

IR&D, B&P, Selling and Related Costs Under Federal Government Contracts -

A Practical Guide

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Preface

This Practical Guide has been prepared by the law firm of



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for use by contractors with the federal government who perform contracts that are subject to the provisions of the Cost Accounting Standards or Federal Acquisition Regulation.

It is designed to assist personnel at management, supervisory and working levels in determining how to charge costs for work that is in the nature of research and development.

This Practical Guide represents the consolidation of interpretive materials that have been developed over approximately 50 years. It is important that the use of the Practical Guide be initiated with a carefully planned and executed education program, which will ensure that the Practical Guide is accurately and consistently interpreted.

This Practical Guide is not designed to provide legal opinions or advice. The meaning, relevance and significance of any particular consideration discussed in this Practical Guide to a particular contractor is a function of the contractor's circumstances and an assessment by qualified individuals as to what is needed to comply with a particular relevant requirement given the contractor's circumstances. Moreover, changes to the relevant rules may occur. Thus, this Practical Guide should be considered along with any changes to relevant requirements that occur after the date below when assessing compliance with relevant requirements.

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Purpose and summary of contents

I. Purpose and summary of contents

The federal government recognizes that contractors undertake research and development (R&D) efforts in a variety of circumstances. This Practical Guide addresses the rules applicable to federal government contracts (rules applicable to grants are not addressed in this guide) for classifying, accounting and recovering costs of an R&D effort as: (a) contract; (b) independent research and development (IR&D); (c) bid and proposal (B&P); (d) selling; (e) manufacturing and production engineering (M&PE); or (f) other R&D (capital assets, product line or other indirect costs). The federal government also has decided that accounting and reimbursement rules unique to the cost of each of these types of effort are needed. The purpose of this Practical Guide, therefore, is to address: (a) how to classify the R&D effort to be performed; (b) how to account for the cost of that effort based upon its classification; and (c) how to claim reimbursement for the properly accounted for cost.

The importance of correctly classifying the type of effort involved, and then applying the correct accounting and reimbursement rules to the related cost, has been highlighted over the years by various distinct trends. First, the federal government continues to pursue issues involving the misclassification of costs through the use of the civil False Claims Act (FCA), 31 U.S.C. § 3729, et seq. In essence, the government has taken many accounting issues, traditionally treated as administrative matters, and treated them as an opportunity to recover extensive damages and penalties available under the FCA. Additionally, individual plaintiffs pursue these same FCA liability issues against contractors through “qui tam” actions (actions brought on behalf of the government and in the government’s name). These cases collectively pose substantial risk and costs to government contractors.

Second, since the advent of acquisition reform, the government has used continually its “other transaction authority.” Under this authority, the government can procure a diverse range of goods and services, previously obtainable only through strict procurement contracts. Agreements entered into using other transaction authority often only summarily define the work to be performed or the end items to be delivered. While this form of contracting has been a positive development from the standpoint of flexibility and streamlined acquisitions, it creates significant risk to contractors. Specifically, when an agreement does not describe in detail the work that is within its scope, the line between contract effort and, for

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example, IR&D, is blurred. This lack of clarity in drawing the lines between contract and other effort brings with it increased scrutiny by auditors and raises the risk of eventual challenges by the government, or *qui tam* plaintiffs, on the correct charging for the related costs.

Similarly, the government continues to emphasize, although to a lesser degree than previously, the development of commercial applications for the results of R&D effort and its own need to benefit from commercial R&D. This has led to the use of “cooperative arrangements” between the government and contractors, as well as between contractors looking for alternative means of teaming for development purposes. Accordingly, the Federal Acquisition Regulation (FAR) cost principles recognize that unfunded R&D costs incurred in connection with cooperative arrangements may be classified as IR&D.

Third, currently and for the foreseeable future, tight federal government and state government procurement budgets are forcing contractors to invest in competitive positioning more than ever. This is occurring through teaming agreements and cooperative arrangements with other contractors in order to spread the capital risk. Similarly, contractors are increasing their investments using “parallel” IR&D and aggressive B&P and selling efforts.

And fourth, the government continues to take inconsistent positions regarding contractor R&D investments. The government understands its potential cost savings when, for example, contractors use the results of “parallel” IR&D to support contract performance. The government, however, also is leery of the risks that it believes result when contracts are supported by parallel IR&D. As a result, from time to time, contract clauses are used to address contractor R&D investments. Contractors also must remain attentive to regulatory changes, such as those indicated in the Department of Defense’s (DOD) Better Buying Power 3.0 initiative and DOD’s subsequent August 26, 2015 White Paper, which signal the potential for coming changes to the DOD FAR Supplement (DFARS) relating to the allowability of IR&D and B&P cost. DFARS § 231.205-18. These changes create uncertainty that, in turn, presents risks that must be managed.

Each of these trends must be attended and managed to avoid unnecessary cost disallowances resulting from the misclassification of costs so that contractors can protect reasonable profits. To assist in successful risk management, this Practical Guide first summarizes the existing requirements for the classification of costs of R&D efforts that are established by statute

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and regulation. It then discusses in detail how to classify R&D effort as contract, IR&D, B&P, selling, M&PE or other R&D effort and how to account for and claim reimbursement for the related costs. The Practical Guide closes with a discussion of suggested policies and procedures.

This Practical Guide should be used as a tool for a contractor's management and working-level personnel. The Practical Guide will enable these personnel to "spot" issues and avoid the many pitfalls present in these unique areas of government contracts cost accounting. As with many issues in the complex area of government contracts cost accounting, the final resolution of particularly troublesome or difficult issues often may require consultation with senior management and legal counsel. Finally, proper cost classification necessarily turns on the contractor's established or disclosed accounting practices and the particular facts and circumstances of the underlying transaction. Thus, this Practical Guide is not intended and may not be relied upon as legal advice.

¹ Many of the cases, regulations and other documents referenced in this guide are included in the appendix for convenience of the reader.

The statutory and regulatory framework

II. The statutory and regulatory framework

Certain statutes, the FAR (and various agency FAR supplements, such as the DFARS, the Department of Energy (DOE) Acquisition Regulation (DEAR)) and the Cost Accounting Standards (CAS) establish the specific rules covered in this Practical Guide. These statutory and regulatory provisions are supplemented by other materials available to contractor personnel that provide helpful guidance (but not requirements), including the Defense Contract Audit Agency (DCAA) Contract Audit Manual (DCAAM), as well as periodic Memoranda for Regional Directors (MRDs) that DCAA issues to its Field Audit Offices, and Defense Contract Management Agency guidance. The hierarchy of statutes and regulations is discussed below.

Importantly, the governing statutes and regulations have changed over time, both in substance and in their applicability to other than DOD contracts. Of course, these changes are not relevant to ensuring compliance today and, for that reason, the remainder of this Practical Guide focuses largely on today's requirements. The changes over time, however, are relevant to the extent that issues that arose in the past require resolution. In many instances, using today's rules to assess past issues may lead to the wrong conclusion. To help in addressing past issues, therefore, the Practical Guide discusses historical requirements where it is likely that issues may still be encountered that are dependent on past requirements.

A. Statutory authority

A contractor's right to recover IR&D and B&P costs under its DOD contracts is based on statute. In all other circumstances, a contractor's right to recovery is based solely upon regulation and the contract.

Currently, 10 U.S.C. § 2372 (1994) directs the Secretary of Defense to prescribe regulations that encourage contractors to engage in R&D activities of "potential interest" to the DOD, including activities intended to:

1. Enable superior performance of weapon systems;
2. Reduce acquisition and life-cycle costs of military systems;
3. Strengthen the U.S. defense industrial and technology base;
4. Enhance U.S. industrial competitiveness;
5. Promote the development of critical technologies;

The statutory and regulatory framework

6. Increase development and promote efficient and effective applications of dual-use technologies; and
7. Provide efficient and effective technologies for achieving environmental benefits.

As discussed in Section XI.A, this statutory directive is implemented in DFARS § 231.205-18, which supplements FAR § 31.205-18.

B. FAR and Its Supplements

The FAR is important because it applies to all contracts entered into by any executive agency whereby a contractor is to supply goods or services and the government is to pay for those goods or services with appropriated funds, with the exception of grants and cooperative agreements. The importance of the FAR to this Practical Guide is that it contains the definitions important to properly classifying the type of R&D effort involved, which in turn allows the proper accounting for the type of cost involved under the CAS or the FAR (as discussed in Section X). The FAR also defines when a type of cost is reimbursable.

The following FAR sections relate specifically to R&D costs:

FAR § 31.205-18	Independent Research and Development and Bid and Proposal Costs
FAR § 31.205-23	Losses on Other Contracts
FAR § 31.205-25	Manufacturing and Production Engineering Costs
FAR § 31.205-32	Precontract Costs
FAR § 31.205-38	Selling Costs
FAR § 31.205-48	Research and Development Costs

This Practical Guide discusses these FAR sections in detail throughout.

The statutory and regulatory framework

In addition, certain other FAR sections have application to R&D costs, particularly for contractors not subject to CAS. These sections are:

FAR § 31.001	Definitions
FAR § 31.201-1	Composition of Total Cost
FAR § 31.202	Direct Cost
FAR § 31.203	Indirect Costs

Finally, certain agencies have supplemented these various FAR provisions with requirements that impact the extent to which the agency will reimburse the costs of R&D effort under a contract awarded by that agency. DOD has supplemented FAR § 31.205-18 with DFARS § 231.205-18. DOE has supplemented FAR § 31.205-18 with DEAR § 931.205-18. These regulations are discussed in Section XI addressing reimbursement issues.

C. CAS

The CAS govern how a government contractor accounts for costs. They do not apply to all contracts, however, so it is necessary to assess their relevance to accounting requirements under any specific contract. When applicable, the CAS govern the measurement (identifying, accumulating and defining the amount of a cost), the assignment (assigning the cost to one or more cost accounting periods) and the allocation (distributing a cost to contracts or other cost objectives) of costs. The CAS and implementing regulations appear in Part 99 of Title 48 of the Code of Federal Regulations. The standards most relevant to this Practical Guide are:

CAS 402	Consistency in Allocating Costs Incurred for the Same Purpose
CAS 418	Allocation of Direct and Indirect Costs
CAS 420	Accounting for Independent Research and Development Costs and Bid and Proposal Costs

The statutory and regulatory framework

CAS 420 is the primary and specific guidance in the CAS for the measurement, assignment and allocation of IR&D and B&P costs. CAS 402 and 418 provide general guidance on allocating costs to final cost objectives. When confronted with an issue that bears on the allocation of a cost, contractors should analyze closely these standards as they may provide the appropriate requirements.

Other CAS may also have relevance, particularly CAS 404 and 409. These two CAS address the capitalization and depreciation of the cost of tangible capital assets. Issues sometimes arise regarding the relevance of depreciation costs to the cost of R&D efforts. These issues are discussed later.

The basic determination: classifying the type of effort involved

III. The basic determination: classifying the type of effort involved

The most fundamental and complex issue is the proper classification of R&D effort as either: (a) contract effort; or (b) IR&D, B&P, selling, M&PE or other R&D effort. As already emphasized, proper classification is the most important task because it determines the proper accounting for, and reimbursement of, the cost of the effort.

The key to the proper classification of effort as contract or a type of indirect effort lies in answering the following fundamental question: What is the principal purpose for which the effort is to be undertaken? The principal purpose is a function of such facts as: (a) what caused the effort to be undertaken; (b) what is the goal of the effort; (c) what funds were used for the effort; and (d) what will benefit from the effort (e.g., a contract or an IR&D project)?

Unfortunately, proper classification is often not an easy task. First, the scope of any relevant contract is crucial because it will determine when the effort is contract effort. As discussed throughout this Practical Guide, therefore, the most important steps contractor personnel can take to recover R&D costs are to: (a) plan and then document the reasons and circumstances for undertaking an effort; (b) read and thoroughly understand the relevant contracts; (c) ensure consistency of documentation between contract language, documents supporting contract efforts (e.g., basis of estimate (BOE)), contract pricing/costing documents, contract technical descriptions and similar language and documents supporting indirect efforts; and (d) disclose to appropriate government personnel in writing the contract objectives, the objectives of indirect-type efforts and the relationship between the two. It is the contracting parties who determine the requirements and deliverables of the contract, and hence, what effort is contract effort.

A contract's scope, however, is frequently and unfortunately often not well defined. As a result, the regulatory definition of a "direct cost" and other regulations relevant to identifying what effort a contract requires become relevant, but even these provisions are ambiguous and, at times, overlapping and even conflicting.

The basic determination: classifying the type of effort involved

Whether effort is contract effort, therefore, is the most difficult and contentious subject addressed in this Practical Guide. Accordingly, this Practical Guide examines this subject in detail in the next section and then re-visits the issue when discussing specifically how to classify the type of non-contract R&D effort involved.

Unfortunately, once it has been concluded that an effort is not contract effort, the classification issues do not end, but become almost as complicated. Now a conclusion should be reached regarding whether the effort is IR&D (see *Section V*), B&P (see *Section VI*), selling (see *Section VII*), M&PE (see *Section VIII*) or other R&D (see *Section IX*). The regulatory definitions of these costs are, in virtually all cases, unclear and overlapping. Choices among these indirect cost categories should be made carefully and consistently, using the contractor's best technical and legal judgment after a thorough review of the nature of the effort in question.

Finally, even after an effort has been classified initially, contractors should continue to monitor whether the initial classification remains proper on a prospective basis. Specifically, the nature or objectives of an effort may change over time. This requires reassessing the initial classification and changing prospectively this classification (with carefully documented justification) as the evolution of the project's purpose occurs. The importance of continuously reviewing and revisiting proper classification of contract effort versus IR&D or other effort is particularly pressing for major contractors. Under recent updates to DFARS § 231.205-18, covered major contractors should annually report all IR&D projects through the Defense Technical Information Center (DTIC) through an online reporting tool. As will be discussed in more detail in Section XI, failure to properly and timely report on IR&D projects will render the associated costs unallowable, and potentially subject the contractor to penalties for claiming expressly unallowable costs.

The challenges in properly classifying R&D effort establish the need for a contractor to have and enforce user-friendly standard operating procedures, to carry on continuing education on key topics, and to maintain a mechanism to collect, report and resolve cost classification and other associated issues. See Section XII.

Classification as contract effort

IV. Classification as contract effort

Determining whether effort is contract effort is the necessary first step in the proper charging of R&D costs. By definition, effort specifically required by an existing contract or sponsored by an existing grant may not be IR&D or B&P effort. The determination of whether the costs associated with a particular R&D project should be properly classified as contract effort requires analysis of: (a) the terms and conditions of relevant contracts; (b) whether relevant contracts funded the R&D effort; and (c) whether the party undertaking the R&D effort had a reasonable belief that the R&D effort created a reasonable opportunity of future contracts. This section discusses each of these factors for determining when R&D effort is contract effort.

A. The terms of the contract control

Effort is most easily classified as contract effort when the contract expressly requires that an effort be performed. Conversely, effort is most easily classified as not contract work when the contract expressly excludes the effort. These seemingly obvious points highlight two critical steps to the proper classification of R&D effort: (1) draft contracts clearly and precisely so that required and/or excluded effort is both easily identified and unambiguous; and (2) carefully read existing contracts when assessing whether an existing or new R&D project may be classified as an IR&D project.

B. What to do when contract terms are unclear

When a contract does not expressly include or exclude an effort, the issue is whether the R&D effort in question is specifically required by the contract or otherwise is effort that creates direct contract costs. As discussed in Sections V and VI, assessing what is specifically required is directly relevant to IR&D and B&P and requires examination of other documents and circumstances to determine if the contract specifically requires the effort. When there is no specific requirement stated in the contract, R&D effort is not required in the performance of a contract and may be IR&D or B&P.

Relevant to the inquiry regarding a specific requirement are: (1) facts relating to the negotiation of the contract's scope of work; and (2) facts relating to the pricing of the contract, including BOEs and technical descriptions. Either set of facts might reveal what the parties intended regarding a particular effort. For example, the contract wording might be silent regarding a particular effort, especially when the contract

Classification as contract effort

addresses deliverables but not their design or production. The negotiations, however, might have addressed the effort as included or excluded. Similarly, how the contractor developed its proposed price, especially when a cost build-up methodology is used, and how the parties negotiated the price might well show whether an effort was included or excluded.

R&D effort that is not IR&D or B&P effort, nevertheless, may be contract effort if the cost of the effort is a “direct” contract cost pursuant to the CAS and FAR definitions of direct costs, as implemented, in the contractor’s CAS Disclosure Statement, if one is required. A direct cost is “any cost that is identified specifically with a particular final cost objective...” FAR § 2.101; 48 C.F.R. § 9904.402-30(a)(3). A direct cost also is any cost incurred for the same purpose in like circumstances to another cost that is a direct cost. FAR § 31.202; 48 C.F.R. § 9904.402-40. An indirect cost, on the other hand, is “any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. It is not subject to treatment as a direct cost.” FAR § 31.203; 48 C.F.R. § 9904.402-30(a)(5). In other words, indirect costs fulfill the objectives of more than one contract, project or need of the contractor.

These definitions focus on the beneficial or causal relationship between an effort and cost objectives. The concepts of “identified specifically,” used to define a direct cost, and “not directly identified,” used to define an indirect cost, mean that an exclusive beneficial or causal relationship typically exists between the cost of R&D effort and a single contract when that contract specifically requires the effort. Making such a determination requires exploration and understanding regarding why an effort is being undertaken and the intended goals of the effort. These facts should be available from the justification for undertaking the effort, such as a budget request and authorization or the scope of work for the effort.

C. Significance of the type of contract involved

When attempting to determine if an effort is contract effort, the type of contract involved is also important to the analysis. The different contract types and their significance to classifying R&D effort is discussed below. This subject is also discussed further in subsequent sections, as appropriate.

Classification as contract effort

1. Fixed-price contracts

A fixed-price contract requires that the contractor deliver a product or service for a fixed price. The cost of that effort is irrelevant in that the product or service should be delivered regardless of cost. Fixed-price contracts are the most difficult contract type to work with when attempting to identify contract work because, generally, they have the most ill-defined scopes of work, at least in terms of required effort. What is required often is just a deliverable. Moreover, the government is incentivized to conclude that as much effort as possible is required by a fixed-price contract because the price is fixed, regardless of cost, and contract costs in excess of the fixed price are not recoverable under any other contract under FAR § 31.205-48. Conversely, contractors are incentivized to interpret the scope of work of a fixed-price contract narrowly because costs that are not contract costs may be recoverable as indirect costs. These competing interests result in many disputes regarding what effort is contract effort. Contractors should ensure, therefore, that fixed-price contracts clearly exclude effort not required to perform the contract.

2. Level-of-effort and cost reimbursement contracts

In contrast to fixed-price contracts, where, as just discussed, the deliverable is required regardless of cost and level of effort, cost reimbursement contracts have ceilings based upon hours or costs incurred. When the relevant ceiling has been exceeded and the government has decided not to increase it, the contract is complete and further work, therefore, is not contract work. Moreover, the contract's requirements are often written in terms of required effort. Thus, it is usually easier to determine what effort is required in the performance of a level-of-effort or cost reimbursement contract than in the performance of fixed-price contracts.

Again, be certain to understand the contract. A contract might appear to be fixed-price, but other terms might render it a level-of-effort or cost reimbursement contract or establish that the contract, for whatever reason, is completed.

Classification as contract effort

CASE STUDY

Unisys Corp.

