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Allowable Costs

Federal Circuit Provides Needed Clarity On Proper Classification of IR&D Costs

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On March 19, 2010, the United States Court of Appeals for the Federal Circuit provided much needed clarity regarding the definition of independent research and development (IR&D) costs, an issue of first impression in the Federal Circuit. *See ATK Thiokol, Inc. v. United States*, No. 2009-5036 (Fed. Cir. Mar. 19, 2010) (hereinafter ''*ATK*'') (93 FCR 260, 3/30/10).

The Federal Circuit's judgment affirmed the November 30, 2005 United States Court of Federal Claims' decision in *ATK Thiokol v. United States*, 68 Fed. Cl. 612 (2005). The Federal Circuit's decision, combined with the COFC decision, should end much of the debate that has existed for nearly four decades regarding the proper interpretation of the regulatory phrase ''required in the performance of a contract,'' used to define IR&D.

The Federal Circuit held that the phrase means that research and development efforts are independent, and the associated costs qualify as IR&D costs, unless the R&D effort is specifically required by the terms of a contract. This standard applies to all R&D, including development of commercial products, and permits ''parallel'' IR&D and the use of ''branch technology,'' so long as contracts are negotiated and drafted properly and the proper cost accounting standards are in place and followed consistently.

The Federal Circuit's decision also provides contractors added confidence that their adherence to the terms of their Cost Accounting Standard Disclosure Statements will guide whether R&D costs properly are classified as indirect costs under CAS 420 and are allowable under Federal Acquisition Regulation § 31.20518. The Federal Circuit affirmed that contractors, within the broad parameters the CAS establishes, are free to establish cost accounting practices that make sense for their business and that, once established and not otherwise noncompliant, bind the contractor and the government.

Background. The fundamental issue before the Federal Circuit was the proper standard for determining when R&D costs are indirect IR&D costs and when these costs are direct costs of a contract. Two regulations that define the type of costs that qualify as IR&D were at issue in the appeal.

First, CAS 420 provides that the term IR&D does ''not include the costs of effort sponsored by a grant or *required in the performance of a contract*.'' (emphasis added). CAS 420 governs the allocation of IR&D and B&P costs.

Under CAS 420, R&D costs that are ''independent'' have a broad benefit and are indirect costs allocated to all contracts. By contrast, when R&D costs are ''required in the performance of a contract,'' they must be treated as direct costs because only one contract is benefited.

Second, Federal Acquisition Regulation § 31.20518(a), again, contains the same limiting phrase in defining both IR&D and B&P to describe costs that do not qualify as IR&D or B&P. FAR § 31.205-18 governs the allowability of IR&D as well as a similar type of cost, known as bid and proposal (B&P) costs.

In fact, FAR § 31.205-18 utilizes the same limiting phrase ''required in the performance of a contract'' to define the types of costs that do not qualify as B&P. As discussed below, the fact that IR&D and B&P costs are defined by the same limiting phrase was key to the Federal Circuit's decision.

The government has long recognized that IR&D benefits and is critical to contractors' financial health and technological growth and, thus, to the contractors' ability to supply the goods and services the government requires. Beginning in the late 1980s and accelerating in the 1990s, however, the government began to question contractors' treatment of R&D effort as IR&D.

During this period, there was a decline in defense spending. This decline prompted a government push for defense contractors to expand their business into commercial markets. This push was viewed as a means of increasing the contract base and decreasing government indirect contract costs.

These shifts brought with them a concomitant increase in IR&D effort, which prompted an increase in the number of disputes regarding the issue of what qualified as IR&D. These disputes consistently turned on disagreements regarding the meaning of the phrase ''required in the performance of a contract'' that defines, by exclusion, IR&D costs in CAS 420 and FAR § 31.205-18.

