’s argument that the FAR determination of allowability controls the CAS determination of allocability. That argument conflicts with accepted principles of construction. See *Boeing*, 298 F.3d at 1274.

**Indirect Allocation of Production Equipment Was Proper**—The Court held that ATK properly capitalized the production tooling and facility modifications necessary to transfer rocket motor production to Utah. The Court found that the tooling and modifications were tangible assets and could be used to produce Castor rocket motors for commercial customers. Under ATK’s disclosed policy, the assets’ service life and value dictated that ATK capitalize the costs. This policy complied with CAS 404 and required ATK to depreciate the assets and allocate that depreciation as an indirect cost according to CAS 409 and FAR 31.205.11(b), the Court held.

The Court rejected the Government’s argument that CAS 404 and 409 apply only if the production costs meet the FAR 31.205-25 definition of “manufacturing and production engineering effort” (MPE), rather than the FAR 31.205-18 definition of IR&D. That interpretation wrongly treats the FAR cost principles as allocation rules rather than allowability rules, the Court held. The argument also incorrectly concludes that production costs are either IR&D or MPE. The Court stated that the Government failed to recognize depreciation as a distinct category of allowable cost and misconstrued the FAR 31.205-18 definition of “development” “in an attempt to treat tangible costs as a development effort.”

♦ **Practitioner’s Comment**—The Court’s decision in *ATK Thiokol* is significant for several reasons. First, it is precedent setting, because it is the first case by a Government contract tribunal to decide the long-debated definition of the term “required in the performance of a contract” as that term is used in CAS 420 and FAR 31.205-18. Indeed, the Court provided a full administrative history of the term and noted the lack of any specific definition, which has been a bane to contractors and the Government alike. Second, the Court adopted the interpretation that contractors have long espoused: that one must look to the contract’s SOW to determine whether the work and associated costs are “required in the performance of a contract.” The Court left its decision flexible, however, by stating that a determination must be made on a case-by-case basis. In this regard, the Court identified several factors to consider when determining whether the costs incurred were “required in the performance of a contract”: the terms of the contract itself, the definition of direct versus indirect costs and the treatment of IR&D costs under the contractor’s CAS Disclosure Statement, and whether the costs can reasonably be expected to benefit multiple projects.

Finally, the Court’s decision is significant because it effectively rejects *U.S. v. Newport News Shipbuilding, Inc.*, 276 F.Supp.2d 539 (E.D. Va. 2003). In *Newport News*, the district court held that a contractor could not treat IR&D costs as indirect costs if the costs were implicitly required in the performance of a contract, even if the costs stood to benefit other contracts. This is a theory that the Government presented in *ATK Thiokol* as well. The *Newport News* decision caused much distress in the Government contract community. That decision will now have limited application, if any, because the COFC and the boards of contract appeals are the only tribunals that decide Government contract disputes. (*Newport News* was decided in the context of a False Claims Act case, not a Contract Disputes Act case). A question remains whether the boards of contract appeals will follow the COFC’s position in this debate. For now, however, *ATK Thiokol* is controlling law, and contractors may rely on the decision for treatment of IR&D costs.



*This PRACTITIONER’S COMMENT was written for THE GOVERNMENT CONTRACTOR by Paul E. Pompeo, a partner in the Government Contracts Practice at the law firm of Holland & Knight LLP, resident in the Washington, D.C. office.*