ASBCA No. 41135, 94-2 BCA ¶ 26,894

In October 1987, Hughes Aircraft Corporation (Hughes) and Unisys Corporation (Unisys) entered into a subcontract relating to the design competition phase for a system relating to air traffic control. The Unisys subcontract was divided into two parts: (1) one part was a "Basic" part, consisting of tasks to be performed prior to December 31, 1987; and (2) the other part was an "Option" part, which consisted of tasks to be performed between January 1, 1988 and June 20, 1988. The subcontract "Option" part expired without being exercised.

On January 22, 1988, all of Hughes' funding for the Unisys subcontract was exhausted. After that date, until June 20, 1988, Unisys used its own financial resources and continued to work on completion of related tasks, including technical and developmental work, as part of the process of supporting the team's pursuit of an Advanced Automation System acquisition phase contract award. These later tasks included some of the tasks that would have been covered under the unexercised option of the contract.

In July 1988, the government awarded the system acquisition proposal production contract to IBM. In September/October 1988, Unisys transferred \$2.5 million of direct costs incurred for completion of the related tasks after January 22, 1988, and before June 20, 1988, from the direct cost subcontract accounts to B&P and IR&D accounts.

The government claimed that the transferred cost was the cost of a contract. Unisys appealed. The Board sustained the appeal. With respect to technical work ultimately charged to IR&D, the Board found that the obligation to perform the "Basic" tasks expired under the terms of the subcontract on December 31, 1987. Moreover, Hughes did not exercise the "Option." Thus, the Board concluded that no contractual obligation ever came into being that required any of the tasks Unisys performed in 1988, rendering the effort IR&D.

Classification as contract effort

CASE STUDY

Gen. Dynamics Corp. v. United States

No. CV 89-6762 JGD, 1990 WL 267366
(C.D. Cal. Nov. 7, 1990)

In late 1979, the government and General Dynamics entered into a “fixed-price, best efforts” contract to develop the Divisional Air Defense System (DIVADS). General Dynamics classified its R&D efforts as contract efforts until the cost of its efforts to develop the DIVADS equaled the contract’s fixed-price. At that point, General Dynamics believed the contract to have ended, but, nevertheless, decided to continue its efforts and to classify them as IR&D.

Government auditors concluded that General Dynamics had classified improperly effort required in the performance of a contract as IR&D effort. The auditors found that the contract was fixed-price, requiring General Dynamics to perform R&D effort until the development effort was complete regardless of the cost. Because of that conclusion, the auditors found General Dynamics’ classification of its efforts as IR&D improper. The auditors’ conclusions led to the indictment of General Dynamics and four of its executives.

Ultimately, the indictments were dismissed after General Dynamics established to the prosecutor’s satisfaction that the contract was not a firm, fixed-price contract, requiring delivery regardless of cost. Rather, as the government’s own documents justifying the contract described, the contract was a “best efforts” contract, requiring General Dynamics to use its best efforts to complete the development effort until its costs equaled the stated “fixed-price.” This meant that when General Dynamics’ costs equaled the contract’s price, the contract was over, precluding any further work from being required in the performance of the contract. Thus, General Dynamics properly classified the effort it expended after costs equaled the contract’s “fixed-price” as IR&D effort.

Classification as contract effort

3. Agreements other than “traditional” contracts

Recently, the trend within both federal and commercial procurement is to use other than traditional acquisition contracts to accomplish R&D work. The traditional acquisition contract creates a relationship whereby the buyer is acquiring goods or services from a seller for the direct benefit of the buyer and profit for the seller.

In the federal procurement arena, acquisition contracts traditionally have excluded grants and cooperative agreements. FAR § 2.101. As a result, the FAR is not applicable to these types of “non-acquisition” contracts.

With increasing frequency since the early 1990s, the government and contractors have been entering into “other transactions” pursuant to 10 U.S.C. § 2371 (1994) and the National Defense Authorization Act for Fiscal Year 1994, Pub. L. No. 103-160, 107 Stat. 1547 § 845 (1993), to perform R&D, especially R&D necessary to the development of major weapons systems. These contracts usually involve cost sharing. The practice has been to consider such contracts as non-acquisition contracts not subject to the FAR.

Recently, commercial businesses have begun to enter into agreements that do not result in the acquisition of goods and services, but rather are “cooperative arrangements” whereby the participants intend to conduct R&D for their mutual benefit. FAR § 31.205-18(e) defines “cooperative arrangements” as a situation where a contractor is “working jointly with one or more non-Federal entities pursuant to a cooperative arrangement (for example, joint ventures, limited partnerships, teaming arrangements, and collaboration and consortium arrangements)...” FAR § 31.205-18(e)(1), (2). The essential concept underlying this rather unclear definition is that the parties to the agreement are cooperating to accomplish a mutually beneficial goal. In the context of R&D effort, this means that the agreement creates a relationship, the principal purpose of which is to jointly carry out R&D to the mutual benefit of the parties.

While not addressed in FAR § 31.205-18(e), a key indicator of a cooperative arrangement is the generation of mutual ownership rights in the technology or products developed under the cooperative arrangement. Clearly, if exclusive ownership rights

Classification as contract effort

accrue to the other party, it is more likely that the other party purchased an R&D effort and the only benefit to the performing party is revenue from the work.

Another important indicator of mutual benefit is the enhancement of each party's technical capabilities, even in the absence of a technology that can be owned. For example, an agreement to participate in a joint basic research project would not necessarily result in any technology to own, but it would certainly benefit both participants. Accordingly, any fact showing a material mutual benefit from joint R&D work is important to establishing the existence of a cooperative arrangement.

Importantly, cooperative arrangements may include arrangements whereby one party performs some or all of the effort and the other party contributes money to offset the cost of the effort. So long as the end result of the effort is a mutual benefit, the agreement remains a cooperative arrangement.

The use of a non-acquisition contract to perform R&D is of great importance. Under FAR § 31.205-18(e), efforts required under a non-acquisition contract are considered IR&D effort in their entirety if the effort would have been classified as IR&D, absent the agreement. Thus, for example, where the parties to a cooperative arrangement for R&D contribute effort and materials, the cost of the materials and effort contributed by a party results in an IR&D cost for that party.

The fact that payments are made to the performing party, however, is important. A contractor performing under a cooperative arrangement that receives reimbursement should reduce its IR&D costs by the amount of the reimbursement. See Gen. Dynamics Corp., ASBCA No. 10254, 66-1 BCA ¶ 5,680 (IR&D regarding nuclear energy undertaken pursuant to cooperative arrangements with utility companies and associations did not bar recovery of costs above contributions by those sources).

The recognition of effort to perform a non-acquisition contract as IR&D effort, to be reimbursed as IR&D costs, as discussed in Section XI.A, is what makes performance under such a contract attractive. Care should be taken, therefore, to ensure that an agreement intended to be a non-acquisition contract is just such a contract.

Classification as contract effort

4. Pre-contract costs

In certain circumstances, contractors will perform effort prior to the award of a contract that relates to the subsequently executed contract. To the extent that this effort is expressly required by the contract or is something exclusively caused by, or benefiting, the contract, the effort is contract effort and not IR&D, B&P or other non-contract effort.

This is true even though the effort might result in costs not reimbursable under the contract under FAR § 31.205-32 or any agency FAR Supplement, such as DEAR § 931.205-32. Those principles, essentially, provide that pre-contract costs are unallowable unless pre-approved by the government. The lack of pre-approval, however, does not mean that the costs are not costs of the contract. It simply means that the costs are not reimbursable. The end result is that for purposes of determining what is contract effort, one should not assume that any R&D effort occurring prior to contract award could not be contract effort. Rather, one should read any relevant contract to understand its scope and understand why the work occurred to make the proper classification decision.

Classification as IR&D effort

V. Classification as IR&D effort

This section discusses how to identify IR&D effort. The accounting for the cost of IR&D effort is discussed in Section X.A and the reimbursement of IR&D effort is discussed in Section XI.A.

R&D effort required in the performance of a contract is not IR&D. However, distinguishing contract effort from IR&D effort can be difficult. This section, therefore, using the discussions in the previous section on how to identify contract effort as its basis, focuses mainly on how to distinguish IR&D from contract effort.

A. Pertinent statutes and regulations

CAS 420 defines IR&D effort as “effort which is neither sponsored by a grant, nor required in the performance of a contract, and which falls within any of the following three areas: (i) Basic and applied research, (ii) Development, and (iii) Systems and other concept formulation.”

FAR § 31.205-18(a) currently defines IR&D as an effort that: (1) falls within one of the four following categories of effort ((a) basic research; (b) applied research; (c) development; or (d) systems and other concept formulation studies); and (2) is “not sponsored by a grant or required in the performance of a contract.”

FAR § 31.205-18(a) also provides that IR&D effort does not include “technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.” FAR § 31.205-18(a). Such effort is B&P and is discussed in Section VI. IR&D effort also does not include development effort for manufacturing processes. That effort is M&PE and is discussed in Section VIII.

ATK Thiokol held that the definitions of IR&D in CAS 420 and FAR § 31.205-18 have the same meaning. *ATK Thiokol, Inc. v. United States*, 68 Fed. Cl. 612 (2005), *aff’d*, 598 F.3d 1329 (Fed. Cir. 2010). Thus, the discussion below cites to CAS 420 and FAR § 31.205-18 as appropriate to provide a detailed explanation, but what is IR&D effort is the same under both the CAS and the FAR. See Section IV discussion that cooperative arrangements, essentially, are not a contract for purposes of classifying efforts as IR&D.

Classification as IR&D effort

B. The four types of effort that may be IR&D

1. Basic research

Basic research is “that research directed toward increasing knowledge in science. The primary aim of basic research is a fuller knowledge or understanding of the subject under study, rather than any practical application of that knowledge.” FAR § 31.205-18(a) (citing FAR § 2.101(b)). Basic research often is difficult to distinguish from applied research. Practically speaking, there is no need for distinguishing between these two types of effort. The classification of and accounting for basic research and applied research is identical.

2. Applied research

Applied research is:

[T]hat effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) attempts to determine and exploit the potential of scientific discoveries or improvements in technology, materials, processes, methods, devices, or techniques, and (3) attempts to advance the state of the art. Applied research does not include efforts whose principal aim is design, development, or test of specific items or services to be considered for sale; these efforts are within the definition of the term “development.”

FAR § 31.205-18(a).

As noted above, distinguishing applied research from basic research is not important. Distinguishing applied research from development is important. Basic or applied research can be only either contract effort or IR&D or B&P effort. Development effort, however, can be M&PE effort, as discussed in more detail later, when it relates to the development of manufacturing processes, tools, equipment or materials, rather than a product for sale. As discussed later in Section X, the accounting for the cost of IR&D and B&P effort is different from the accounting for the cost of M&PE effort, requiring the proper categorization of the effort.

Classification as IR&D effort

3. Development

Development is:

[T]he systematic use, under whatever name, of scientific and technical knowledge in the design, development, test, or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purpose of meeting specific performance requirements or objectives. Development includes the functions of design engineering, prototyping, and engineering testing. Development excludes: (1) Subcontracted technical effort which is for the sole purpose of developing an additional source for an existing product, or (2) Development effort for manufacturing or production materials, systems, processes, methods, equipment, tools, and techniques not intended for sale.

FAR § 31.205-18(a).

Development effort is usually easy to distinguish from basic or applied research. Development effort, contrary to basic and applied research, has a specific goal of achieving certain performance objectives.

The most common issue regarding whether an effort is development effort relates to determining whether the effort relates to a product or service for sale. As just noted, development effort that does not relate to a product or service for sale, but rather manufacturing process, equipment, tools or materials, is M&PE effort and not IR&D effort.

4. Systems and other concept formulation studies

Systems and other concept formulation studies are “analyses and study efforts either related to specific IR&D efforts or directed toward identifying desirable new systems, equipment or components or modifications and improvements to existing systems, equipment or components.” FAR § 31.205-18(a).

Little guidance other than the quoted definition exists to help determine what effort may be classified as systems and other concept formulation studies. The usual classification difficulties here occur when attempting to determine if the effort is IR&D or selling effort. For example, an effort is undertaken to determine if a market exists for a potential new product or service and includes surveying potential customers for their interest and assessing technical and

Classification as IR&D effort

market information to determine what is available currently in the marketplace. Such effort would not be systems and other concept formulation study effort because its focus is to develop information about a market. Effort to gather technical data or other technical information to assist in assessing the ability to develop a product, however, should be classified as IR&D effort.

C. “Required in the Performance of the Contract”

Once it has been determined that effort falls within one of the four types of effort that FAR § 31.205-18(a) defines as R&D, the next question is whether the effort is IR&D because the effort is not “sponsored by a grant or required in the performance of a contract.” As discussed below, this means that R&D effort is IR&D effort unless it is: (1)(a) reimbursed by a grant or contract or (b) specifically required in the performance of a contract; and (2) a “cooperative arrangement” is not involved.

Until 1992, the FAR defined IR&D as excluding effort “sponsored by or required in the performance of a grant or contract.” In 1992, that language was changed to the current language: not “sponsored by a grant or required in the performance of the contract.” That change appears to have made the concept of “sponsorship” apply only to grants; however, such is not the case. The change was not intended to be substantive. See 57 Fed. Reg. 44,264, 44,265 (Sept. 24, 1992). Thus, for purposes of distinguishing contract effort from IR&D effort, two questions should be answered: (1) is the effort sponsored by a contract or grant; or (2) is the effort required in the performance of a contract?

“Sponsorship” means that a grant reimburses the costs of the R&D effort or a contract, other than a cooperative arrangement, reimburses the costs of the R&D effort.

Absent clear reimbursement of R&D costs, the analysis is whether the effort is “required in the performance of a contract.” Making this assessment often is difficult because of the general wording “required in the performance of a contract.” It has been particularly difficult in the later stages of R&D (development and formulation studies) where IR&D projects may overlap with contract effort and other effort, such as B&P, selling and M&PE. Contractor personnel should carefully analyze individual tasks in an IR&D project, and tasks called out in any related effort, to determine whether a particular effort is IR&D, B&P, selling, M&PE or contract effort. When there is any doubt about the

Classification as IR&D effort

classification of certain effort, and there usually is, a contractor should: (1) document and elevate the issue within the contractor's organization to formulate a reasonable and defensible decision; and (2) fully disclose the contractor's position to appropriate government personnel, when appropriate. Importantly, the *ATK Thiokol* decisions have brought much more certainty to identifying when R&D effort is required in the performance of a contract.

1. The ATK Thiokol Decision

In *ATK Thiokol*, both the Federal Circuit and the Court of Federal Claims held that R&D effort that is not OO by a contract is properly classified as IR&D effort when other criteria are met. These decisions further held that whether effort is specifically required is a function of the terms of the relevant contract and the contractor's cost accounting practices. When a contract does not specifically require the R&D effort in its scope of work or in its costs or price, and the contractor's accounting practice is to classify R&D effort in that circumstance as IR&D effort, the effort is IR&D. The courts rejected the government's argument that R&D effort "implicitly" required by a contract because it was "necessary" to perform the contract is not IR&D effort. Only effort specifically required by the contract is precluded from being IR&D effort.

The courts did recognize that R&D effort expended that benefits a single contract is specifically required by that contract. The rationale is that if no reasonable expectation of benefit to other than a single contract exists at the time the R&D effort is undertaken, the only reason for the effort is the benefiting contract. Thus, the effort is specifically required.

Under the *ATK Thiokol* guidance, a "yes" answer to the following questions establishes the effort in question as IR&D effort:

1. Is the effort R&D effort?
2. Is there an absence of:
 - a. Any specific requirement for the R&D effort in a contract's scope of work;
 - b. Any estimated costs for the R&D effort in the contract's estimated costs; and

Classification as IR&D effort

- c. Other facts that would show that the buyer intended to pay for the R&D effort?
3. At the time the effort is planned, was there a reasonable expectation of multiple future use (i.e., multiple contracts even if with only one buyer)?
4. Do the contractor's relevant cost accounting practices provide that the costs of R&D work undertaken in these circumstances will be classified as IR&D costs?

Ensuring the ability to answer "yes" to the above questions requires:

1. Careful contract drafting, with the clearest and safest means to support R&D effort as IR&D effort being an express exclusion of the R&D effort from the contract.
2. Careful documentation (e.g., delineations of work) regarding the nature of the work, why it is not specifically required by a contract and why a reasonable expectation of multiple use exists.
3. Clear and consistently applied cost accounting practices that specify that R&D effort is IR&D in the circumstances just described.

2. Specific issues

Additional guidance on identifying whether effort is required or sponsored appears in the following sections of this Practical Guide. Discussions include specific issues that continually arise in making a determination of whether effort is IR&D or contract effort. The most common, and most difficult, issues are discussed first. In addition, the "IR&D Decision Tree," reproduced in Figure A, is designed to summarize the basic factors to be considered in deciding whether effort is IR&D. Other issues are addressed in a subsequent series of questions and answers at the end of this section.

- a. [How the effort associated with R&D efforts that bear a relationship to a contract should be classified](#)

On some occasions, an IR&D project will eventually bear a relationship to contract-required/sponsored work. Once that relationship exists, a contractor should determine how to

Classification as IR&D effort

classify any effort that will continue under the project. When this situation exists, the terms “generic IR&D,” “branch/derivative IR&D” or “parallel IR&D efforts” are often used to signify that at least some identifiable R&D effort is not required or sponsored by a contract.

What is “generic” IR&D

IR&D projects often commence with objectives of sufficiently general applicability so that they may be described as “generic.” “Generic IR&D” refers to the practice of developing a base technology using IR&D effort that has potential application beyond a single contract. Consistent with *ATK Thiokol*, it is that potential application to multiple contracts that precludes the effort from being required in, or sponsored by, a contract absent a specific requirement in a contract.

In the past, the government has argued that what is actually benefitted by the results of an R&D effort determines the effort’s proper classification. Thus, where a market fails to materialize beyond a single contract, the government often concludes that the effort was required in the performance of a single contract. That position is incorrect. As *ATK Thiokol* held, the contractor’s potential applications control. In fact, in *ATK Thiokol*, the court found that ATK Thiokol had a reasonable expectation of multiple use even though only one contract materialized for many years. Of course, there should be a reasonable basis for the potential applications, such as market, strategic or business plans. When this type of support exists for potential applications beyond a single contract, the R&D effort is generic and, therefore, IR&D effort.

Typically, facts demonstrating that there was a reasonable expectation of potential future multiple use will be contained in documents reflecting the contractor’s internal planning and budgeting relating to long-range plans, as well as in each IR&D project description. Contractors should expect that DCAA will request to review such planning, budgeting and project description information, consistent with DCAAM guidance on testing sensitive accounts. DCAAM § 5-1009(b).

Classification as IR&D effort

What is “branch” or “derivative” IR&D

Branch or derivative IR&D is effort undertaken to refine the results of generic IR&D to more specific applications. The specific application may be under another IR&D effort, B&P effort or a specific contract and should be classified accordingly without regard to the classification of the generic effort.

What are “parallel” IR&D efforts

Parallel IR&D efforts occur when a generic IR&D project continues even after branch or derivative efforts have been initiated under contract. This occurs when the purpose of the generic and branch efforts is different. When that difference exists, the efforts will proceed in parallel, hence the concept of parallel efforts.

How to classify the types of efforts

By definition, generic IR&D is IR&D effort. Effort to develop branch technology may be IR&D, contract effort or other type of effort addressed in this Practical Guide, depending upon the purpose of the effort. If the branch technology effort is not sponsored by, or required in, the performance of a contract or grant, it is IR&D, unless it is in direct support of the development of a proposal rendering it B&P.

At various times, the government has propounded an extreme interpretation of the definition of IR&D that calls into question a contractor’s ability to continue a generic IR&D effort as IR&D once derivative projects are undertaken in the performance of a contract. Such an interpretation is incorrect.