This phrase had remained, unchanged, in relevant government contract procurement regulations since 1971 and had been the subject of significant debate between the government and its contractors for decades. During the past two decades, however, government auditors became increasingly aggressive in attempting to prevent the government from paying for what the government viewed as ''commercial development'' based upon the assertion that such development was ''required in the performance'' of contractors' commercial contracts.

Since the 1990s, and prior to *ATK*, there had been a number of federal court decisions that reinforced the government's view that the phrase ''required in the performance of a contract'' should be interpreted broadly. *See United States ex rel. Mayman v. Martin Marietta Corp.*, 894 F. Supp. 218 (D. Md. 1995), and *United States v. Newport News Shipbuilding Inc.*, 276 F. Supp. 2d 539 (E.D. Va. 2003); *TRW Inc.*, ASBCA No. 51171, 51530, 01-1 B.C.A. ¶ 31,390.

This trend emboldened auditors to increasingly question IR&D costs, operated to disqualify more and more costs from being considered IR&D, and created increased uncertainty and risk of fraud allegations for government contractors.

Indeed, the *Mayman and Newport News* cases both turned on issues relating to the proper definition of IR&D and arose under the civil False Claims Act. The allegation of civil fraud and the presentation of these cases to courts inexperienced in government cost accounting issues may have adversely impacted the briefing and focus of the legal analysis in these cases.

The outcome was that these federal district courts issued decisions regarding the meaning of the phrase ''required in the performance of a contract'' that were inconsistent with the settled distinction between direct and indirect costs, as well as the interpretation of B&P costs, which, as noted above, are defined using the same limiting phrase and are otherwise very similar to IR&D costs. Indeed, in *Newport News*, the federal district court went so far as to interpret ''required in the performance of a contract'' to mean any effort ''implicitly'' required to perform a contract.

The government's successful position in *Newport News* was adopted and significantly relied upon in its dispute with ATK and in its briefing to both the COFC and the Federal Circuit. The COFC and Federal Circuit both clearly and unambiguously rejected the interpretation of IR&D reached in *Mayman* and *Newport News*, providing contractors with much needed clarity regarding the meaning of the phrase ''required in the performance of a contract.''

B&P Costs, CAS 402, and Interpretation No. 1. Essential to understanding the Federal Circuit's decision in *ATK* is background on B&P costs, CAS 402, and CAS 402 Interpretation No. 1.

As pointed out above, B&P costs are defined in CAS 420 and FAR § 31.205-18 using the same limiting phrase ''required in the performance of a contract.'' In contrast to IR&D, however, the definition B&P is also addressed in CAS 402, Original Interpretation No. 1.

The CAS Board issued CAS 402 Interpretation No. 1 in 1976, before issuing CAS 420. CAS 402 Interpretation No. 1 stated that absent a ''specific requirement'' in a contract, the costs of bid and proposal effort may be treated as indirect B&P costs.

In the process of issuing CAS 402 Interpretation No. 1 and accepting the ''specific requirement'' standard, the CAS Board refused to delete ''specific requirement'' and to use, instead, ''words, such as 'related to,' 'arising from,' 'identified with' or 'directly associated with.' '' 41 Fed. Reg. 24,691 (June 18, 1976). These phrases are indistinguishable from the ''implicit'' requirement that the *Newport News* court accepted and the government argued in *ATK*.

The CAS Board then issued CAS 420, effective in 1980, which contained the phrase ''nor required in the performance of a contract'' to define both IR&D and B&P costs. The CAS Board's intent was that the definition of IR&D and B&P in CAS 420 would mean the same as the definitions of these costs then found in the Defense Acquisition Regulation (DAR).

Moreover, at the time it issued CAS 420, the CAS Board did not withdraw CAS 402 Interpretation No. 1 or provide, or even imply, that CAS 402 Interpretation No. 1 and CAS 420 were inconsistent. Thus, the CAS Board manifested an intent that ''nor required in the performance of a contract,'' as used in CAS 420 and in the DAR, meant that no ''specific requirement'' for the R&D or bid and proposal effort existed in a contract.

Despite the CAS Board's intent that the definitions of IR&D and B&P in CAS 420 and the DAR have the same meaning, the DAR, and then the FAR, were worded somewhat differently from CAS 420 until the early 1990s.

The most significant difference was that DAR § 15205.35 and FAR § 31.20518 did not use the phrase ''nor required in performing a contract'' when defining B&P costs. The DAR Council did not believe that to be significant because the DAR Council understood that the DAR (and then FAR) definition of B&P had been interpreted since the early 1970s in a manner consistent with CAS 402 Interpretation No. 1 (*i.e.*, B&P costs existed when a bid and proposal effort was not a specific requirement of a contract).

When the CAS was reissued in 1992, the DAR Council changed the definition of B&P in FAR § 31.20518 to be entirely consistent with CAS 420. Accordingly, since the early 1970s, the CAS Board and the DAR Council both believed that IR&D and B&P costs existed when the associated effort was not a specific requirement of a contract.

The ATK Thiokol Dispute. In the early 1990s, in response to shifting market conditions and the increase in the commercial space launch market, ATK's predecessor, Thiokol Corporation (ATK) concluded that, with certain technical upgrades, a variant of its Castor IV rocket motor could help increase its business base

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through sales to both commercial and government buyers.

To execute on this commercial sales strategy, ATK began to market the upgraded Castor IV motor to various potential customers including McDonnell Douglas, Lockheed Martin, and the United States Air Force.

In February 1996, Mitsubishi Heavy Industries (Mitsubishi) began to express serious interest in purchasing the upgraded Castor motor, but refused to pay for the general development effort required to upgrade the motor. ATK's proposals to Mitsubishi, therefore, stated that ATK would sell to Mitsubishi a readytolaunch, upgraded motor and did not include in the contract price or statement of work (''SOW'') any of the upgrade effort. The executed contract was consistent with ATK's proposals and contained no specific provision that either required Mitsubishi to pay or ATK to perform the upgrade effort.

It is worth noting here that the government worked hard to persuade both the COFC and the Federal Circuit that the negotiations between ATK and Mitsubishi were improperly designed to shift the upgrade costs to the government. Neither the COFC nor the Federal Circuit agreed with the government's claims and found nothing objectionable in the parties' agreement to exclude the costs or ATK's decision to charge the costs as IR&D.

As discussed further below, other key fact findings appear to have impacted both courts' decision on this issue. Specifically, both the COFC and Federal Circuit noted that Mitsubishi and ATK reasonably determined that there was a potential market for the upgraded motor and, therefore, a reasonable likelihood of multiple sales. Additionally, both the COFC and Federal Circuit found that ATK's charging decision was made consistent with its disclosed accounting practices.

In July 1997, ATK's management approved the expenditure of company R&D funds to complete the upgrade effort. This decision was based upon the determination that, at that time, it was reasonably likely that the motor would be sold to more than just Mitsubishi.

ATK also decided that it would account for the costs as IR&D. This decision was consistent with ATK's disclosed cost accounting practices for R&D, as well as its past practice in accounting for R&D costs relating to certain government programs.

As a result, ATK's consistent and disclosed cost accounting practice was to treat R&D costs as indirect costs unless: (1) the particular contract in question specifically required that ATK incur the cost; (2) the contract paid for the cost; or (3) the cost had no reasonably foreseeable benefit to more than one cost objective. *ATK* at 3.

Based upon the terms of the Mitsubishi contract, the likelihood of other buyers, and ATK's disclosed cost accounting practices, ATK classified the R&D costs as IR&D costs. Thus, ATK accounted for these costs as indirect costs allocable to both government and commercial contracts and not direct costs allocable only to the Mitsubishi contract.