Government contract regulations do not prohibit tailoring, “leveraging” or “synergizing” development effort to the work of an existing or contemplated contract to enhance performance of that contract. A well-planned IR&D project, for example, often will have relevance to a contractor’s current business and, therefore, can offer benefits to current contracts. A contractor is not likely to be technologically able to compete for future business without a well thought-out new business program that builds on existing capabilities through coordination of new contracts and contractor projects. In pursuing parallel contract R&D and IR&D efforts, some “cross-fertilization” of

Classification as IR&D effort

the fruits of IR&D to related ongoing contractual objectives will be both desirable and beneficial to the government. In fact, the government often formulates contracts in such a way as to anticipate the fruits of an IR&D project without actually sponsoring or requiring the R&D work.

Consistent with the ATK Thiokol criteria set out above, a contractor should observe certain critical cautions when parallel contract effort and IR&D are occurring.

1. There should be no double recovery.
2. The specifications, tasks, BOEs or project statements should articulate clearly the distinctions between the contract (direct) and IR&D (indirect) effort. This requires the use of consistent terminology in all relevant documents. This will avoid later allegations of improper classification undertaken to avoid cost recovery limitations either as direct contract costs or as indirect costs. For example, in *Hughes Aircraft*, the government claimed that Hughes had improperly shifted costs from the fixed-price F-15 subcontract to the cost-plus B-2 subcontract. *Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939 (1997). In *Mayman*, the government's false claims case contended that Martin Marietta intentionally underbid a particular project and planned to bill the unrecoverable shortfall to the government as part of the contractor's IR&D effort. *Mayman v. Martin Marietta Corp.*, 894 F. Supp. 218 (D. Md. 1995).

As these cases suggest, the "shifting of costs" will place the contractor's interests at risk. Thus:

- a. Have in place and follow a formal, written position interpreting the IR&D cost principle. If one does not exist, the contractor should adopt one that includes the handling of parallel development.
- b. Avoid making distinctions between IR&D and contract work based only on considerations of funding sources. It is the nature and substance of the work itself that should be distinguished. Use of IR&D simply to reduce contract costs without differentiation in the nature of the work to be accomplished likely will create issues.

Classification as IR&D effort

- c. Maintain a clear understanding of the potential applications of the generic IR&D. How viable are the uses of the work other than for one specific contract?
- d. Do not base the continuation of generic IR&D on the award or progress of a particular contract.
- e. Be mindful of the cost of the generic IR&D compared to the cost of the related contracts. Normally, the cost of the generic effort is such that it makes no sense to charge it to one contract and thus, to one customer.
- f. Administer effort sponsored by contract funds separately from effort sponsored by contractor funds. Administrative separation entails separate statements of work (SOWs), separate work authorizations, separate subcontracts and cost segregation.
- g. Do not include the work to be performed with non-contract funds in the contract SOW as a required task. Such work should, however, as appropriate, be referenced in Section H (Special Contract Requirements) of the contract as related, non-contract work, the fruits of which are intended to be utilized in the end-product of the contract.

For example, where performance specifications are used, the distinction between the contractual effort and the IR&D effort should be carefully embodied in both technical and management memoranda and disclosed to the government, and IR&D effort should be excluded from contract proposals. The contractor should seek as much specificity as possible in defining the respective contract and IR&D efforts. The contractor also may want to consider limiting its obligation in such contracts

²If that separation cannot be made clearly, the contractor, in some cases, may be justified in allocating between the contract and IR&D the tasks performed after the decision. An allocation between the contract and IR&D satisfies one basic purpose of the IR&D cost principle; that is, to preclude double recovery for the effort. No clear authority exists, however, which approves this allocation method. As a result, such an approach should be viewed as an aggressive position, and the rationale and mechanics for its use should be carefully documented. The details of the allocation determination should be fully disclosed to relevant government personnel, including cognizant contracting officers and program managers, prior to billing the government for any of the direct (contract) or indirect (IR&D) costs.

Classification as IR&D effort

have been considered and these costs excluded from the pricing for the proposed contract effort, it is suggested that proposals specifically identify related non-contract projects that will be performed in parallel with the contract.

- b. State the contractor's charging practices in proposals and contracts. A statement summarizing the contractor's charging practices, in light of the formal policy discussed above with regard to the requirement that IR&D and B&P be independent of any contract, should be inserted in every proposal and contract where there is related or parallel IR&D or B&P effort ongoing. This statement should provide the government with formal notice that the related IR&D and B&P efforts have been evaluated and that a determination was made that such efforts are not sponsored by, nor required in, contract performance. In addition to these specific disclosures, it is recommended that a contractor apprise its customers generally, in writing, of the contractor's IR&D programs and contracts to which these programs relate.

b. [How the effort of an R&D task that is partially sponsored by a contract should be classified](#)

A contract may, by its terms, partially "sponsor" R&D effort even if no generic IR&D exists already; hence the common phrase "partial sponsorship." That is, the contractor and a customer may identify a subject for R&D and choose to split the effort between the contract and contractor-funded work. Contract sponsorship of a portion of an R&D project does not make the entire project ineligible as IR&D. So long as the remaining portion of the work also is not sponsored or required by the terms of the contract, the contractor may treat the work as IR&D. For example, if a contract (commercial or government) funds part of a contractor's R&D effort, but does not fund the entire project, the contractor may treat the unfunded part as IR&D, so long as the unfunded effort is not required by a contract. It is absolutely essential, therefore, that where these divisions of R&D effort are to be made, their boundaries be defined clearly both to contractor personnel and to the government in its contractual and IR&D project approval capacities.

Classification as IR&D effort

As discussed previously in Section IV.C.3, FAR § 31.205-18 specifically provides for such a result for cooperative arrangements. Thus, where an R&D effort will be partially sponsored, consider using a cooperative arrangement.

c. [How the effort for a contract requirement involving efforts already being performed under an IR&D project should be classified](#)

If it appears from a request for proposal (RFP) that a proposed contract will require the performance of certain R&D effort, which a contractor is presently performing under an IR&D project, a contractor has three options:

1. The contractor may leave the overlapping effort within the scope of the IR&D project and attempt to convince the buyer to revise the proposed contract SOW so as to specifically exclude from the proposed contract the technical effort the contractor contemplates completing under the IR&D project. If the RFP is based upon a sole-source solicitation, it may be necessary for the procurement agency to redraft the SOW, and doing so may necessitate that competitors be given an opportunity to compete on that basis.
2. The contractor may continue to identify all overlapping efforts as IR&D until the date of contract award. In some instances, the contractor may need to amend the contract proposal to exclude the “overlapping” work performed as IR&D prior to the estimated award date. The contractor then should propose contract costs only to perform the remaining overlapping work not already performed as IR&D. The contractor should update the cost charging as necessary if the actual contract award date varies from the estimate. Finally, the contractor should discontinue the IR&D effort after the award date and leave all IR&D effort as recorded prior to that date.
3. The contractor may redefine the scope of the IR&D project in question to exclude tasks included in the contract SOW and then identify the effort of the tasks included in SOW as contract effort.

Classification as IR&D effort

With all three options, the technical results of the past and then parallel IR&D efforts may be incorporated into the contract. Note that whichever option is selected, the contractor should explicitly propose and negotiate with the government the cost charging practice it proposes to use.

d. [How effort required by a contract that is continued after contract completion should be classified](#)

A contractor may encounter circumstances where R&D effort that had been contract effort is now being independently pursued by the contractor and is no longer specifically required by the contract. This continued effort may be classified as IR&D. This occurs most often when R&D performed under a contract shows promise, and the contractor decides to pursue the effort further. It also can occur for an R&D effort begun and then “suspended” because of the award of a contract and continued after contract completion.

Identifying the continuing R&D effort that previously had been contract effort as IR&D is proper only after the contract that had required the effort is complete. Important to determining when a contract is complete is the type of contract involved and its specific terms, as discussed previously in Section IV. For example, a cost reimbursement contract is complete when contract funds have been exhausted. Conversely, a fixed-price contract is complete only after the deliverables have been accepted.

Identifying the continuation of an R&D effort after contract completion is a practice that almost guarantees government review, especially when a fixed-price contract is involved. Thus, it is critical to understand the complete nature of the relevant contract and to document the basis for the decision to convert the R&D from contract to IR&D effort.

e. [How efforts involving a substitute technical approach should be classified](#)

A contractor sometimes is able to provide a different and better technical approach than required by the contract because of results from an IR&D effort. If the IR&D project is complete at the time a contractor decides to use the project’s results as a

Classification as IR&D effort

substitute technical approach, the results of the IR&D project may be used on the contract without identifying the prior IR&D effort as contract effort. However, any effort required to adapt the results of the IR&D project to the contract requirements is contract effort.

If the IR&D project is not complete at the time a contractor decides to use the substitute technical approach, the IR&D project should be evaluated to determine what parts of it are now required in performance of the contract. All efforts performed after the decision to use the substitute approach that are required in the performance of the contract should be identified as contract effort. On the other hand, if the project can be explicitly segregated into efforts that are, and are not, required to complete the substitute approach, the contract-required task efforts should be identified as contract effort and the task(s) not required by the contract may be identified as IR&D effort.²

If a technical approach is set forth in the contract SOW, the contractor should seek government approval of a contract change before proceeding with the substitute performance method. The substitution may result in a change order. The wording of the change order should be such to state clearly what effort is now required and what effort, if any, will remain IR&D.

f. [How efforts should be classified in the context of a pre-contract cost agreement](#)

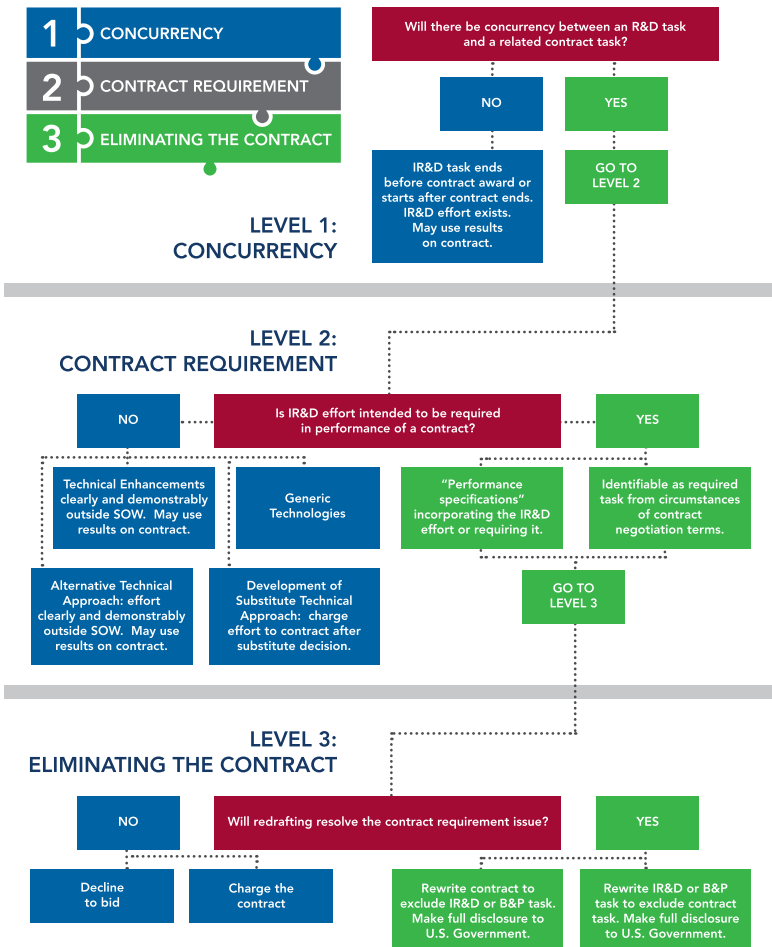
Generally, if a contract has not been executed, costs may not be charged to that contract (no “contract” exists). However, if a contractor has entered into a pre-contract cost advance agreement, effort that will be required to be performed under the contract upon execution should be identified as contract effort. Therefore, under these circumstances, if the contractor is performing an IR&D project which contains tasks that will be required to be performed under the contract, the contractor should cease identifying the effort associated with those tasks as IR&D as of the effective date of the pre-contract cost advance agreement, rather than transferring them as of the execution date of the contract.

Classification as IR&D effort

D. IR&D Decision Tree

The IR&D decision tree in **Figure A** is designed to summarize the basic factors to be considered in deciding whether R&D effort may be classified as IR&D effort.

FIGURE A - IR&D DECISION TREE



Classification as IR&D effort

QUESTIONS & ANSWERS

A. Types Of Effort That May Be IR&D

Question 1: Are systems and concept formulation studies IR&D?

““[S]ystems and other concept formulation studies” effort which is either related to a specific IR&D effort or is directed toward identifying desirable new systems, equipment or components or modifications and improvements thereto, constitutes IR&D. FAR § 31.205-18(a). However, if a solicitation requires a contractor to perform certain “systems and other concept formulation studies” effort, and that effort is segregable from other such effort, then the segregable portion of that effort should be charged to B&P.

Question 2: Are IR&D project plans, periodic and final reports and reporting in accordance with DFARS § 231.205-18 classifiable as IR&D effort?

Effort drafting IR&D project plans, generating periodic and final project reports and reviewing the project with management or the customer and reporting in accordance with DFARS § 231.205-18 constitutes IR&D. Likewise, evaluation of alternative concepts or designs to satisfy mission requirements, and comparison with known capabilities and concepts or designs of potential competitors, is chargeable to IR&D. However, if the purpose of these efforts is to communicate the fruits of research directly to customers or potential customers, then the activities should be charged to selling (overhead).

Question 3: Can consultant fees be recovered as IR&D?

Whether a consultant performs a portion of an IR&D project or the entire project under an arrangement such as a grant, the costs of engaging the consultant to support an IR&D project are IR&D costs. Note, however, the additional rules for allowability of consultant’s costs are set forth at FAR § 31.205-33 (professional and consultant service costs).

Question 4: Can literature searches be classified as IR&D?

If a literature search is part of an effort to advance the state of the art, the effort may be classified as IR&D.

Classification as IR&D effort

Question 5: Under what circumstances may training costs be classified as IR&D?

Some training is inherent in many IR&D efforts. A contractor can classify the training as IR&D if such training is: (a) specifically required to complete certain IR&D tasks; and (b) unique to the IR&D program. Other training may be an allowable cost under the provisions of FAR § 31.205-44 (training and education costs).

Question 6: Under what circumstances may the costs of attending a conference be classified as IR&D?

Similar to training, the costs of attending the conference should be classified as IR&D if attendance at a conference is: (a) specifically required to complete an IR&D project; and (b) unique to the IR&D project.

Question 7: Under what circumstances can computer programming be classified as IR&D?

Any software development effort, which meets the FAR § 31.205-18(a) definition of basic research, applied research, development or system and other concept formulation studies, is IR&D. Where software previously developed through IR&D is being modified for use on a particular contract, however, the modification or “tailoring” should be a direct charge to the particular contract. Software developed for other than sale likely is M&PE, subject to FAR § 31.205-25 and capitalization under CAS 404 may be appropriate.

Question 8: Is it permissible to classify facility design and check out effort as IR&D?

Generally, the work directly associated with the design and check out of new facilities and equipment is not considered to be IR&D, but may be M&PE. The contractor may use IR&D funds only to design and check out new facilities or equipment, which are unique to an IR&D project. For example, the costs of a non-standard test rig, which should be fabricated for a specific IR&D project is IR&D, provided that the contractor does not intend to use the rig for follow-on production or as part of a standard test facility. In this circumstance, the length of the specific IR&D project will determine whether the cost should be capitalized under CAS 404 and depreciated pursuant to CAS 409.

Classification as IR&D effort

Question 9: How should technical development effort be classified if the contractor is eventually likely to submit a proposal relating to such effort?

Any technical development or data collection and evaluation task should be classified as IR&D when the effort meets the definition of IR&D and the contractor has not planned any current specific proposal activity relating to that effort, even though the contractor recognizes that eventually it is likely to submit a proposal that draws upon such IR&D effort. The same task instead should be classified as B&P where the contractor plans to prepare a specific solicited or unsolicited proposal. However, continuing technical effort initially classified as B&P later may be classified as IR&D once the effort is no longer directed at supporting any current specific proposal effort.

Question 10: When is a technical development or data collection and evaluation task IR&D, as opposed to B&P?

Any such task should be classified as IR&D when the effort meets the definition of IR&D and the contractor has not planned any current specific proposal activity relating to that effort, even though the contractor recognizes that eventually it is likely to submit a proposal that draws upon this IR&D effort. The same task instead should be classified as B&P where the contractor plans to prepare a specific solicited or unsolicited proposal. However, technical effort initially classified as B&P later may be classified as IR&D once the effort is no longer directed at supporting any current specific proposal effort.

Question 11: When is technical effort to develop equipment and similar assets IR&D rather than M&PE?

This issue is discussed in greater detail in Section VIII. Essentially, if the development effort is to develop a new or modified product for sale, it is IR&D.

B. Required in, or Sponsored by, a Contract

Question 1: If funding for an R&D task is included in a contract but there is not a specific contract requirement for that task to be performed, is it IR&D effort?

No, either traceable funding for R&D work or a specific contract requirement for its performance is sufficient to make the work contract effort and not IR&D. R&D effort should be evaluated under each of these two elements to ensure that all R&D costs claimed as IR&D are properly classified.

Classification as IR&D effort

Question 2: If a commercial contract sponsors or requires an R&D task, is the effort IR&D?

No, R&D effort is not IR&D if it is sponsored by, and required in, the performance of any type of typical “buy/sell” contract, whether government or commercial. Note, however, the discussion in Section IV regarding corporative arrangements, which can exist between commercial companies and may result in IR&D costs.

Question 3: How can a contractor demonstrate the existence of “generic” IR&D?

Important facts include: (a) the absence of any relevant contracts; (b) the timing of the IR&D effort relative to the award of a contract; and (c) business plans and similar documents forecasting a variety of potential needs for a technology.

Question 4: What is the relevance to the classification of effort as IR&D if the potential needs for the technology do not materialize?

There is no relevance. The failure of potential needs to materialize does not require that generic IR&D effort be reclassified. This is true even if the only need that does materialize is a single contract. So long as a reasonable expectation of multiple needs exists at the time the project is initiated, the effort remains generic IR&D, assuming, of course, the effort is never required in the performance of a contract.

Question 5: Under what circumstances may the contractor continue to perform a “parallel” (i.e., ongoing) R&D task as IR&D concurrently with a contract that benefits from the IR&D effort?

Two circumstances would permit parallel projects. First, the R&D task is “generic IR&D” because it may benefit tasks other than the contract. The approval/justification documents are key in this regard. Also important would be facts showing that the contract effort will involve “branch technology” and not the specific technology being researched and developed under the R&D task. In fact, the government often formulates contracts in such a way as to anticipate the fruits of an IR&D project without actually sponsoring/ requiring the R&D work.

Second, the contractor may perform such a project where the benefiting contract specifically delineates which tasks will be charged to the contract and which tasks will be charged to IR&D. The contract should further provide that no costs of work being performed under the IR&D effort will be allocated directly to the contract.

Classification as IR&D effort

Question 6: How should IR&D effort, which is interrupted by a contract requirement, be classified after contract obligations have been satisfied?

When a contract has been completed, or no further contract performance is required, there remains no effort that can be sponsored by, or required in performance of, that contract. Thus, R&D effort undertaken prior to the existence of a contract, which was then suspended because of the coverage of the contract, may again be charged to IR&D after completion of the contract. The key issue in resuming work as IR&D is whether, and at what time, the obligations specified in a contract have been satisfied. The answer to these questions may depend upon the type of contract involved.