Shortly after making this accounting decision, ATK proposed an advance agreement to its Divisional Administrative Contracting Officer (''ACO'') to establish the costs as properly allocable and allowable IR&D costs. Despite the fact that ATK had classified the costs in a manner consistent with its disclosed and approved accounting practices, the DACO disallowed the costs on the basis that they were ''required in the performance'' of the Mitsubishi contract and, therefore, had to be charged direct to that contract.

The COFC Decision. Resolving cross-motions for summary judgment, the COFC's decision held that determining when R&D effort results in IR&D costs should be resolved as a matter of contract interpretation, an inquiry informed by relevant CAS, FAR cost principles, and the terms of the contract(s) that arguably require the performance of the R&D effort in question. The court found that it is these contract terms that define when R&D is not ''required in the performance of a contract,'' resulting in IR&D costs, and protect the government from paying twice for the cost of R&D effort.

The COFC reached its interpretation after a detailed discussion of the relevant regulatory history. Based upon this regulatory history, and its consideration of other relevant regulations, including CAS 402 and Original Interpretation No. 1, the COFC concluded that it was the CAS Board's intent in using the phrase ''required in the performance of a contract'' in CAS 420 that controlled the issue of what are IR&D costs.

Applying these legal conclusions, the court found that ATK and Mitsubishi did not intend Mitsubishi to pay for the upgrade costs under the contract because the parties believed that there was a commercial market for the upgraded motors and it appeared likely that there would be multiple purchasers of the upgraded motor.

The court also found that ATK had accounted for the effort in a manner consistent with its disclosed cost accounting practices. Accordingly, the court held that ATK properly had charged the costs as IR&D.

The Government's Appeal. The government appealed the COFC's decision. In its appeal, the government argued that the COFC's legal analysis was incorrect. The government contended that the proper interpretation of the phrase ''required in the performance of a contract,'' based upon its plain language, precluded all costs whether specifically or implicitly required by a contract from being classified as IR&D.

The government argued that ATK could not meet its contractual commitment to sell to Mitsubishi an upgraded motor without performing the upgrade effort. Thus, the government argued that the upgrade effort was ''necessary'' or ''implicitly required'' and, therefore, required in the performance of the Mitsubishi contract. Before the Federal Circuit, the government substantially relied upon the reasoning of the district court in *Newport News*.

In addition to its textual arguments, the government argued that the COFC's decision should be reversed on policy grounds. Specifically, the government contended that the COFC's decision would enable government contractors to routinely ''game the system'' by improperly shifting commercial contract costs to the government. Thus, the government argued that the COFC's decision should be reversed to prevent the routine abuse that the government believed would occur if the COFC's interpretation of the phrase ''required in the performance of a contract'' was affirmed.

ATK, however, urged the Federal Circuit to affirm the COFC's decision. ATK focused its argument upon the fact that the COFC's decision achieved harmony between the definition of IR&D and B&P. The fact that IR&D and B&P costs are defined using the same limit-

ing phrase meant that the two types of costs should be interpreted consistently.

Accordingly, ATK argued that COFC's interpretation of IR&D costs was correct because the COFC properly had considered the interpretation of B&P contained in CAS 402 Interpretation No. 1.

Moreover, ATK urged the Federal Circuit to affirm the COFC's decision because it was consistent with the Federal Circuit's holding in *Boeing Co. v. United States*, 862 F.2d 290 (Fed. Cir. 1988).

In *Boeing*, the issue in the case was whether a differing circumstance existed that warranted charging certain related B&P costs direct and some indirect. The court relied upon Interpretation No. 1 and its guidance that a ''specific requirement in an existing contract'' is the differing circumstance that triggers charging B&P costs direct to a contract.

Given the fact that IR&D and B&P are defined using the same language and given the established interpretation of B&P under *Boeing* and Interpretation No. 1, ATK argued that this precedent and guidance should control the interpretation of IR&D.

In response to the government's reliance upon the *Newport News* decision, ATK argued that the decision was wrong because it had ignored these related regulatory provisions and Federal Circuit precedent when interpreting the IR&D definition. For these reasons, ATK urged the Federal Circuit to affirm the COFC's decision, which had rejected the analysis performed by the district court and its conclusion.

Finally, in response to the government's policy arguments, ATK countered that the cost shifting feared by the government was precluded by CAS 402 and compliance with a contractor's established cost accounting practices.

In disclosure statements submitted to the government, contractors are required to define the differing circumstances that will govern the treatment of costs that are sometimes direct and sometimes indirect. Because contractors must adhere to their disclosed cost accounting practices, the manipulation that the government claimed would occur would be precluded by the requirement that a contractor consistently adhere to its adopted practices.

More importantly, ATK argued that the government's interpretation created a countervailing and adverse impact on IR&D, known as the first-in-line problem. As argued by ATK, and significantly and persuasively established by the briefs submitted by the amicus, the government's position would actually cause harm to the government.

Specifically, if the government's interpretation of the phrase ''required in the performance of a contract'' as including any effort ''implicitly'' required were to be adopted, the first purchaser of any product would have to pay all R&D costs associated with that product or the contractor would have to recognize it R&D costs as a loss for any successful R&D effort. The government often is the first purchaser of products that benefit from significant R&D effort by contractors.

Thus, the government's broad interpretation of the IR&D exclusion would result in significant R&D costs being considered a direct cost of government programs. In this way, the government would no longer benefit from contractors' ability to spread R&D costs for government products that had potential commercial application across a business base that includes both government and commercial work.

The Federal Circuit's Decision. The Federal Circuit's decision establishes that R&D effort is IR&D unless the effort is ''specifically required by the terms of an existing contract.'' In reaching this decision, the Federal Circuit adhered to settled principles of construction in interpreting regulatory language.

First, the Federal Circuit considered whether the phrase ''required in the performance of a contract'' has a clear meaning based upon the plain language of CAS 420 and FAR § 31.205-18. The Federal Circuit concluded that ''[s]tanding alone, the language of the regulation is ambiguous.'' *See* ATK at 7.

In reaching this decision, the Federal Circuit rejected the purported plain-language interpretation advanced by the government based on *Newport News*, where the court concluded that the phrase ''required in the performance of a contract'' includes the cost of effort both specifically or implicitly required by a contract. By rejecting the government's plain-language argument, the Federal Circuit also rejected the legal analysis that forms the basis for the *Newport News* decision.

Second, the Federal Circuit considered the relevant regulatory history to determine whether it aided in the interpretation of the phrase. While the Federal Circuit credited the COFC's ''thorough and well-documented review of the regulatory history,'' it concluded that ''[l]ike the text . . . the regulatory history is inconclusive.'' *See* ATK at 7.

Given its conclusion that the plain language of the regulation was ambiguous and that the regulatory history was not helpful, the Federal Circuit turned to other relevant regulations, specifically CAS 402 Interpretation No. 1 and the settled interpretation of B&P costs.

The Federal Circuit explained that ''we agree with the trial court and ATK that the meaning of [the limiting phrase] in the definition of IR&D must be the same as the meaning of the identical phrase in the definition of [B&P] costs.'' *Id.* at 9. Accordingly, the Federal Circuit concluded that CAS Interpretation No. 1, and the Federal Circuit's prior decision in *Boeing Co. v. United States*, 862 F.2d 290 (Fed. Cir. 1988), governed the proper interpretation of the IR&D definition.

CAS 402 Interpretation No. 1 provides, in pertinent part:

''[C]osts 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 requirements*. 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.'' *See* CAS 402-61(c).