C. Other Issues

Question 1: May one division/subsidiary perform IR&D effort for the benefit of another division/subsidiary?

Yes, under CAS § 420-50(d). If a segment performs R&D work for another segment and the effort is not part of an IR&D project of the performing segment, the effort is IR&D effort of the non-performing segment and not IR&D effort of the performing division/subsidiary. Essentially, the performing segment is “selling” R&D effort to the non-performing segment.

Question 2: Under what circumstances is effort to develop a prototype not IR&D effort, even though the effort is not required in the performance of a contract?

Effort to develop a prototype of a product to be sold is B&P effort when the effort is performed to support a specific proposal effort. Effort to develop a prototype of a product to be sold is selling effort when the effort is performed as part of a direct selling effort. Effort to develop a prototype of a manufacturing process is M&PE effort.

Question 3: May a buyer classify subcontract effort as IR&D?

Yes, when the buyer entered into the subcontract to obtain goods or other services to enable the buyer to perform an IR&D project.

Question 4: May a subcontractor classify effort specifically required by a subcontract as IR&D effort because the subcontractor will perform the effort for a buyer which will classify the purchased effort as IR&D?

No, unless the subcontract between the buyer and the subcontractor is a cooperative arrangement. Absent this circumstance, the subcontractor’s effort is specifically required in the performance of a subcontract and is not IR&D effort.

Classification as B&P effort

VI. Classification of B&P effort

B&P costs, as defined in FAR § 31.205-18, are “the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts” unless this type of effort is “sponsored by a grant or cooperative agreement, or required in the performance of a contract.” FAR § 31.205-18(a); 48 C.F.R. § 9904.420-30(a)(2).

A. What is B&P effort

B&P encompasses all effort whose fundamental purpose is the preparation of a solicited or unsolicited proposal. B&P includes the effort involved in: (1) preparing the response to RFPs and Requests For Quotations (RFQs); (2) preparing unsolicited proposals; (3) undertaking R&D effort to support a proposal; (4) supplementing a proposal with additional information or responding to questions regarding the proposal, including fact finding; and (5) preparing a best and final offer (BAFO). B&P effort includes efforts to pursue government (DOD and all other agencies) and strictly commercial sales opportunities because B&P effort is defined by its purpose of preparing or supporting a proposal. When an acquisition program potentially requiring the procurement of goods or services from the contractor is canceled, or when the contractor makes a decision not to bid on a procurement, the costs of B&P effort performed before cancellation or prior to the no-bid decision are proper B&P costs.

Moreover, even when a contract specifically requires preparation of a proposal for follow-on efforts or for other reasons, B&P effort may still occur. The contractual requirement to submit a proposal may not encompass all related effort. Each element of effort should be examined independently to determine whether it is “specifically required” by the contract or is effort sponsored by a grant or cooperative agreement.

B. Timing and the classification of effort as B&P

A difficult issue for classifying effort as B&P is timing. In order to properly begin classifying effort as B&P, the effort should occur in support of a “known” proposal opportunity. A “known” proposal opportunity exists when an RFP, invitation for bid (IFB) or RFQ is issued. A known proposal opportunity also likely exists upon the issuance of a draft RFP or RFQ. Finally, depending on the facts, a known proposal opportunity might exist when a contractor becomes aware of the potential issuance of a draft RFP or an RFQ.

Classification as B&P effort

CASE STUDY

Boeing Co. v. United States

862 F.2d 290 (Fed. Cir. 1988)

In April 1976, the Air Force issued an RFP for two proposals for the competitive design, production and demonstration of a B-52G and a KC-135 weapon systems trainer. The winner of the Phase I initial production contract competition would receive the Phase II contract for the balance of the equipment. Contract Line Item Number (CLIN) 0010 of the RFP required each offeror to prepare a proposal for the Phase II contract and to specify a target cost for the proposal preparation. The RFP stated that the proposal instruction package would be issued 23 months after award of the Phase I contract and that the proposal for Phase II would be due two months later. In October 1976, Boeing submitted its bid for the Phase I contract, including a target cost of approximately \$1 million for the Phase II proposal effort. Boeing classified all proposal activity as B&P effort except for that effort which occurred between receipt of the Phase II proposal instruction package and submission of the Phase II proposal. Boeing classified that later type of effort as contract effort.

The government challenged Boeing's approach, but the Federal Circuit held that Boeing's practice was appropriate. The court found only those efforts specifically required by the contract to be direct costs of the contract, with the remainder classified properly as B&P.

For example, B&P work for major systems procurement proposal opportunities may start years ahead of the final RFP. Even for research and exploratory development, contractors usually learn about impending procurements several months before an RFP is released and begin work on the proposal at that time. The key determinations for properly classifying an effort as B&P when there is a potential issuance of an RFP or RFQ are: (a) whether the buyer's needs are sufficiently defined at the time to allow the contractor to actually begin efforts to develop; and (b) whether the contractor has made a firm decision to begin to develop a proposal.

Classification as B&P effort

Another example is a customer's request for information (RFI) to assess whether it needs to upgrade its computer software, but the request does not establish a specific need. Efforts undertaken to respond to the request would not be B&P, but likely would be selling effort. Once the agency concludes that it will upgrade its software in a specific manner, efforts to respond to that need are properly classified as B&P even if no final RFP has been issued.

Effort expended after the award of a contract is typically not proposal effort and, therefore, could not be B&P effort. One exception would be effort that relates directly to the wind-up of the proposal effort, such as attending the procurement award debriefing with the agency and the effort disbanding the proposal team, so long as classifying this effort as B&P is consistent with the contractor's cost account practices.

Another exception is when, during performance of the contract, a pricing action that would change the contract's price is reasonably identifiable and efforts to develop a proposal begin. The Boeing case study above is an example of such a circumstance. In such circumstances, the question is whether the effort is specifically required by the contract. When the effort is specifically required by a contract, it is not B&P effort. The costs of such effort are contract costs unless it is the contractor's disclosed practice to classify all proposal-related efforts as indirect effort. See 48 C.F.R. § 9904.402-61.

C. How to Distinguish Between IR&D and B&P

The distinction between IR&D and B&P effort is whether the R&D effort is directed at a specific proposal, resulting in B&P effort. Effort directed solely at advancing knowledge or developing a product is IR&D effort. Because the same R&D effort might be IR&D or B&P based upon whether the effort is to support a specific proposal, it is possible for an R&D effort to begin as IR&D, become B&P when the effort is directed to support a specific proposal, and then revert back to IR&D upon completion of the proposal effort. Of course, it also is possible to have parallel B&P and IR&D efforts if the R&D effort in support of the proposal is developing *branch* technology based upon the results of the ongoing generic IR&D.

Classification as B&P effort

QUESTIONS & ANSWERS**Question 1: Does B&P include negotiation effort?**

No, such effort is selling effort.

Question 2: Does B&P include the effort of preparing a BAFO?

Yes, because preparation of a BAFO is part of the effort that, when requested, is directly related to the preparation of a proposal.

Question 3: Does B&P include customer contacts?

No, unless the contact relates to the preparation of a specific proposal. Otherwise, the effort associated with customer contacts is properly classified as selling effort.

Question 4: How should the contractor classify travel costs incurred in attending a proposal debriefing, and costs associated with disbanding the proposal team?

Debriefings and dissolution of proposal teams are normal steps in the proposal preparation and submission process. Although the contractor should attempt to close a B&P account as soon after award as possible, it may charge all costs related to debriefing and disbanding to the existing B&P account.

Question 5: What distinguishes B&P from selling costs?

There are several factors that help distinguish the two different types of costs. The source of the request for the effort to be performed is one factor. If a proposal team requests the effort, the costs of that effort are presumptively B&P. On the other hand, costs of effort the marketing department requests to support a marketing plan are presumptively selling costs. The timing of the effort is also a consideration where the effort is conducted prior to proposal submission. Effort conducted two years before proposal submission is less likely to be B&P than the same effort conducted six months before a proposal is submitted. The government's interest in the type of effort the contractor proposes to undertake is another factor. If a government procurement program is well established and the contractor is reasonably certain that an RFP eventually will be issued, effort undertaken to be prepared to submit a proposal, prior to the formal issuance of an RFP, is B&P. If, on the other hand, there is only a general interest in a product but no established procurement

Classification as B&P effort

plan, the cost of effort expended to generate government demand for the contractor's product probably should be classified as selling costs. See Section VII for more information on "selling costs."

Question 6: May a contractor adopt and follow a policy that B&P effort begins only after the issuance of a formal IFB, RFP or RFQ?

Yes, so long as that policy is disclosed and followed consistently. The determination of when proposal activity begins is not clearly defined, vesting discretion in contractors to establish a reasonable policy.

Question 7: When is effort relating to a proposal for a contract modification direct contract cost or indirect cost?

Effort expended developing a proposal, whether for a modification or a follow-on contract, that is specifically required by an existing contract, is considered to be incurred in differing circumstances from other proposal effort (i.e., B&P effort) and is a direct contract cost unless the contractor's cost accounting practices classify all proposal effort as indirect effort. See 48 C.F.R. § 9904.402-61. Effort required by a contract that will be classified as indirect effort under the contractor's cost accounting practices, however, is not B&P effort because it is specifically required by a contract. See 48 C.F.R. § 9904.420-30(a)(2). Note that this same analysis does not apply to R&D effort that is specifically required by a contract because the cost of such effort must be classified as a contract cost. In other words, for purposes of properly classifying proposal effort specifically required by an existing contract as direct or indirect, the contract language and the contractor's consistently applied practices are determinative.

DOD has stated, in a memorandum dated November 10, 2011, that the following contract provisions represent contract language that supports charging proposal preparation costs as contract costs: (a) proposals for changes directed by the government under the Changes clause; (b) value engineering change proposals; (c) engineering change proposals; (d) proposals for new requirements added to existing contracts; and (e) proposals for the definitization of unpriced contractual actions. Office of the Under Secretary of Defense, Acquisition, Technology and Logistics, Mem., Direct and Indirect Charging of Contractor Proposal Preparation and Negotiation Support Costs (Nov. 10, 2011).

Classification as B&P effort

Question 8: When is effort relating to proposal for a follow-on contract, contract or B&P effort?

Effort expended developing a proposal for a follow-on contract is contract effort unless it is the contractor's consistently applied practice to classify all proposal effort as indirect effort. See 48 C.F.R. § 9904.402-61; Boeing, 862 F.2d 290.

In the DOD memorandum identified in the answer to Question 7, DOD states:

Follow-on work does not automatically qualify to be charged directly to a contract merely because there is an assumption that the contractor will submit a proposal as part of a continuing program. For the costs to be charged directly to a contract there must be a specific requirement in an existing contract to submit that particular proposal, not just an implied requirement. If a contracting officer requires a proposal for a follow-on contract or for new requirements, or determines it is necessary to award undefinitized contractual actions, the Department will often be placed in the position of paying for the proposal and negotiation costs on a reimbursable basis with little or no competitive control over the costs incurred. Contracting officers should avoid placing the Government in this position.

If a contracting officer determines that allowing proposal preparation and negotiation costs to be charged directly to a contract is in the best interest of the Government, the contracting officer should consider controls on such costs. Examples include having the proposal preparation as a firm fixed priced (FFP) or Not-To-Exceed (NTE) contract line item. To help determine the FFP or NTE price for such work, we encourage contracting officers to examine the typical B&P costs, which are indirect charges that the contractor incurs for similar proposal preparations. In addition, we will soon be issuing a proposed DFARS rule (Case No. 2011-D042), that will provide a check-list to help gauge the adequacy of a contractor proposal.³ Such controls like this checklist, once finalized, will help prevent the Department from being billed for a substandard proposal package that will not adequately support negotiation of a reasonable price.

Office of the Under Secretary of Defense, Acquisition, Technology and Logistics, Mem., Direct and Indirect Charging of Contractor Proposal Preparation and Negotiation Support Costs 2 (Nov. 10, 2011).

³ This rule has been issued. See DFARS § 252.215-7009.

Classification as selling effort

VII. Classification as selling effort

In addition to IR&D and B&P effort, R&D efforts also may result in “selling” effort, depending upon the primary purpose for the effort. Selling effort is discussed in this section and M&PE is discussed in the following section.

The FAR recognizes that there are a variety of possible types of selling effort:

1. Advertising (subject to allowability provisions of FAR § 31.205-1(d) and (f));
2. Corporate image enhancement, including broadly targeted sales efforts, other than advertising (subject to allowability provisions of FAR §§ 31.205-1(e) and (f) and 31.205-14);
3. B&P costs (subject to allowability provisions of FAR § 31.205-18);
4. Market planning (subject to allowability provisions of FAR § 31.205-12); and
5. Direct selling (subject to allowability provisions of FAR § 31.205-38).

Only “direct selling” might include R&D efforts, creating a classification issue.

A. What is direct selling effort?

FAR § 31.205-38(b)(5) defines “direct selling” as:

[T]hose acts or actions to induce particular customers to purchase particular products or services of the contractor. Direct selling is characterized by person-to-person contact and includes such efforts as familiarizing a potential customer with the contractor’s products or services, conditions of sale, service capabilities, etc. It also includes negotiation, liaison between customer and contractor personnel, technical and consulting efforts, individual demonstrations, and any other efforts having as their purpose the application or adaptation of the contractor’s products or services for a particular customer’s use. (Emphasis added.)

Direct selling costs include all effort by the contractor’s personnel, including technical and scientific personnel, who engage in activities by which the contractor brings its products, services and capabilities to the attention of existing and potential customers. This effort is undertaken to stimulate the interest of various existing and potential customers, whether government or commercial, towards procurement

Classification as selling effort

of the contractor's products, services and capabilities, including potential products and services that the contractor reasonably intends to develop. The effort should be in support of sales promotion/marketing activities that are clearly not related to (in support of) a specific contract, B&P project or IR&D project.

The following are typical examples of effort that fall within the scope of direct selling costs:

1. Presentations and demonstrations to inform existing and potential customers of the contractor's products, services and capabilities.
2. Travel and shipping costs incurred in connection with personnel contacts and the above presentations.
3. Technical personnel support of tours of the contractor's facilities by potential customers to demonstrate that the contractor has the manufacturing, development and testing facilities to meet customer needs.
4. Preparation of planning documents for use in sales promotion/marketing activities and which involve the compilation of "existing data" related to the contractor's products, services and capabilities. Note that if the planning document is successful in stimulating customer interest, and the government issues an IFB, RFP or RFQ or the contractor internally decides to submit an unsolicited proposal, the ensuing proposal effort is B&P.
5. Sales promotion effort, including technical exchanges, which does not constitute an offer or quotation and which is not specifically oriented to an identified B&P project. This includes effort by technical and scientific personnel involved in the compilation and presentation of briefing and sales promotion material which is derived from existing information/data. Note that this effort does not include generating or developing the technology or product the contractor is trying to market. "Technical exchange" is limited to an exchange of existing data and should not involve effort intended to advance the "state of the art" at either the industry or the contractor level.
6. Written or oral communications of a technical nature between contractor personnel and potential customer personnel when promoting the contractor's products, services and capabilities. This includes the preparation of documents and graphics that form the basis of technical discussions with government agencies and prime

Classification as selling effort

contractors, and which may ultimately lead to the issuance of an RFP or the issuance of an unsolicited proposal.

7. Compiling existing data to answer questions posed by potential customers. This may involve: (a) a search of the contractor's records, scientific journals, textbooks and industry publications or use of the computer to process and retrieve existing data; (b) a compilation of findings; and (c) possibly some discussions in securing the answer desired by the potential customer. It may also involve interpolating and extrapolating existing data from curves or tables to answer customer questions. This effort specifically precludes development or product improvement-type work.
8. Literature searches in support of sales/marketing effort where the information/data is available either from the contractor's records, scientific journals, textbooks, industry publications, computer systems or is under study within the contractor or at other contractor facilities or institutions or known in concept, but does not in any way advance the "state of the art." The literature search/information gathering and compilation effort involves only the assemblage of existing data including the use of the computer to process and retrieve data where no extension of the "state of the art" is inherent in the computational process.

B. How to distinguish selling from IR&D and B&P effort

The most difficult issue regarding the classification of selling efforts is distinguishing between selling and B&P efforts. In general, the fundamental distinction between direct selling efforts and B&P efforts is whether there is a focus on a specific proposal opportunity. When a specific proposal opportunity exists, as discussed in Section VI, effort to support that focus is B&P once a decision is made to pursue the opportunity. In the absence of a specific solicitation, and prior to a firm decision to prepare a specific proposal, all activity, ranging from discussions with government personnel regarding new programs to early engineering analyses and investigations, should be classified as selling.

Classification as selling effort

The distinction between selling costs and IR&D is relatively simple. The definition of direct selling focuses on effort expended dealing directly with a customer. It would be rare for basic or applied R&D to have any aspect of direct customer contacts. Importantly, however, the development of a prototype solely to support a selling effort would be a selling cost. Of course, the results of R&D effort might be used in a direct selling effort, such as using a prototype developed under an IR&D project in a selling effort, but that does not make the underlying R&D effort selling effort.

Classification as selling effort

QUESTIONS & ANSWERS

Question 1: What kind of effort is included in the term “negotiation” as used in the FAR § 31.205-38 definition of “direct selling”?

“Negotiation” includes effort performed in negotiating a contract following the selection of the contractor by the procuring activity. Negotiation effort normally begins when the contractor’s bid or proposal has been accepted by the customer as technically acceptable and in the competitive range, but subject to final negotiation. Negotiation effort may continue through consummation of a signed contract with the customer. All effort performed to submit revisions or changes to a bid or proposal is classified as B&P and not selling costs. Technical and administrative effort to support the negotiations, (i.e., development of new cost, technical or scientific data specifically to support the bid or proposal) also is classified as B&P.

Question 2: What is the proper interpretation of the term “technical” as used in the definition of “direct selling”?

“Technical” is used within the definition of “direct selling” to include effort by technical and scientific personnel involved in sales promotion, negotiations, presentations, contacts, demonstrations and liaison with potential customers. This effort may include the systematic organization of data into a meaningful and useful format for presentations, briefings and other communications with prospective clients, but will not include generating a new product or technology which the contractor is marketing. Technical effort as applied to selling costs should not include that technical effort which: (a) is sponsored by, or required in performance of, a contract or grant; (b) falls within the scope of IR&D costs (i.e., basic and applied research, development or systems or other concept formulation studies); or (c) falls within the definition of B&P. “Technical” does include preparation for, and participation in, technical exchanges with potential customer personnel that involve presentations, discussions or compilation and exchange of existing data.

Question 3: What does the term “consulting” mean as used in the definition of “direct selling”?

“Consulting” is used within the definition of “direct selling” costs in a generic sense. It is a sales promotion effort where the contractor personnel work closely with the potential customer in recommending a particular program, part, component, process or test, discussing probable schedules, projecting

level of effort and presenting known techniques and processes as an aid to the potential customer. The effort under consulting generally occurs once the potential customer has indicated an interest in the contractor following the preliminary sales promotion or customer contact, usually by a marketing representative. The potential customer will ordinarily be in the process of considering future procurements but will not have reached the point of having definitized the requirement sufficiently to prepare an RFP. Consulting effort, as applied to selling costs, should not include technical effort which is sponsored by, or required in the performance of, a contract or grant, or which falls within the definition of IR&D or B&P.

Question 4: What is the meaning of the term “demonstration” in the definition of “direct selling”?

“Demonstration” is used within the definition of “direct selling” to include effort by technical and scientific personnel who, as part of a sales presentation or briefing, demonstrate an existing contractor product, part, component, test, technique or capability. The effort associated with the demonstration, such as compilation of existing data, preparation of displays and setup of equipment and product displays, are considered selling provided they are intended as direct support for a demonstration or briefing to existing or potential customer personnel who are technically competent to evaluate the product, service or capability.