The Federal Circuit explained that the ''effect of Interpretation No. 1 is to equate the B&P definitional exclusion of proposal costs that are 'required in the performance of a contract' with the category of costs that are 'specifically required by the provisions of a contract.' '' *See ATK* at 10. The Federal Circuit then held that, while Interpretation No. 1 does not address IR&D costs, IR&D cannot be interpreted differently from B&P costs because such an outcome would ''result in a con-

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struction in which identical regulatory language . . . would be interpreted differently for IR&D than B&P.'' *Id.*

Based upon the foregoing, the Federal Circuit held that the phrase ''required in the performance of a contract'' defining IR&D, by exclusion, must be interpreted the same as this phrase when used in defining B&P and, therefore, the phrase means costs that are specifically required by a contract do *not* qualify as IR&D or B&P. *Id.*

In reaching its decision, the Federal Circuit also summarily rejected the government's policy arguments. The court found that there was no risk that government contractors would, as suggested in the government's brief, routinely manipulate contract terms in order to charge the government for costs that do not properly qualify as IR&D.

In rejecting the government's policy arguments, the Federal Circuit identified, as a chief concern, the potential detrimental impact on the government from the first-in-line problem identified by ATK and persuasively explored in detail in the amicus briefs. The Federal Circuit agreed, explaining that the government's approach would either disproportionately burden the contract that happened to be first in line or ensure that the first contract would be a losing one.

For research that, by hypothesis, benefits multiple potential contracts, both commercial and government, allocating general research and development costs in that manner is not sensible as a policy matter. *See ATK* at 11-12.

In addition to its concern regarding the first-in-line problem, the Federal Circuit explained that the purpose of IR&D is to benefit both the government and contractors by encouraging innovation. IR&D costs are allowable as a matter of government policy because the associated effort invigorates and improves the products offered to the government.

For these reasons, the Federal Circuit rejected the government's policy arguments.

Clarifying the IR&D Test. The Federal Circuit's decision in *ATK* primarily will provide clarity to contractors and the government regarding what R&D effort is not independent, requiring that the related costs be classified as direct contract costs. The decision also impacts other related cost accounting issues and establishes certain ''best practices'' for government contract cost accounting.

The Federal Circuit's decision establishes that, similar to B&P costs, R&D effort is independent unless the effort is specifically required by the terms of an existing contract. Absent a specific contract requirement, therefore, contractors confidently can classify R&D costs as IR&D and charge such costs indirect.

Despite this clarification from the Federal Circuit, however, contractors still must ensure that their disclosed practices are compliant with the requirements of CAS 420 and CAS 402. Specifically, contractors should ensure that R&D costs incurred in like circumstances for the same purpose are classified consistently as either a direct or indirect cost.

Further, contractors determining whether R&D costs qualify as IR&D costs must still consider the circumstances and purpose of the R&D and how these circumstances are addressed in the contractor's CAS Disclosure Statement.

Based upon the Federal Circuit's decision, it is now clearly appropriate for a CAS Disclosure Statement to provide that the cost of an R&D effort that is not ''specifically required by a contract'' is an IR&D cost. To provide added clarity in implementing this concept in a Disclosure Statement, it would be appropriate to define ''specifically required by a contract'' to mean that: (1) the effort is not specifically required by the contract's SOW or specifically included in the contract's costs or cost buildup in support of the contract's price; and (2) there is a reasonable expectation that the effort will benefit more than one contract.

While factual issues were not central to the Federal Circuit's holding regarding the meaning of the phrase ''required in the performance of a contract,'' the trial court's decision makes clear that the facts and circumstances relating to a contract will continue to be relevant. Accordingly, contractors should carefully consider the facts relating to any contract that might arguably specifically require R&D effort to ensure that the determination made regarding classification of the related costs as IR&D costs is appropriate and consistent with the contractor's disclosed practices.

Facts relevant to such an inquiry will typically include: (1) the parties' intent, as shown by proposals, negotiation documentation, and internal documentation regarding contract negotiation; (2) the contract's wording; and (3) the contract's cost estimates and actual costs. Also relevant are documents relating to why the contractor decided to undertake the R&D in question. A reasonable expectation of multiple contracts for the product will help support the related costs are IR&D costs.