Question 5: Under what circumstances may the costs of designing and fabricating models and mock-ups be classified as selling costs?

Only if the model or mock-up is used exclusively to demonstrate a product, and the cost of designing and fabricating the model is relatively low. If the model or mock-up will be used to support production engineering activities, use of the model or mock-up for customer demonstrations will not make the costs of designing and fabricating the model or mock-up selling costs. Alternatively, even if the model or mock-up is used solely for demonstration purposes, but the costs of fabrication are high, the costs properly should be charged to IR&D, provided that they otherwise meet the definition of IR&D.

Question 6: Are the costs of performing a market survey considered to be selling costs?

It depends upon whether the survey is long-range and its purpose. The effort of performing a long-range survey to assess what product a market might be interested in should be classified as economic planning costs under FAR § 31.205-12. The costs of effort for other market surveys to assess market interests can be classified as selling and the related costs are

Title

allowable to the extent that: (a) they are reasonable; and (b) their focus is upon determining the requirement for various types of products, services or capabilities, and whether it is worthwhile for the contractor to develop such products, services or capabilities. The costs of such surveys are more likely “direct selling” costs when the survey is tailored to specific customers or groups of customers or potential customers. This tailoring is consistent with the need for selling costs to be directed toward individual customers rather than more general marketing. Surveys to gather technical information to support R&D efforts or to identify new or improving systems, equipment or components are IR&D effort.

Question 7: If the government issues a “solicitation” which in part, or as a whole, is a preliminary request for information rather than a true RFP, how should the effort expended in preparing the contractor’s response to the RFI be charged?

The proper classification of this type of effort depends upon the nature of the government’s request for information and the contractor’s cost accounting practices. If the “request” is a formal RFI, the cost of responding to the RFI should be classified as selling cost. Further, if the RFI is more like a draft RFP, which is sufficiently vague so that the contractor is unable to project its response effort, the costs of responding may be classified as selling cost. On the other hand, if the contractor receives a draft RFP, which is specific enough on the agency’s planned acquisition of requirements to permit the contractor to begin its proposal effort, the contractor should classify the costs of responding as B&P, if consistent with its cost accounting practices.

Question 8: What does the term “product” in the selling cost principle mean?

With respect to the fabrication of any model or mock-up, the term “product” means that in order to be a selling effort, the effort relating to the model or mock-up should have occurred to demonstrate a potential product and not fabricated simply to verify a contractor’s design theories. On the other hand, the term does not mean that at the time the contractor begins its marketing efforts, a fully defined product should exist in order for the contractor to charge the costs of its efforts as selling cost.

Classification as M&PE effort

VIII. Classification as M&PE effort

The next type of effort that may involve R&D is M&PE costs. The FAR addresses M&PE at FAR § 31.205 25. That section defines M&PE to include all effort to improve the quality and efficiency of production processes, reduce manufacturing costs or utilize modern production methods. Significantly, the cost principle also includes in M&PE certain effort relating to the development of materials, equipment and tools, which are, or are intended to be, used in producing products or services, provided that the contractor does not then intend to sell the items. Any basic or applied research, however, is IR&D.

Two major classification issues exist for M&PE. The first is distinguishing when such effort is a direct or an indirect cost. Although the definition of M&PE, unlike the definitions of IR&D and B&P, does not contain an exclusion for contract work, properly classifying M&PE as contract or non-contract effort remains important. M&PE is contract effort when the costs of the effort are charged to a contract as a direct cost in accordance with the contractor's consistently applied cost accounting practices, while other M&PE effort is indirect effort where the related costs are charged as indirect costs.

The major difficulty in classifying M&PE effort occurs because M&PE efforts normally takes place just subsequent to the completion of an R&D effort or late in the performance of IR&D projects, making it difficult to distinguish the M&PE effort from contract or IR&D effort. For example, when the government is "sponsoring" R&D work through the use of research, development, test and evaluation (RDT&E) contracts, M&PE effort frequently will be undertaken late in the RDT&E effort to prepare the contractor for full scale development. Where it is clear that an RDT&E contract does not expressly require or sponsor the M&PE effort, the M&PE effort is an indirect expense if this classification is consistent with the contractor's cost accounting practices.

Thus, when a contractor enters into a contract with the government to produce certain specified parts and discovers that a particular process is needed to produce the parts, the development of that process is not a contract effort absent contract terms that require this effort or the contractor's consistently applied cost accounting practice is to classify the effort as contract effort. This applies to efforts aimed at gaining a basic understanding of the process, demonstrating the feasibility of the process or actually developing the process.

Classification as M&PE effort

Likewise, if a contractor enters into a contract with the government to produce certain specified parts and discovers that a particular process is needed to produce the parts, the cost of having a subcontractor develop that process is chargeable as indirect M&PE on the same terms as if the work were performed by the contractor. The fact that a subcontractor will perform the work does not change the fact that the costs of the effort should be charged by the contractor as direct or indirect costs consistent with relevant contract language and the contractor's cost accounting practices.

When assessing if M&PE effort is contract effort where the contract is silent on the issue, the requirements of CAS 404 ("Capitalization of Tangible Assets"), CAS 409 ("Depreciation of Tangible Capital Assets"), and FAR § 31.205 40 ("Special Tooling and Special Test Equipment Costs") are relevant. Assuming the M&PE effort relates to preparing an asset for use and is material, CAS 404 requires that the cost of the effort be capitalized if the useful life requirement is met. CAS 409 then requires that the cost be depreciated and allocated as an indirect cost, except in narrow circumstances. One such circumstance would be if the M&PE effort were to relate to items that are special test equipment or tooling under FAR § 2.101(b). Under that circumstance, FAR § 31.205 40 requires that the cost related to the special tooling or special test equipment be allocated directly to the benefiting government contract(s) for which it was required. Thus, absent specific contract language, the contractor's consistently applied cost accounting practices or other evidence showing the effort is contract effort, M&PE should be classified as indirect effort.

The second major classification issue relating to M&PE is distinguishing M&PE from IR&D effort. Properly distinguishing M&PE from IR&D remains important for at least two reasons. First, usually the costs are allocated over different allocation bases: IR&D being allocated over the contractor's general and administrative (G&A) base and M&PE being allocated over an overhead base. And second, for major contractors faced with the DFARS reporting requirement, discussed in Section XI, the failure to report an IR&D project renders the costs unallowable. This reporting requirement does not apply to M&PE.

Classification as M&PE effort

The difficulty in distinguishing M&PE from IR&D arises for reasons similar to why M&PE is difficult to distinguish from contract work. That is, M&PE often will occur near the end of an IR&D project when it becomes clear that a product can be developed and the means to manufacture the product should be developed. To develop the means, it is not unusual to apply some of the same technology that has been developed for the product. Thus, it is easy to overlook that M&PE effort is occurring. However, when development effort is being expended to develop materials, processes, equipment or other items for use in manufacturing, and not for sale, the effort is M&PE and should be distinguished from the ongoing IR&D in the same manner as necessary to separate generic IR&D from branch or derivative efforts.

QUESTIONS & ANSWERS

Question 1: Is there a “rule of thumb” for identifying what might be M&PE effort?

Yes, development effort related to the means or methods by which a product will be produced is likely M&PE and development effort relating to developing the product itself is IR&D.

Question 2: Is all effort necessary to prepare an asset for use in production of an item M&PE effort?

No, the effort should involve forms of “development” as that term is defined in FAR § 31.205-25.

Classification as other types of R&D effort

IX. Classification as other types of R&D effort

R&D efforts that do not fall into any of the categories discussed previously should be classified as one of the following: (a) capital asset effort; (b) program effort; or (c) general indirect effort.

A. Capital asset effort

Capital assets are either tangible or intangible. Regardless of the type of capital asset involved, the bottom line is that R&D effort undertaken for the primary purpose of possessing a capital asset is capital asset effort.

Regarding tangible capital assets, CAS 404 and 409, and FAR § 31.205-11, require that contractor effort to fabricate a tangible asset that meets the service life and cost requirements for capitalization be capitalized and depreciated.

Efforts expended to fabricate a tangible capital asset may include R&D effort when, for example, a test bed or a prototype is being fabricated. So long as this R&D effort is primarily intended to permit the fabrication of a tangible capital asset, it should be capitalized. In contrast, R&D effort to develop a product is IR&D effort, so long as it is not sponsored by a grant or required in the performance of a contract. Also, R&D effort to develop a manufacturing tool is M&PE, even though the fabricated tool is a capital item, unless the contractor's practice is to capitalize such costs.

The most common area of classification uncertainty regarding tangible capital assets relates to prototypes. An effort that is undertaken to fabricate a prototype with the purpose of using the prototype, for example, as a tool, a test bed or for demonstrating product capabilities to various buyers, would be a capital effort if the prototype service life and cost exceed the criteria under CAS 404 for capitalizing costs. In contrast, a prototype effort performed as part of an IR&D project to help evaluate the results of a development effort would be an IR&D effort.

An additional issue regarding classifying R&D effort as tangible capital asset effort exists when R&D supports the fabrication of tangible assets that are identical with, or substantially similar to, a contractor's product for sale. CAS § 404-50(b) recognizes that this occurs, but does not specifically address how to classify the R&D effort when it supports fabrication of a tangible asset, such as a prototype, as well

Classification as other types of R&D effort

as production of a product sold under a contract. While the facts regarding primary purpose always are relevant, the CAS 404 mandate to capitalize costs of fabricating tangible capital assets suggests that such effort may be capital effort and not contract effort. This is a gray area, however, suggesting that careful thought be given, and then documented, as to why the contractor is engaging in the R&D effort and then the effort should be classified accordingly.

Regarding intangible assets, no CAS or FAR provision addresses the measurement or assignment of these costs. Thus, unlike tangible capital assets, determining when R&D effort is intangible asset capital asset effort is a function of generally accepted accounting principles (GAAP) and a contractor's consistently applied practices.

The intangible capital asset most relevant to the classification of R&D effort is internal use software, which is software that is not a product for sale. Accounting Standards Codification (ASC) § 350-40 sets forth accounting requirements for internal use software. Generally, ASC § 350-40 provides that effort to develop internal use software should be capitalized as part of the software's capital costs. Thus, GAAP for internal use software is substantially similar to CAS 404 and 409 regarding what R&D effort should be classified as intangible capital asset effort.

B. Product line costs

The Federal Circuit's decision in *ATK Thiokol* states that a contractor's practice of accounting for R&D costs "required in the performance of a contract" as indirect costs is not improper, in certain cases, even when the costs are not IR&D. *ATK Thiokol, Inc. v. United States*, 598 F.3d 1329 (Fed. Cir. 2010). The Federal Circuit observed that "the contractor may treat some [R&D effort] as indirect [effort] because [it] benefit[s] an entire product line, even if they are expressly required by a particular contract and thus would not qualify as IR&D." See *id.* at 1332.

The basis for the Federal Circuit's observation is not clear. The Federal Circuit may be stating that R&D specifically required in a contract, while not IR&D, may be an indirect cost when the benefit runs to a product line. The difficulty with this reasoning is that this swallows the requirement of treating R&D specifically required by a contract as

Classification as other types of R&D effort

other than a direct contract cost. R&D effort that supports a product, by definition, almost always supports a product line. Thus, under the Federal Circuit's comment, classifying R&D effort as a direct contract cost would be rare.

Putting aside this specific Federal Circuit comment in ATK Thiokol just discussed, the question exists whether R&D effort required by the first of a likely string of contracts may be accumulated and spread over an entire product line or program as direct costs. Generally accepted accounting practices previously have recognized the appropriateness of so-called "program accounting" for government contracts, although in very limited circumstances. See AICPA Audit & Accounting Guide, Fed. Gov't Contractors, Am. Institute of Certified Public Accountants, Inc. ¶¶ 3.58-3.61 (2004), but see ASC § 912-20-00, which now casts doubt on the appropriateness of program accounting. Assuming program accounting remains a recognized GAAP practice in limited circumstances, appropriate use would comply with the FAR § 31.201-2(a)(3) requirement to comply with GAAP. Thus, with appropriate support, R&D effort may be able to be spread over a number of contracts.

C. Other indirect costs

When effort is not properly classified under any of the classifications discussed in this Practical Guide, the question is how should it be classified. Government contract cost accounting is based upon the concept of "full costing." This means that all costs must be allocated to final cost objectives, which leads to the requirement that all costs be classified to permit their proper allocation.

R&D costs that do not fall within any of the classifications discussed in this Practical Guide likely should be classified as simply overhead effort and the related costs should be included in the overhead pool that best relates those costs to the activities that benefit from these costs. For example, in a manufacturing context, the likely appropriate pool would be the manufacturing overhead pool. A contractor's specific circumstances, however, will dictate the appropriate overhead pool.

Accounting requirements

X. Accounting requirements

This section discusses the required accounting for the costs of an R&D effort once the effort has been classified properly.

A. IR&D and B&P costs

CAS 420 sets forth the requirements for measuring, assigning and allocating the costs of IR&D and B&P effort. FAR § 31.205 18(b) applies the measurement and assignment requirements of CAS 420 even to contracts not subject to CAS, provided the cost principles are applicable to the contract. FAR § 31.205 18(b)(2) adopts CAS 420 allocation requirements, so long as fully CAS-covered contracts are under performance. Otherwise, FAR § 31.205 18(b)(2) specifies rules for the allocation of IR&D and B&P costs to contracts otherwise subject to the cost principles.

The fundamental principle underlying CAS 420's measurement requirement is that the individual IR&D or B&P project is the basis for the identification and accumulation of costs of an IR&D or B&P effort. The project is the basis for identification because the purpose of the project defines what effort relates to the project in the same way a contract's SOW defines whether an effort is contract effort. In other words, an IR&D or B&P project is treated as a final cost objective for cost accumulation purposes with the exception of G&A costs, as discussed below.

Once an IR&D or B&P project exists, CAS 420 requires that all costs, except G&A costs, allocable to a project, pursuant to the contractor's consistently applied cost accounting practices, be accumulated for that project. This requires accumulating for each project all labor, material and other costs that would be charged as direct costs to final cost objectives, if incurred in like circumstances. Overhead costs should be allocated to each project in an amount equal to the amount the contractor's cost accounting practices would require to be allocated. In other words, the contractor should follow its standard cost accounting practices for measuring IR&D and B&P costs. See 48 C.F.R. §§ 9904.420 40(a), (b), 50(a).

The CAS 420 assignment requirement is that accumulated IR&D and B&P costs should be recognized in the year incurred, except that IR&D costs may be deferred when permitted by law, regulation "and other controlling factors." 48 C.F.R. § 9904.420 40(f). For a regulatory

Accounting requirements

example of a permissible deferral, see FAR § 31.205 18(d), which creates a very narrow circumstance for deferral.

The allocation requirements in CAS 420 are complex. The ultimate objective is to allocate IR&D and B&P costs to the final cost objectives of the segment(s) that caused or benefited from the projects.

The first step in the allocation process is to develop IR&D and B&P cost pools for each performing segment, or home office, that actually performs IR&D or B&P effort, by adding together the costs accumulated for all IR&D and all B&P projects of the segment or home office. 48 C.F.R. §§ 9904.420 40(c), 50(b).

The second step in the allocation process is to adjust segment and home office IR&D and B&P cost pools, developed in the manner just described, as follows.

1. When a segment performs IR&D or B&P effort for another segment that is not IR&D or B&P of the performing segment, the relevant costs should be transferred to the IR&D or B&P cost pool of the non-performing, but benefiting, segment. Such a transfer is required when the performing segment receives no benefit from the project. The existence of a planned project at the performing segment is evidence of benefit to the performing segment. When the costs are IR&D or B&P costs only of the non performing segment, the performing segment should transfer the full cost of that effort, plus allocable G&A (an exception to the general rule that IR&D and B&P costs do not include G&A costs), to the other segment. Such a transfer reduces the performing segment's IR&D or B&P cost pool and increases the other segment's IR&D or B&P cost pool. See 48 C.F.R. § 9904.420 50(d). Essentially, this accounting mirrors the accounting required when the performing segment performs R&D effort under a contract.
2. Segment IR&D and B&P cost pools should be reduced by the cost of projects (without any G&A) that benefit the performing segment, as well as one or more other segments. The cost of such projects, but without any G&A allocation, should be transferred to and accumulated in a cost pool at the home office appropriate for allocation to all benefiting segments. 48 C.F.R. § 9904.420 50(d), (f)(1).
3. Home office and segment IR&D and B&P cost pools, developed as just described in Steps 1 and 2 above, are to be allocated as follows.

Accounting requirements

Each home office IR&D and B&P cost pool is to be allocated to benefiting segments essentially in the manner dictated by CAS 403. 48 C.F.R. §§ 9904.420 40(d), 50(e). Each segment IR&D and B&P cost pool, plus any home office allocation to the segment, is to be allocated to the segment's final cost objectives, using the segment's G&A allocation base. 48 C.F.R. §§ 9904.420 40(e), 50(f)(2).

The accounting requirements for IR&D and B&P costs under CAS 420 are summarized in **Figure B**.

B. Capital asset costs

CAS 404 and 409 address the accounting for the costs of tangible capital assets. The basic requirement is to measure the capitalized cost at the asset's acquisition cost. 48 C.F.R. §§ 9904.404-40(a), -50(a).

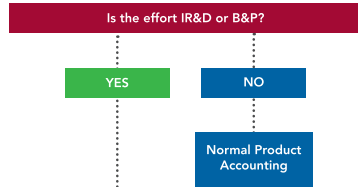
When a tangible capital asset is fabricated, CAS § 404-50(b) describes the measurement of the asset's acquisition cost. Essentially, the fabrication effort is to be a final cost objective that accumulates all direct and appropriate indirect costs. Indirect costs are to include G&A costs when management provides identifiable support to the capital effort or the effort will result in assets identical to, or similar to, a contractor product.

CAS § 409-40(a) requires that the capitalized cost be assigned over the years of the asset's useful life, using an appropriate depreciation methodology. CAS § 409-40(b) requires that the depreciation cost assigned to a given cost accounting period either be allocated directly to contracts (occurs in limited circumstances), be included in the cost pool for the service center using the assets for allocation to users of the service center or be included in an appropriate indirect cost pool for allocation.

ASC § 350-40-35 addresses the accounting for intangible assets that are internal use software. ASC 350-40 requires that capitalized costs include all costs with the exception of indirect costs. It also requires that the capitalized cost be amortized over the internal software's useful life on a straight-line basis absent a methodology that is more representative of the software's use. Amortization costs measured and assigned on this basis should be allocated in accordance with CAS 402 and 418.

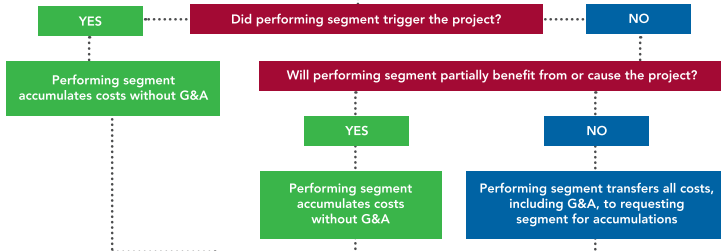
Accounting requirements

FIGURE B – ACCOUNTING FOR IR&D AND B&P COSTS

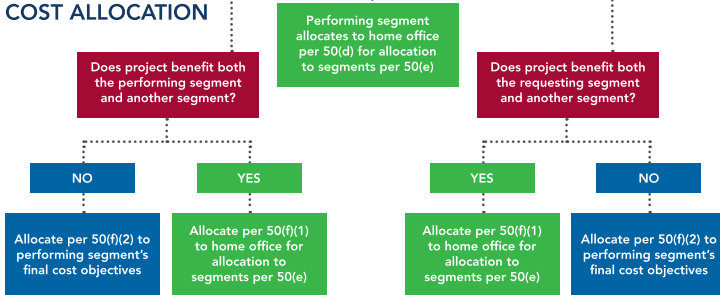


COST IDENTIFICATION

COST ACCUMULATION



COST ALLOCATION



Accounting requirements

C. Other R&D effort costs

The CAS and FAR do not contain specific accounting requirements for the cost of selling, M&PE, program or general indirect R&D efforts. Thus, contractors should develop, and then follow consistently, practices for the proper allocation of these costs, as measured and assigned pursuant to GAAP, as home office costs (see CAS 403) or as segment G&A costs (see CAS 410) or as segment overhead costs (see CAS 418). Such costs are rarely direct contract costs. In practice, contractors are divided between classifying selling costs as overhead or G&A costs. In contrast, M&PE costs are most often allocated as overhead costs, often through a manufacturing cost pool when one exists.

Accounting requirements

QUESTIONS & ANSWERS

Question 1: How is IR&D effort distinguishable from capital asset effort?

IR&D effort is effort that has as its primary purpose a potential product for sale. Capital effort is effort that has as its primary purpose a tangible or intangible item that is not for sale and will provide benefits to contractor operations over more than two years and exceeds the contractor's capitalization threshold.

Question 2: If R&D costs should be classified as program costs, will they be unallowable costs?

No, FAR § 31.205 does not provide that such costs are unallowable. The government, however, often attacks program costs on the basis of a violation of CAS 406, arguing that assigning these costs over two or more cost accounting periods is improper. Often this argument is incorrect. Nevertheless, obtaining an advance agreement under FAR § 31.109 is a recommended course of action.

Question 3: Should a contractor simply label all R&D costs not specifically required by a contract as "other indirect costs"?

No, this approach fails to comply with the CAS and FAR. The primary purpose of an effort determines its proper classification. An R&D effort is an "other indirect cost" only when the effort's primary purpose is not related to a potential product (IR&D), a proposal (B&P), direct selling, manufacturing capabilities (M&PE), a capital asset or a specific program.

Question 4: Should effort performed pursuant to cooperative agreements and cooperative arrangements be accounted for in accordance with CAS 420?

Yes, the FAR defines that effort as IR&D effort and permits recognition of the resulting costs, net of any reimbursement, as IR&D costs.

Question 5: Does CAS 420 require a contractor to use any cost accounting practices that it does not otherwise use to account for its costs in general?

No, with one exception. To measure the cost of an IR&D or B&P project, the contractor should follow the same accounting practices it follows to measure the cost of a contract, with the exception that G&A is not allocated to a segment's IR&D or B&P projects unless the project is performed for another segment and does not benefit the performing segment.

Accounting requirements

Question 6: May a contractor choose to charge to an IR&D or B&P project the cost of a type of effort that in other circumstances would be classified as an indirect cost?

the contractor should accumulate IR&D and B&P costs in accordance with its cost accounting practices applied consistently. Thus, if the effort in question would result in indirect costs in similar circumstances, that cost may not be accumulated directly in the costs of an IR&D or B&P project, but only may be allocated as overhead costs to IR&D or B&P projects.

Question 7: Because the contractor should follow its cost accounting practices when measuring the cost of IR&D and B&P projects, when should a contractor include in the cost of such projects the acquisition cost of a tangible asset?

The total acquisition cost of a tangible asset should be included in the cost of an IR&D or B&P project as a direct cost only if, consistent with the contractor's consistently applied cost accounting practices: (a) the asset's cost is not capitalized and its intended use is solely for a project (see CAS 411); or (b) the asset's cost is capitalized and direct charging of depreciation costs is appropriate under CAS § 409-40(b)(1). Under most contractors' cost accounting systems, the acquisition cost of a tangible capital asset is rarely charged directly to a contract. Rather, the cost is capitalized and depreciated, and the depreciation cost is allocated as an indirect cost. Thus, depreciation costs included in an overhead pool would be allocated to IR&D and B&P projects in accordance with the contractor's consistently applied cost allocation practices for overhead costs.

Question 8: When would a segment perform an IR&D or B&P project for another segment without benefiting from the project, requiring that the cost of the project, plus allocable G&A, be transferred?

CAS § 420 50(d) describes the pertinent circumstances as: (a) a project is performed by one segment at the request of another segment; and (b) the effort is not part of an IR&D or B&P project intended to benefit, at least in part, the performing segment. Whether or not a final plan or list of projects for a segment exists, the essential test under CAS § 420 50(d) is the presence or absence of a benefit to the performing segment other than merely performing the work and generating revenue.

CAS 420 supports the focus on the benefit to the performing segment because examples in CAS 420 recognize that a segment can be benefited directly by a project it performs or benefited indirectly because the project benefits the contractor as a whole. See 48 C.F.R. § 9904.420 60(d)-(g).

Accounting requirements

Accordingly, where the performing segment benefits from IR&D or B&P projects only through the generation of revenue (or, in other words, in the manner as if it performed a contract), the performing segment should transfer the costs of its performance, plus allocable G&A, to the requesting segment.

Question 9: DCAA sometimes will take the position that contractors should account for all costs of performance under an “other transaction” or a cooperative arrangement consistently. Is that guidance correct?

CAS 402 requires that costs incurred for like purposes in similar circumstances be accounted for consistently, so that the relevant costs are either direct or indirect. From that conclusion, DCAA sometimes will state that if a contractor classifies costs of performing an “other transaction” or a cooperative arrangement as direct costs to the extent reimbursed and as indirect IR&D costs to the extent not reimbursed, the contractor is in violation of CAS 402.

DCAA's conclusion is incorrect because it is founded upon an incorrect assumption. Under FAR § 31.205 18, contractors may classify the cost of all effort under “other transactions” and cooperative arrangements as IR&D costs, assuming the effort is of a type to be IR&D, and then reduce that cost (i.e., credit project costs) for any reimbursement. A contractor accounting for its “other transactions” and cooperative arrangements in this manner complies with CAS 402 because the costs are IR&D costs, which are subject to reduction due to reimbursement.

Question 10: May IR&D costs include the value of intellectual property “contributed” under a cooperative arrangement?

Yes, in the proper circumstances. A cost exists under the CAS when a contractor incurs an economic sacrifice. The use of intellectual property in the performance of a cooperative arrangement will result in a cost, therefore, to the extent it results in an economic sacrifice because, for example, revenue has been foregone or an ownership interest reduced. The issue in that circumstance will be measuring the cost.

DCAA issued guidance in early 1999 that a contractor may not claim as a cost, for cost sharing purposes under an “other transaction,” the cost of prior research. DCAA's opinion has support to the extent that a cost previously incurred cannot be incurred a second time. See DCAA, DOD Mem. No. 99 PSP 043(R), Audit Guidance on Acceptability of Prior Research Effort on Other Transaction Agreements (OTAs) (1999). To the extent that DCAA implies that the use of intellectual property can never result in a cost, DCAA is incorrect, as just discussed.

Cost reimbursement

XI. Cost reimbursement

Once R&D effort has been classified and accounted for properly, the last issue is whether the government will reimburse the cost; i.e., are the costs allowable. Reimbursement here means that the government will recognize the cost for purposes of its own negotiation position for pricing fixed-price contracts, measuring incentives under fixed-price contracts or reimbursing costs under cost-type contracts. Contract effort, of course, is reimbursable under the terms of the contract. The discussions below, therefore, focus on reimbursement of costs for non-contract work.

A. IR&D and B&P costs

Whether IR&D and B&P costs are reimbursable was tightly controlled by regulation through September 30, 1992. After that date, a three-year phase-out of the strict controls occurred. Since October 1, 1995, IR&D and B&P costs have not been subject to any restrictions under the FAR other than the general reasonableness and allocability standards in FAR §§ 31.201-3 and -4. See FAR § 31.205-18(c).

Since 1995, DOE has limited IR&D costs allowable under DOE contracts to projects that have relevance to DOE. See DEAR § 931.205-18. DOD adopted this policy in 1999 for IR&D and B&P costs of “major contractors,” and, in 2012, added other allowability restrictions on IR&D costs through changes to DFARS § 231.205-18. Thus, when addressing IR&D or B&P cost allowability issues, the date of cost incurrence and the terms of the relevant contracts and associated cost principles should be considered carefully.

Specifically, prior to October 1, 1992, contractors of a certain size were required to negotiate advance agreements and reimbursement ceilings on IR&D and B&P costs. For example, just prior to October 1, 1992, a contractor that received payments for IR&D and B&P costs in a fiscal year, either as a prime contractor or subcontractor, exceeding \$7 million from government agencies was required to enter into an advance agreement that established a ceiling for the allowability of IR&D and B&P costs for the following fiscal year. “Old” FAR § 31.205-18(c)(1)(i). If the contractor exceeded the ceiling, the excess was unallowable.

Effective October 1, 1992, Congress mandated a phase-out of the then-current requirements. During the three-year phase-out, the cost allowability ceilings were gradually removed.

Cost reimbursement

On December 9, 1997, the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council agreed on a final rule amending FAR § 31.205-18 for fiscal years beginning after September 30, 1995. That final rule removed the requirements to negotiate a ceiling for IR&D and B&P costs. In addition, paragraph (c) of FAR § 31.205-18 was completely revised from the “long version” to the following simple statement: “Allowability. Except as provided in paragraphs (d) and (e) of this subsection, or as provided in agency regulations, costs for IR&D and B&P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.” The FAR final rule was effective February 9, 1998.

Paragraph (d) provides that deferred IR&D costs are allowable only in very limited circumstances. Thus, as a general rule, deferred IR&D is unallowable.

Paragraph (e) provides that the unreimbursed costs of R&D efforts performed pursuant to a “cooperative arrangement” are allowable IR&D costs. Paragraph (e) recognizes that while “cooperative arrangements” are contracts, they are not contracts to which the FAR and CAS apply because they are not acquisition contracts under FAR § 2.101. See Section IV.C.3.

DOD modified DFARS § 231.205-18, effective February 23, 1999, to supplement FAR § 31.205-18, as it existed then, and as it essentially exists as of the date of this Practical Guide. This DFARS modification began a trend of creating allowability differences between contracts awarded by DOD and contracts awarded by agencies subject solely to FAR § 31.205-18 and DOE, which addresses IR&D in DEAR § 931.205-18.

As of 1999, for DOD contracts, DFARS § 231.205-18 limited the allowability of IR&D and B&P costs beyond the FAR limits for “major contractors.” Thus, for a contractor that is not a major contractor, the allowability of IR&D and B&P costs under DOD contracts was limited only by the FAR.

DOD again modified DFARS § 231.205-18, effective January 1, 2012. As modified, DFARS § 231.205-18 continues to limit the allowability of IR&D and B&P costs as follows:

- (A) The amount of IR&D/B&P costs allowable under DOD contracts shall not exceed the lesser of —

Cost reimbursement

- (1) Such contracts' allocable share of total incurred IR&D/B&P costs; or
 - (2) The amount of incurred IR&D/B&P costs for projects having potential interest to DOD.
- (B) Allowable IR&D/B&P costs are limited to those for projects which are of potential interest to the DOD, including activities intended to accomplish any of [seven listed goals].

DFARS § 231.205-18(c)(iii)(A), (B).

limitations just described apply only to "major contractors," defined as a contractor whose "covered segments allocated more than \$11,000,000 in IR&D and B&P costs to covered contracts in the preceding year." A "covered segment" is either a "product division" that allocated more than \$1.1 million in IR&D and B&P costs to DOD contracts in the preceding year or, if no "product divisions" were to exist, it is the contractor as a whole. A "covered contract" is a contract or subcontract above the simplified acquisition threshold, other than a fixed-price contract or subcontract without cost incentives. A "product division" that does not meet the \$1.1 million threshold is not subject to the allowability restrictions. Thus, a contractor might have segments that do not count for determining whether the contractor is "major" or, if the contractor is "major," do not generate IR&D or B&P costs unallowable under the DFARS § 231.205-18. See DFARS § 231.205-18(a), (c)(ii), (c)(iii)(A)-(B).

DFARS § 231.205-18, effective June 16, 2015, reinstated the language that the administrative contracting officer (ACO) shall determine whether IR&D and B&P projects performed by major contractors are of potential interest to DOD. See DFARS § 231.205-18(c)(iv)(A). This determination is relevant to the allowability criterion identified previously that IR&D and B&P project costs should result from projects having potential relevance to DOD. See DFARS § 231.205-18(c)(iii)(A)(2), (B).

Importantly, DFARS § 231.205-18, as modified, contains a restriction on the allowability of a major contractor's IR&D costs. This restriction applies to IR&D projects, the costs of which are incurred on or after January 1, 2012, and are allocated to contracts awarded or modified on or after January 1, 2012.

DFARS § 231.205-18(c)(iii)(C) states that "[f]or a contractor's annual IR&D costs to be allowable, the IR&D projects generating the costs

Cost reimbursement

must be reported to the Defense Technical Information Center... using the...on-line input form.” This reporting is to begin no later than three months after the end of the fiscal year in which the contractor initially incurs the associated IR&D costs, is required to be updated annually and is required when a project is completed. See DCAA, DOD Mem. No. 14-PAC-005(R), Audit Guidance on Allowability of Independent Research and Development under January 2012 Change to DFARS 231.205-18(c)(iii)(C) (2014). The cognizant ACO and auditor are to be copied. The apparent intent of this reporting is to permit the ACO to make a determination of potential relevance to DOD. Thus, major contractors should ensure cost allowability by providing the required reports timely and ensuring that the relevance of an IR&D project to DOD is easily understandable to an ACO and to an auditor in order to avoid disagreements regarding allowability. Disagreements regarding potential relevance to DOD will parallel the disagreements that occurred up through 1992, during the era of negotiating IR&D cost ceilings. Moreover, while contractors that do not meet the major contractor threshold are not required to report IR&D in the DTIC, they are “encouraged to input their IR&D projects...to provide DoD with visibility into the technical content of their activities.” DOD Instr. No. 3204.01, DoD Policy for Oversight of Independent Research and Development (IR&D) (2014).

As with any other reporting requirement, contractors should ensure that information supplied to the government is current and accurate. Additionally, given the heightened attention on IR&D costs, and the importance of ensuring that only costs of effort not required in the performance of a contract are claimed, major contractors reporting on their IR&D projects through the DTIC should take care that personnel describing the projects are precise in their descriptions and attentive to detail. Finally, major contractors that fail to properly report IR&D projects in the DTIC will face not only potential cost disallowances, but also potential penalties because DCAA has taken the position that a failure to report properly renders the associated IR&D costs expressly unallowable under the DFARS cost principle and the auditors are advised to consider whether a failure to report signals a failure in the contractor’s internal controls, which could result in an accounting system deficiency. See DCAA, DOD Mem. No. 14-PAC-005(R), Audit Guidance on Allowability of Independent Research and Development under January 2012 Change to DFARS 231.205-18(c)(iii)(C) (2014).

Cost reimbursement

DOD's Better Buying Power 3.0 initiative and an August 26, 2015 White Paper further signal potential changes to the allowability of IR&D costs allocated to DOD contracts. Specifically, DOD has indicated that it will begin requiring that all contractors ensure that, prior to initiating an IR&D project, a technology interchange meeting with DOD personnel occurs. It remains unclear, as of the publication of this Practical Guide, precisely what amount of information exchange must occur, whether approval must be obtained from the DOD personnel, or if DOD can reject an IR&D project on the basis that it is not appropriately aligned with DOD's interest. What these continuing changes do show is that DOD is continuing to struggle to find the balance between oversight, on the one hand, while simultaneously avoiding imposing bureaucratic requirements that stifle the very independence and innovation that IR&D has long produced.

DOE's cost principle on IR&D in the DEAR contains a limitation on allowability similar to the DFARS' limitation, though without DOD's added online reporting requirement. DEAR § 931.205-18 provides:

IR&D costs are recoverable under DOE contracts to the extent they are reasonable, allocable, not otherwise unallowable, and have potential benefit or relationship to the DOE program. The term "DOE program" encompasses the DOE total mission and its objectives. B&P costs are recoverable under DOE contracts to the extent they are reasonable, allocable, and not otherwise unallowable.

This rule applies to all DOE contractors.

B. Capital costs

FAR § 15.205-11 provides that depreciation costs are allowable when the contractor complies with CAS 409. When CAS 409 is not applicable, the depreciation costs are allowable when the contractor complies with GAAP.

C. Selling, M&PE, program and general indirect costs

The FAR and the various FAR supplements do not specifically limit the allowability of direct selling, M&PE or other indirect costs. So long as the costs are reasonable, allocable and allocated in accordance with CAS, they are allowable absent a special contract clause that provides that such costs are unallowable. FAR § 31.205-38, however, provides that selling costs, other than direct selling costs, are unallowable.

Cost reimbursement

QUESTIONS & ANSWERS

Question 1: Are proposal costs for cooperative arrangements allowable B&P?

Previous FAR revisions broadened the classification of allowable IR&D costs to allow IR&D costs performed by contractors working jointly pursuant to a cooperative arrangement. FAR § 31.205-18(e). A question existed, however (prior to a FAR clarification), whether the costs of preparing and submitting a bid to obtain a cooperative arrangement would be allowable as B&P costs. After all, the FAR definition of “Bid and Proposal Costs” states that the term “does not include the costs of effort sponsored by a grant or cooperative agreement...” FAR § 31.205-18(a).⁴

On December 9, 1997, the FAR was amended to clarify that “costs incurred in preparing, submitting, and supporting offers on potential cooperative arrangements are allowable to the extent they are allocable, reasonable, and not otherwise unallowable.”

Question 2: What does potential relevance to DOD mean?

DFARS § 231.205-18(c)(iii)(B) lists seven areas of interest to DOD. An IR&D or B&P project is of relevance to DOD if the project has the potential to produce research or development results or relates to a procurement opportunity that may be reasonably tied to any of the seven listed areas of interest. A project’s potential is a function of the project’s goal and the activities that will be engaged in to achieve the project’s goal.

⁴The legislative history of the statutory change states:

The conference agreement would eliminate both the advance agreement and formal technical review processes. All independent research and development and bid and proposal costs would be reimbursed to the extent that they are reasonable, allocable, and not otherwise made unallowable by law or regulation. The conferees note that in the past, questions have arisen as to whether such costs, when incurred by a contractor through participation in consortia or cooperative agreement, would be reimbursable. The conferees agree that such costs should be reimbursed. Under the conference agreement, such costs would be fully reimbursable to the extent that they are reasonable, allocable, and not otherwise disallowed under applicable laws or regulations.

H.R. Conf. Rep. No. 102-311 (1991), reprinted in 1991 U.S.C.C.A.N. 1042, 1124 (emphasis added).

Cost reimbursement

Question 3: What type and what level of information is needed to meet the reporting requirement and to establish potential relevance while protecting trade secrets and confidential business information?

In the notice and comment period associated with the DFARS changes in 2012, a number of concerns were raised regarding DTIC reporting and the potential compromise to contractor trade secret and otherwise confidential and business sensitive information. Specifically, comments were submitted urging that DOD ensure that contractor trade secrets and proprietary information is protected. In fact, DOD had concerns with the security of proprietary information contained in the DTIC database, as discussed in a September 2008 presentation by the Deputy Undersecretary of Defense, International Technology Security.