In addition to the above, a very important result of the Federal Circuit's decision is that it permits contractors to engage in R&D effort to support ongoing contract work and to classify the resulting costs as IR&D, so long as the necessary requirements just described are met. This means that the long-standing practice of engaging in ''parallel'' or ''generic'' IR&D remains appropriate.

Similarly, the Federal Circuit's decision means that contractors may use ongoing IR&D effort to support a contract that is to be performed. This circumstance exists, for example, when the contractor is performing an IR&D project that generates technology that will support a contract being negotiated or is reasonably likely to support other future contracts.

An equally relevant example is when a contractor is performing an IR&D project for the purpose of permitting the development of ''branch technologies'' that will be used in performing contracts. So long as the contractor appropriately negotiates and drafts its contracts and acts in accordance with its cost accounting practices, the costs of these types of R&D efforts are IR&D costs.

Other Impacts The Federal Circuit's affirmation of the COFC also is helpful in addressing other government contract cost accounting issues, and in establishing certain ''best practices'' for government contract cost accounting.

For accounting purposes, B&P costs are subject to the same rules as IR&D costs. Indeed, the fundamental basis for the Federal Circuit's decision is its recognition that CAS 402 Interpretation No. 1 and prior interpretations of B&P costs govern the interpretation of IR&D because the IR&D and B&P accounting rules are essen-

tially identical. Thus, the Federal Circuit's decision regarding how to determine when R&D is required in the performance of a contract also applies to determining when the costs of B&P efforts properly are treated as B&P costs.

In light of the Federal Circuit's decision that the exclusionary language that defines both IR&D and B&P is to be consistently interpreted, contractors' cost accounting practices regarding what is required in the performance of a contract should be the same between IR&D and B&P effort. Different practices might result in disapproved costs and cost accounting practices.

The Federal Circuit in *ATK* held that contractors enjoy substantial discretion in selecting their disclosed accounting practices. Specifically, the Federal Circuit explained that ''CAS 402 gives the contractor considerable freedom in the classification of particular costs, so long as the contractor maintains consistency in making that determination.'' *See ATK* at 4.

The Federal Circuit also recognized that contractors' primary means for establishing these practices is through their CAS Disclosure Statement. These observations are important. The Federal Circuit's reaffirmation that contractors have broad discretion regarding their government contract cost accounting practices provides a sound basis to dispute government, especially DCAA, attacks on contractor cost accounting practices as ''not acceptable'' or not the best practice.

ATK establishes that contractor practices are acceptable absent a noncompliance with a CAS requirement. Thus, contractors should demand that the government establish a CAS noncompliance or provide compensation for a change in practice.

In the circumstance where the government coerces a change, such as a disapproval of the contractor's accounting system because an accounting practice creates a deficiency, contractors should acquiesce only after reserving their rights to be compensated for a contract change or breach of contract.

The COFC's holding in *ATK* recognized the contractually binding nature of CAS Disclosure Statements. The Federal Circuit's recognition of contractor discretion to use cost accounting practices of its choosing, so long as CAS complaint, supports this conclusion.

Accordingly, a government failure to object to a contractor's CAS Disclosure Statement means that both the government and the contractor are bound contractually to the practices in the Disclosure Statement. This further supports that a government demanded change in practice, absent a CAS noncompliance, creates contractor entitlement to recovery for a contract change or breach of contract.

Conclusion. The Federal Circuit's *ATK* decision has provided much needed clarity to contractors regarding the proper determination of when R&D effort results in IR&D costs.

Contractors should examine their cost accounting practices, CAS Disclosure Statement and related policies and procedures to ensure that IR&D cost allowability is maximized. Contractors also should ensure that their contract pricing and negotiation policies and procedures, as well as standard terms and conditions and SOWs, for both government and commercial contracts, establish a clear statement of intent in the contract language regarding what research or development effort is specifically required by the contract.

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