In issuing the final rule, DOD addressed the various comments that were raised by explaining that DTIC had advised DOD that adequate controls are in place to protect information from compromise. DOD also explained that only unclassified IR&D project summary information should be provided and that information submitted is within the scope of Freedom of Information Act Exemption 4. 5 U.S.C. § 552(b)(4).

As to how much information needs to be disclosed under the DFARS reporting requirement, no specific guidelines exist, but it is the contractor's obligation to reasonably explain why the project is of interest to DOD. When in doubt, a contractor should consider previewing a DTIC submission with the cognizant ACO to test whether the submission contains sufficient information or if more information is needed before uploading the information to DTIC. By communicating with the cognizant ACO in advance, major contractors are likely to be able to find a balance between over- and under-reporting information in DTIC.

Proper policies and procedures

XII. Proper policies and procedures

Adequate monitoring and educational programs should be in place to ensure that: (a) the individuals who are making classification decisions regarding R&D costs are making the right decisions; (b) appropriate documentation exists to support decisions; (c) senior contractor personnel review such decisions and consult with counsel when necessary; (d) adequate training is provided; and (e) adequate internal reviews occur.

As the first step to achieving and maintaining compliance, contractors need to establish written internal policies and procedures regarding the classification of, and accounting for, the costs discussed in this Practical Guide. These policies and procedures should be clear and followed consistently. Clear policies and procedures serve to foster confidence within the government auditing community and, thus, may preclude needless challenges. In addition, established policies and procedures could prove useful in the event the government later challenges the allowability of IR&D and B&P costs. Some suggested guidelines follow.

A. Classification of effort

1. Adopt written appropriate policies and procedures.
2. Define the relevant types of effort.
 - a. The policies and procedures should define for R&D costs the following types of effort: (1) contract; (2) IR&D; (3) B&P; (4) selling; and (5) M&PE.
 - b. The policies and procedures should specifically state that, for IR&D and B&P, the phrase “required in the performance” includes only effort that: (1) is required as a CLIN or is expressly required under the contract’s SOW or specification, is being funded by contract, or is included in the costs that support the negotiated contract price; and (2) does not include work that merely supports, is related to, or provides an indirect benefit to ongoing contractual effort.
 - c. The policies and procedures also should provide that the classification of other types of R&D work is a function of the contractor’s definition of direct and indirect costs and the terms of any relevant contracts.

Proper policies and procedures

3. Create controls appropriate to ensure proper classification.
 - a. The policies and procedures should set forth internal review and control procedures to assure the proper initial and continuing classification of effort. The internal review and control procedures, at a minimum, should require that:
 - i. The classification decision be made by other than the individual(s) responsible for performing the effort and authorizing the effort.
 - ii. The classification decision be made before the effort occurs, or as soon as possible thereafter.
 - iii. The basis for the classification decision be documented.
 - iv. A control exists so that any change in circumstances will trigger the need to revisit the determination by the reviewing authority for a determination of whether a change in classification is required.
 - v. Internal audit review of classification decisions to ensure compliance with the policies and procedures.
4. Provide the policies and procedures to the government.
 - a. Furnish the policies and procedures to the cognizant ACO(s) and individual government contract negotiators as part of cost or pricing data submissions required under FAR Subpart 15.4.
5. Disclose related IR&D projects in proposals.
 - a. Disclose related, parallel IR&D projects in contract proposals, document the distinctions between these IR&D projects and the anticipated contract work, and try to obtain a bilateral agreement, or at least a return letter from the government, that describes the IR&D project as extra contractual.
6. Obtain approval to substitute IR&D effort.
 - a. Infuse IR&D results into a contract, in place of an approach previously pursued under contract, only with the contracting officer's approval and a resulting closure of the IR&D project.

Proper policies and procedures

7. Clearly delineate IR&D effort in contract reports.
 - a. Contract reports that reference existing or potential IR&D projects should do so only in a clearly delineated section of the report that reflects the extra contractual nature of the IR&D efforts under discussion.
8. Timely report IR&D project information annually (within 30 days of the end of a contractor's fiscal year) and upon project completion.
 - a. The change to DFARS § 231.205-18 requires this, and noncompliance may result in the disallowance of IR&D costs and potential imposition of penalties under CAS 405 and FAR § 42.709.

B. Accounting

1. Describe relevant accounting practices.
 - a. These descriptions should be found in the CAS Disclosure Statement and supplemental procedures and desk references.
2. Achieve proper accounting and reasonable audit trails.
 - a. The contractor's cost accounting system should result in proper accounting and reasonable audit trails by assigning a project work order number to each IR&D or B&P effort and achieving documented proper time charging and cost coding for other costs that result in costs being charged to the correct cost objective for cost accumulation purposes.

C. Create instructions for the internal audit/compliance organization

For the contractor's internal audit/compliance organization, create standard instructions on how to examine cost accounts containing the cost of any R&D effort.

D. Perform adequate training

Adequate training requires that the correct contractor personnel within each functional area with responsibility for compliance (accounting and finance, engineering, contracts, legal, etc.) be trained on a routine basis. Each of these individuals will make decisions that impact the ability to properly manage, account for and be reimbursed for the costs of R&D effort.

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ATK Thiokol, Inc. (now known as ATK Launch Systems, Inc.), Plaintiff-Appellee v. United States, Defendant-Appellant

No. 2009-5036

March 19, 2010

BACKGROUND

Contractor sued United States, seeking to recover development effort costs incurred to upgrade rocket motors as indirect independent research and development (IR&D) costs across all contracts, both government and commercial, rather than only as direct costs of commercial contract. The United States Court of Federal Claims, Susan G. Braden, J., 68 Fed.Cl. 612, granted contractor partial summary judgment. Government appealed.

HOLDING

The Court of Appeals, Bryson, Circuit Judge, held that development effort costs were chargeable as indirect IR&D costs for government contract accounting.

Affirmed.

SUMMARY

ATK Thiokol, Inc., manufactures rocket motors for government and commercial buyers. One of its products is the Castor family of solid rocket motors, which are “strap-on” motors designed to attach to a launch vehicle and provide additional thrust. In the 1990s, ATK began developing the Castor IVA-XL rocket. In 1995, ATK announced that it was closing the Huntsville, Alabama, plant where it had previously built the Castor IVA-XL motor. At that time, ATK analyzed each of the products made by the Huntsville plant as part of a corporate restructuring effort. ATK determined that there was a market for the Castor IVA-XL motor and that the motor would be more competitive if it were upgraded. Specifically, ATK decided to make technical changes to the motor’s design and test fire the motor. The parties refer to those steps as the “Development Effort.” ATK moved production of the Castor IVA-XL motor to its Utah facility in 1995. From 1995 through 1999, ATK marketed

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the upgraded motor to various potential customers, including McDonnell Douglas, Lockheed Martin, and the U.S. Air Force.

In February 1996, the Japanese company Mitsubishi Heavy Industries expressed interest in purchasing modified Castor *1331 IVA-XL motors for Japanese government launch vehicles. While Mitsubishi was willing to pay for adapting and attaching the motors to the launch vehicles, it refused to pay for the more general, nonrecurring work associated with upgrading the Castor IVA-XL motor, in particular the Development Effort. On June 8, 1997, Mitsubishi executed a Statement of Work with ATK. The Statement of Work required ATK to deliver the motor that ATK was updating “to support the general requirements of the strap-on market.” ATK began the Development Effort in July 1997. In October 1998 ATK and Mitsubishi executed a final contract for the purchase. The contract provided for a lump-sum payment for each upgraded motor and a price for modifying each motor to fit to the Japanese launch vehicles. There was no provision for payment of the Development Effort costs.

ATK accounted for the Development Effort costs as indirect independent research and development (“IR & D”) costs and disclosed them as such in a proposed advance agreement submitted in 1997 to a U.S. Defense Department Divisional Administrative Contracting Officer (“DACO”). The effect of including particular charges as indirect IR & D costs is that the charges are allocated to all of the contractor’s contracts for the year, including government contracts. ATK’s consistent and disclosed accounting practice was to treat research and development 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. From 1990 through 1997, the Defense Department had periodically reviewed that accounting practice and found it to be in accordance with the accounting regulations applicable to government contractors.

In March 1999, however, the DACO issued a notice of intent to disallow the cost of the Development Effort for the upgraded Castor IVA-XL motor by removing that cost from the category of indirect IR & D. The DACO noted that the definition of IR & D in the Federal Acquisition Regulation (“FAR”) excludes efforts “required in the performance of a contract.” The DACO reasoned that, because the upgrade cost was necessary to the performance of the Mitsubishi contract, the Development Effort did not qualify as IR & D and that it had to be charged, if at all, directly to the Mitsubishi contract.

ATK filed an action in the Court of Federal Claims, arguing that the DACO's refusal to treat the Development Effort costs as indirect IR & D was improper. The court found that ATK and Mitsubishi did not intend to include the Development Effort costs among the costs paid for under the contract, that the commercial market for the upgraded Castor motor appeared viable, that the allocation of the Development Effort costs to indirect IR & D was in accordance with ATK's disclosed accounting practices, and that the government had not contended that the Development Effort costs were unreasonable. *ATK Thiokol, Inc. v. United States*, 68 Fed.Cl. 612, 640-41 (2005). Based on those findings, and after reviewing the pertinent FAR provisions, the corresponding sections of the Cost Accounting Standards ("CAS"), and the regulatory history of those provisions, the court held that the Development Effort costs were chargeable as indirect IR & D. *Id.* at 641. The government appeals from that decision.

Whether particular research and development costs qualify as indirect IR & D for purposes of government contract accounting is determined by several interrelated regulations. First, section 402 of the Cost Accounting Standards, 48 C.F.R. § 9904.402 ("CAS 402"), defines direct and indirect costs. A "direct cost" is "any cost which is identified specifically with a particular final cost objective"; an "indirect cost" is "any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives, or at least one intermediate cost objective." CAS 402-30(a)(3), (4). 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 CAS 402-20; see also *Boeing Co. v. United States*, 862 F.2d 290, 292-93 (Fed.Cir.1988).

Second, two parallel regulations determine whether certain costs qualify as IR & D. A provision of the Federal Acquisition Regulation, 48 C.F.R. § 31.205-18 ("FAR 31.205-18"), determines whether particular costs are allowable IR & D charges. A provision of the Cost Accounting Standards, 48 C.F.R. § 9904.420 ("CAS 420"), determines whether those costs are allocable to the particular contract in question. Both the FAR and the CAS define IR & D as excluding costs that are "required in the performance of a contract." FAR 31.205-18(a); CAS 420-30(a)(6).

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

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costs that were not paid for or required by a particular contract and that had a reasonably foreseeable benefit to more than one contract.

While we conclude that it was proper for ATK to treat its Development Effort costs as indirect, that does not end the inquiry, because the distinction between IR & D and other research and development costs does not invariably track the distinction between direct and indirect costs. For example, depending on a contractor's disclosed or established cost accounting practices, the contractor may treat some research and development costs as indirect costs because they benefit an entire product line, even if they are expressly required by a particular contract and thus would not qualify as IR & D. See 1 Karen L. Manos, *Government Contract Costs & Pricing* § 25:6, at 396 (2009).

As the trial court's analysis makes clear, however, the costs at issue in this case qualify as IR & D costs. The dispute over that issue focuses principally on the meaning of the phrase "required in the performance of a contract" in the definition of IR & D. The scope of that phrase has been a subject of controversy in the government contracts community since 1971, when it first appeared as part of the definition of IR & D in the Armed Services Procurement Regulation ("ASPR"), a predecessor to the FAR.^{FN1} The government interprets the phrase to mean that IR & D costs do not include the costs of efforts that are either explicitly or implicitly required in order to complete a contract. Under that interpretation, the Development Effort costs would be deemed to be "required in the performance of" the Mitsubishi contract because that contract could not have been performed if ATK had not conducted the background research and development work to upgrade the Castor IVA-XL motor.^{*1333} ATK, by contrast, interprets the phrase to be limited to costs that are explicitly required by the contract. Under that interpretation, the Development Effort costs would not be deemed "required in the performance of" the Mitsubishi contract because there was no explicit requirement in the contract that obligated ATK to undertake the Development Effort or provided for payment of the Development Effort costs.

FN1. In 1978, the ASPR was redesignated as the Defense Acquisition Regulation ("DAR"). The DAR definition of IR & D costs was essentially the same. The FAR replaced the DAR in 1984 without any change to the definition of IR & D.

The government argues that the phrase that excludes costs from the category of IR & D must be construed broadly because it does not simply exclude costs "required by a contract," but uses broader language, excluding

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costs “required in the performance of a contract.” Thus, the government contends that the words “in the performance of a contract” indicate that the focus is on whether the research and development work was necessary to perform the contract, not whether the work was expressly required by the contract. The government relies heavily on the district court decision in *United States v. Newport News Shipbuilding, Inc.*, 276 F.Supp.2d 539 (E.D.Va.2003), which adopted that interpretation. ATK, on the other hand, contends that the term “required” must refer to a requirement of the contract. According to ATK, if the drafters of the regulation had intended to include research and development costs that were needed but not expressly included as a contract requirement, they would have used a word such as “necessary” rather than the word “required.”

We do not find either textual argument particularly persuasive. Standing alone, the language of the regulation is ambiguous. See *United States ex rel. Mayman v. Martin Marietta Corp.*, 894 F.Supp. 218, 222 (D.Md.1995) (noting the “considerable debate” over whether “a contractor can bill to IR & D any work not explicitly called for in the contract” or whether the contractor may not bill to IR & D anything “implicitly necessary to carry it out”); John W. Chierichella, *IR & D v. Contract Effort*, in 90-2 Gov’t Contract Costs, Pricing & Accounting Report 8 (Feb.1990) (noting “sustained intraGovernmental debate and confusion” over whether research and development effort not specified or directly funded by a contract may be disallowed as IR & D because it is deemed “implicitly” necessary).

Both parties invoke the regulatory history for support. Like the text, however, the regulatory history is inconclusive. FN2 Prior to the 1971 amendment that added the disputed language, the applicable regulation defined IR & D as “research and development which is not sponsored by a contract, grant, or other arrangement.” The “ASPR committee,” which was responsible for adopting changes to the ASPR, suggested changing the definition to cover “technical effort which is not sponsored by, or in support of a contract, grant, or other arrangement.” Representatives of the defense and space industries objected that the words “in support of” were too broad and would be a potential “source for future misinterpretation.” The ASPR committee acknowledged that the point was “a valid objection” and altered the language by inserting “required in performance of” in place of the phrase “in support of.” The committee explained that the purpose of the change was “to convey the concept that any work which must be accomplished in order to fulfill contractual requirements is a contract cost. Other similar type effort may be and should be expected to be performed” as IR *1334 & D. The industry representatives then suggested further clarifying the definition

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by adding the words “specifically required by contract provisions” before the words “in performance of a contract.” The ASPR committee, however, rejected that suggestion. The Comptroller General subsequently suggested that the exclusion from the definition of IR & D was too narrow and that the exclusion should be amended to include “technical effort implicitly required to fulfill a purchaser’s requirement under terms of a contract.” A Department of Defense representative, however, took a position contrary to that of the Comptroller General, urging that the exclusion from IR & D should be understood to turn on “whether the effort was specified as a deliverable requirement of an existing contract.” The ASPR committee declined to make any further change in the pertinent regulatory language.

FN2. The trial court’s opinion contains a thorough and well-documented review of the regulatory history. 68 Fed.Cl. at 635–39. We have merely summarized the pertinent points here.

This sequence of events is not particularly instructive as to the meaning of the regulatory definition. Although the ASPR committee declined the industry’s suggestion to limit the exclusion from IR & D to costs “specifically required” by the contract, it also declined the Comptroller General’s suggestion to broaden the exclusion to include costs “implicitly required” by the contract. When the Board responsible for the Cost Accounting Standards (“the CAS Board”) promulgated CAS 420 in 1979, it incorporated in its definition of IR & D the same language that was used in the FAR—“required in the performance of a contract.” The CAS Board did not offer any explanation as to the intended meaning of that phrase, and there has been no change in the pertinent regulatory language since then. The regulatory history is thus inconclusive.

While we find the regulatory language and history to be of little help in discerning the meaning of the phrase “required in the performance of a 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.” *Boeing*, 862 F.2d at 293.

A provision of CAS 402, referred to as Interpretation No. 1, supplies important guidance as to when proposal costs constitute B & P and when they are chargeable against a single contract. It 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.

CAS 402–61(c), 48 C.F.R. § 9904.402–61(c). Interpretation No. 1 distinguishes proposal costs that are “specifically required by” an existing contract from those that “do not result from such specific requirements.” *1335 The former costs “relate only to [a particular] contract,” while the latter costs “relate to all work of the contractor” and thus qualify as B & P. 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.”

In *Boeing*, this court held, based in part on Interpretation No. 1, that proposal costs that are not specifically required by a contract are “properly allocated as indirect B & P costs.” 862 F.2d at 293. As part of its analysis, the court noted that proposal costs that are “specifically required by an existing contract are incurred in circumstances different from proposal costs relative to all work of the contractor.” *Id.* The court ruled that it would be legal error to require like accounting for B & P costs that are “relate[d] to” or “caused or generated by” a contract, and those proposal costs that are “specifically required” by a contract. *Id.* at 292–93.

The same analysis applies to the closely analogous category of IR & D costs. Although Interpretation No. 1 does not by its terms address IR & D, the government’s suggestion that the approach employed in Interpretation No. 1 should be limited to B & P costs, and that IR & D costs should be treated differently, would result in a construction in which identical regulatory language—“required in the performance of a contract”—would be interpreted differently for IR & D than for B & P. 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.

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The government argues that we should be skeptical of accepting such a result because it is contrary to sound procurement policy. In particular, the government argues that allowing a government contractor to charge to an indirect IR & D account those research costs that are necessary to complete a commercial contract but not paid for in that contract will invite a contractor to “game the system” by shifting commercial contract costs to the government.

We are not persuaded by the government’s policy argument. First, the purpose of IR & D is to benefit both government contractors and their customer agencies by encouraging the contractors to engage in research that is likely to benefit multiple contracts, both governmental and commercial. Spreading IR & D costs across multiple contracts encourages general research that enables the contractor to innovate, to maintain a high level of technological sophistication, and ultimately to improve the products it offers the government. As the Department of Defense has explained, providing financial support for IR & D serves several Departmental goals, including creating “an environment that encourages DoD contractors to expand knowledge in mathematics and science, improve technology in areas of interest to the Department of Defense, and enrich and broaden the spectrum of technology available to the Department of Defense.” Dep’t of Def. Directive No. 3204.1, at 3 (May 10, 1999).

Second, the result of requiring IR & D costs to be borne by a contract for which the research and development work in question is deemed necessary could have the perverse effect of charging all of the research and development costs for a proposed product line against the first contract for the products in that line, whether the contract is governmental or commercial. That approach would either disproportionately burden the contract that happened*1336 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 governmental, allocating general research and development costs in that manner is not sensible as a policy matter.

Accordingly, the government’s policy arguments do not persuade us that the phrase “required in the performance of a contract” in the definition of IR & D costs should not be accorded the same meaning as the identical phrase in the definition of B & P costs. 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.

ATK Thiokol, Inc. , Plaintiff v. United States, Defendant

No. 99440C

November 30, 2005

BACKGROUND

Government contractor which manufactured launch vehicle motors brought suit against the United States, seeking in three counts to recover independent research and development (IR&D) costs and production costs incurred to upgrade launch motor for commercial market as indirect costs of government contracts. Government filed motion for summary judgment or, in the alternative, for summary judgment upon first two counts and to dismiss third count. Contractor filed crossmotion for partial summary judgment.

HOLDING

The Court of Federal Claims, Braden, J., held that:

(1) contractor properly allocated its IR&D costs for upgrading launch vehicle motor for the general commercial market as indirect costs for fiscal years 1997 through 1999 across all contracts, both government and commercial, rather than direct costs of commercial contract, and contracting officer (CO) should have allowed such costs with respect to government contracts, and

(2) contractor properly allocated depreciation of production equipment acquired to produce upgraded launch vehicle motor for the general commercial market as indirect costs for fiscal years 1997 through 1999 across all contracts, both government and commercial, rather than direct costs of commercial contract, and CO should have allowed such costs with respect to government contracts.

Plaintiff's motion granted; defendant's motion denied.

SUMMARY

The contribution of the nation's defense and related industries to research and development after World War II is unmatched by any other developed

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country. For example, in fiscal year 1990 alone, the United States Department of Defense reported that 121 defense contractors spent a total of \$7.3 billion in independent research and development and related costs. See “Defense Industrial Base: Industry’s Investment in the Critical Technologies,” United States General Accounting Office Report to the Chairman of the Subcommittee on Defense Industry and Technology, Committee on Armed Services, United States Senate (GAO/NSIAD-92-4) (Jan.1992). Much of the technology and commercial products on which the public depends for basic services and security were spawned from research and development required to be performed in or derivative of contracts with the federal government. To encourage and facilitate the continuation of these benefits, Congress and the relevant government agencies developed and advanced a comprehensive and complementary set of rules governing research and development costs, contained in the Cost Accounting Standards and Federal Acquisition Regulations, to provide specific guidance to achieve uniformity and certainty regarding the accounting and reimbursement of research and development efforts—whether sponsored by a federal grant or required in the performance of a federal contract or undertaken independent of such a contract.

Despite the fact that some commentators and trial courts have suggested a need for more certainty in ascertaining whether research and development is “independent,” the contractual language and conduct of the parties in the context of specific transactions continue to provide the most reliable moorings for adjudicating the proper allocation and allowability of such costs.

To facilitate a review of this Memorandum Opinion, the court has provided the following outline:

RELEVANT FACTS

- A. **Plaintiff’s Launch Vehicle Motor Business Required Significant Research And Development Expenditures.**
- B. **Plaintiff’s Castor® Program–1950–2004.**
- C. **Mitsubishi Heavy Industries’ 1996 Interest In The Castor® IVA–XL Motor.**
- D. **Plaintiff’s 1997–1998 Contractual Negotiations With Mitsubishi Heavy Industries.**
- E. **Plaintiff Incurred Costs For The Acquisition Or Fabrication Of Production Equipment.**

- F. **The Government Determined That Plaintiff’s Disclosed Cost Accounting Practices Were Compliant From 1985–1999.**
- G. **In 1999, The Government Disputed Plaintiff’s “Development Effort” And “Production Equipment” Cost Allocation For The Castor® IVA-XL Motors.**

PROCEDURAL HISTORY

Discussion

Jurisdiction.

A. Standards Of Review.

- i. Standard Of Review On A Motion To Dismiss–RCFC 12(b)(6).

- 1. Standard Of Review On A Motion For Partial Summary Judgment–RCFC 56(c).

B. The Federal Acquisition Regulation System.

- 1. The Cost Accounting Standards Govern The “Allocability” Of Costs.
- 2. The Federal Acquisition Regulations Govern The “Allowability” Of Costs.
- 3. Interpreting The Cost Accounting Standards And The Federal Acquisition Regulations.

C. The Court’s Resolution Of Pending Motions.

- 1. The Parties’ Cross–Motions For Summary Judgment On Count I.
 - a. The Government’s Argument.
 - b. Plaintiff’s Argument.
 - c. The Court’s Resolution Of The Parties’ Cross–Motions For Summary Judgment On Count I.
 - i. CAS 402 Requires The Consistent Allocation Of Costs.
 - ii. CAS 420 Controls The Allocation Of Independent Research And Development And Bid And Proposal Costs.
 - (a) The “Debate” Concerning “Required In The Performance Of A Contract” Language In CAS 420.
 - (b) The Regulatory History Of CAS 420.
 - iii. Plaintiff Properly Allocated Its Independent Research And Development

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Costs To The 1997 Mitsubishi Heavy Industries Contract And, Therefore, Plaintiff's Development Effort Costs Should Have Been Allowed.

2. The Parties' Cross-Motions For Summary Judgment On Count II.
 - a. The Government's Argument.
 - b. Plaintiff's Argument.
 - c. The Court's Resolution Of The Parties' Cross-Motions For Partial Summary Judgment.
 - i. CAS 404 And CAS 409 Control The Capitalization And Depreciation Of Tangible Capital Assets.
 - ii. Plaintiff Properly Allocated The Depreciation Of Tangible Capital Assets And, Therefore, Plaintiff's "Production Equipment" Costs Should Have Been Allowed.

CONCLUSION

*614 Relevant Facts^{FN1}

FN1 Relevant facts recited herein were derived from: Plaintiff's July 2, 1999 Complaint ("Compl."); Defendant's September 3, 2003 Motion For Summary Judgment Or, In The Alternative, For Summary Judgment Upon Counts I And II And To Dismiss Count III ("Gov.Mot."); Plaintiff's January 5, 2004 Cross-Motion For Partial Summary Judgment And Opposition To Defendant's Motion For Summary Judgment ("Pl. Cross-Mot. and Opp."); the July 23, 2004 Consolidated Statement of Facts ("Con. St. of Facts"), and where the parties agreed, ("Con. St. of Facts" ¶ __ (Stip.)); and Plaintiff's July 23, 2004 Exhibits ("PX").

In addition, on July 23, 2004, Plaintiff proffered Declarations of the following individuals: Michael R. Ayers, Director of Finance (1986-1994), Vice President-Strategic Development (1994-1996); Robert Germaine, Manager-Castor® IVA-XL Program (1997-2003); Grady Jacobs, Vice President-Contracts (1988-1997), Vice President-Contracts and Finance (1997-2000); Kent Larsen, Program Manager (1990-1997), Manager-Finance (1997-2000), Cost Estimating Analyst (2002-2004); Stephen E. Moore, Program Manager-Castor® IV Program (1995-2000), Chief Engineer for Insulation and Component Work Center (2000-2001), Director-Space and Launch Vehicle Program (2001-2004); James Ricord, Contracts Manager (1980-1988), Manager of Contracts for Strategic Operations (1988-1997), Consultant (1997-1998); Randy Sokar, Controller (1997-2004), Director of Financial Planning and Reporting (2004).

A. Plaintiff's Launch Vehicle Motor Business Required Significant Research And Development Expenditures.

*615 Since the 1950s, Plaintiff FN2 manufactured aerospace products for space and defense purposes, including launch vehicle motors, munitions and speciality material products, and solid propellant rocket motors. See Cons.St. of Facts ¶ 1 (Stip.). A launch vehicle motor has: a nose cone; a pressure vessel to hold solid propellant; solid propellant; an ignition system; a "throat" at the opening of the case through which gases, produced by the burning of propellant, are emitted to achieve thrust; a nozzle to direct the thrust; and related electronics. Id. ¶ 2 (Stip.). Launch vehicle motors are expensive, require significant time to manufacture, and are not produced or sold on a "commodity" basis. Id. ¶ 5 (Stip.).

FN2. "Plaintiff" herein refers to: Thiokol Propulsion, a division of Cordant Technologies Inc., prior to April 2001; Alliant Techsystems Inc. ("Alliant"), a division of ATK Aerospace Group, during the period April 2001–March 2004; and ATK Thiokol, Inc., a subsidiary of Alliant, from March 2004 to date. See Con. St. of Facts ¶ 93.

Plaintiff manufactured and sold launch vehicle motors to support the National Aeronautics and Space Administration ("NASA")'s Space Shuttle program and several significant ballistic missile programs for three decades, including: the Polaris; the Poseidon; the Trident; the Minuteman; the Small Intercontinental Ballistic Missile and Peacekeeper; the Aerospace; and the MBB/EKNO/EADS. Id. ¶ 3 (Stip.). As the federal government's commitment to the space program waned, Plaintiff had to diversify its business and began to sell launch vehicle motors to foreign governments and commercial companies including: Lockheed Martin Corporation; McDonnell Douglas Corporation; EER; Orbital Sciences Corporation; and Nissan a/k/a IHI. Id. ¶¶ 3–4 (Stip.).

The launch vehicle motor industry was and is technology driven and, to remain competitive, Plaintiff continuously had to perform research and development ("R & D") that primarily was funded internally. See, e.g., Ayers Decl. ¶ 7; Moore Decl. ¶ 7; Jacobs Decl. ¶ 5; Larsen Decl. ¶ 5. In making a decision to fund R & D, Plaintiff had to keep in mind that customers do not want to pay all R & D for a product that later may be purchased by others. See, e.g., Ayers Decl. ¶ 8; Moore Decl. ¶ 8. On the other hand, if a customer funds R & D, Plaintiff may lose the ability to prohibit the use of intellectual property by competitors. Id. For these reasons, Plaintiff was attentive to whether the Government would recognize an R & D expenditure as an "indirect cost" that could be reimbursed under the FAR, which would allow intellectual property rights to remain in the control of Plaintiff. See Ayers

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Decl. ¶ 9. Of course, whether R & D could be recovered through profit was a relevant factor. See, e.g., Ayers Decl. ¶ 10; Larsen Decl. ¶ 6.

R & D was generally incurred at the same time as contract performance. See, e.g., Ayers Decl. ¶ 12; Moore Decl. ¶ 10; Larsen Decl. ¶ 8. Therefore, when a new contract began, Plaintiff accounted for R & D costs in two separate categories: “development work related to the contract and the development work not directly related to a contract.” *Id.* In addition to R & D required to develop a new or modified launch vehicle motors, Plaintiff typically incurred new tooling, equipment, and facilities costs. See, e.g., Ayers Decl. ¶ 13; Moore Decl. ¶ 11.

B. Plaintiff’s Castor® Program–1950–2004.

In the 1950s, Plaintiff developed Castor® launch vehicle motors. See Cons. St. of Facts ¶ 26 (Stip.). All Castor® motors “strapon” and are attached to a launch vehicle to provide additional lift capacity during the main propulsive force for a certain phase of flight. *Id.* A Castor® motor, combined with the necessary hardware, was known as a “booster.” *Id.*

In 1990, Plaintiff began development of the Castor® IVA–XL motor, an improved version of the Castor® IVA motor for the *616 McDonnell Douglas Corporation’s Delta launch vehicle. *Id.* ¶ 29 (Stip.). In 1992, Plaintiff produced, testfired, and otherwise fully qualified three Castor® IVA–XL motors at the company’s Huntsville, Alabama facility. *Id.* ¶ 30 (Stip.). Plaintiff performed this work, pursuant to a contract to support McDonnell Douglas’ attempt to win an upgraded Delta II launch vehicle motor contract. *Id.*

Subsequently, Plaintiff designed the Castor® IVB–XL motor that essentially was the same as the Castor® IVA–XL, except that the Castor® IVB–XL had a moveable nozzle. See, e.g., Moore Decl. ¶ 18; Jacobs Decl. ¶ 11. The Castor® IVA–XL nozzle was fixed. *Id.* On March 1, 1995, Plaintiff applied for a license to export unclassified defense articles and technical data, relating to the Castor® IVA–XL and IVB–XL motors (collectively the “Castor® XL motors”), and identified 30 potential customers, including Mitsubishi Heavy Industries (“Mitsubishi”) and the National Aerospace Development Agency of Japan (“NASDA–Japan”). See Cons.St. of Facts ¶ 33 (Stip.).

In March 1995, as part of a corporate restructuring effort, Plaintiff announced the closure of the Huntsville facility and began moving production and tooling to Utah. *Id.* ¶ 34 (Stip.). The relocation was completed at the end of 1995. *Id.* Although the existing Castor® XL motor production was merely transferred to Utah, the transfer required new and modified facilities,

because the Castor® XL motors were 40 feet long—eight feet longer than any other motor then in production at Plaintiff’s Utah facility. Id. ¶ 35 (Stip.). In addition, two technical changes and a test firing FN3 were required to make the Castor® XL motors more competitive (“Development Effort”). Id.

FN3. A “test fire” is a static test of a motor mounted to a test stand in order to measure certain operating parameters. See PX 2.

The Development Effort required Plaintiff to acquire new production tooling and equipment. Id. The Development Effort also required that the propellant grain produce a more generic thrust force to make the Castor® XL motors also suitable for generic use. Id. ¶ 36 (Stip.). This change meant that the Castor® XL motors would have to be requalified and tested to ensure that with the design change, the product continued to function within the intended parameters. Id. A second technical change was also necessitated, because the supplier of the nozzle materials for the Castor® XL motors no longer produced the required materials. Id. ¶ 37 (Stip.). In addition, the Development Effort required Plaintiff to demonstrate to other customers that the Utah facility could produce an “upgraded motor,” test fire that motor, and operate at full production capability. Id. ¶ 38 (Stip.). This required the Plaintiff to acquire or fabricate the necessary tools and equipment, and perform facility modifications (“Production Equipment”). Id.

In 1995, Plaintiff submitted proposals and held technical discussions with other potential customers for the Castor® IVA-XL motor, including McDonnell Douglas, Lockheed Martin, MHI, and the United States Air Force. Id. ¶ 41 (Stip.). On December 22, 1998, Lockheed Martin initiated an inquiry about the Castor® IVA-XL as a strapon booster for the Atlas IIAR. Id. ¶ 95 (Stip.). No sales to Lockheed Martin, however, were made. Id.

On April 15, 1999, Plaintiff conducted a “first article acceptance test firing” of a Castor® IVA-XL motor. Id. ¶ 98 (Stip.). Ten potential buyers attended this event, including representatives from the Japanese Government, Lockheed Martin, Swedish Aerospace, and Orbital Sciences Corporation. Id. On September 30, 1999, Plaintiff also forwarded marketing material on the Castor® IVB and Castor® IVB-XL motors to Vista Technologies, Inc. Id. ¶ 97 (Stip.).

As of July 23, 2004, Plaintiff had only sold Castor® IVA-XL motors to Mitsubishi. Id. ¶ 99 (Stip.). Plaintiff maintains the Castor® IVA-XL in production-ready status and continues to market it. See Moore Decl. ¶ 54.

C. Mitsubishi Heavy Industries’ Interest In The Castor® IVA-XL Motor.

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In February 1996, Mitsubishi expressed an interest in purchasing the Castor® IVA-XL *617 motor for use by NASDA-Japan in the H-IIA launch vehicle. *Id.* ¶ 29. Plaintiff offered to sell Mitsubishi the Castor® IVA-XL motor, but with the understanding that the motor would be configured into a booster, using attachment hardware designed specifically for the H-IIA launch vehicle. *Id.* Plaintiff advised Mitsubishi that various nonrecurring costs relating to the Castor® IVA-XL motor, would include: 1) Development Effort, 2) Production Equipment, 3) acquisition for transportation and handling equipment for shipping motors to Japan, and 4) design of a unique means to attach the Castor® IVA-XL motor to the H-IIA launch vehicle. *Id.* Mitsubishi, however, advised Plaintiff that Mitsubishi would not pay for any nonrecurring costs that also would benefit the Castor® IVA-XL motor in the commercial market. *Id.*

In July 1996, Plaintiff's management approved expenditures to fund the Development Effort to complete the upgrade of the Castor® IVA-XL motor. See, e.g., Ricord Decl. ¶¶ 5, 7; Moore Decl. ¶ 30; Jacobs Decl. ¶¶ 13, 14; Larsen Decl. ¶ 11.

On December 9, 1996, Plaintiff submitted an updated proposal to Mitsubishi for a "complete, ready to erect booster." *Con. St. of Facts* ¶ 46 (Stip.). In the proposal, nonrecurring contract costs were divided between: 1) contractunique effort to adapt the Castor® IVA-XL motor to the H-IIA launch vehicle that would be paid for by Mitsubishi (the "MHI Adaptation Effort") and 2) the Castor® IVA-XL Motor Development Effort and Production Equipment that would be funded internally by Plaintiff. See, e.g., Ricord Decl. ¶ 6; Moore Decl. ¶ 31; Jacobs Decl. ¶ 15; Larsen Decl. ¶ 14.

Mitsubishi requested an itemization of the price for each part of the MHI Adaption Effort that Mitsubishi would pay for under the potential contract. See Larsen Decl. ¶ 15. On December 16, 1996, Plaintiff responded by providing an itemized list with prices totaling \$5 million for the MHI Adaption Effort. *Id.* Plaintiff anticipated that it would incur \$3,968,254 in costs to perform the MHI Adaption Effort, for which Mitsubishi would pay. *Id.* This itemization for the nonrecurring MHI Adaption Effort was consistent with Plaintiff's December 9, 1996 proposal to Mitsubishi. *Id.*

On December 19, 1996, Plaintiff submitted a "final" proposal to Mitsubishi, wherein Plaintiff would pay for the Development Effort and Production Equipment and Mitsubishi would pay for the Adaptation Effort. See, e.g., Moore Decl. ¶ 33; Larsen Decl. ¶ 15(a).

D. Plaintiff's 1997/1998 Contractual Negotiations With Mitsubishi Heavy Industries.

In early March 1997, NASDA–Japan informed Mitsubishi that NASDA–Japan had selected Mitsubishi’s proposal for the H–IIA launch vehicle, utilizing Plaintiff’s booster (the “H–IIA/SSB program”). See, e.g., Ricord Decl. ¶ 8; Moore Decl. ¶ 36. Accordingly, Mitsubishi advised Plaintiff that “contract negotiations” regarding the Castor® IVA–XL motor and the performance of the Mitsubishi Adaptation Effort should commence. *Id.* In response, Plaintiff began to incur costs relating to the Development Effort. *Id.*

On March 28, 1997, Plaintiff and Mitsubishi negotiated a proposed Memorandum of Understanding (“MOU”), requiring Plaintiff to obtain the necessary export license, as a prerequisite for performance. See Moore Decl. ¶ 37. The proposed MOU also provided that Plaintiff would perform the Mitsubishi Adaptation Effort. *Id.*

On April 2, 1997, Plaintiff submitted a letter to the Divisional Administrative Contracting Officer (“DACO”) FN4 regarding “Expenditure of B & P Costs in Development of Castor IVA–XL” indicating that: “[a]t this time, there is sufficient market interest in this product that a design update program is warranted to enable continued marketing and proposal activity.” PX 30 at GOV 0418. Attached was an “Advance Agreement Between the United States of America and [Plaintiff] Covering the Accounting Treatment for Castor® IVA–XL Bid & Proposal Costs (the ‘Advance Agreement’)”. *Id.* at *618 GOV 0150. The Advance Agreement, in part, stated that:

FN4. The DACO is part of the Defense Contract Management Command, an entity within the Defense Logistics Agency of the Department of Defense. See Compl. at 1.

[Plaintiff] warrants that the project activities set forth in the Plan are not now, nor will they in the future be specifically identified in the statement of work of a Castor IVA–XL® solid rocket motor contract or subcontract or any other expressly stated contract requirement.

Id. at GOV 150, ¶ 3.

On April 17, 1997, Plaintiff set up work orders to record costs to be incurred on the Development Effort for the Castor® IVA–XL motor. See Cons.St. of Facts ¶ 54 (Stip.).

In June 1997, Plaintiff and Mitsubishi “agreed in principle” to a draft a “Statement of Work for the H–IIA Solid Strapon (‘SSB’) Design and Integration Program” (“SOW”) that included the following definitions:

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2.0 Definitions

Castor IVA-XL Solid Rocket Motor The Castor IVA-XL is a solid rocket motor developed by [Plaintiff] for use in the commercial space launch vehicle market place. The Castor IVA-XL is an extended length version of the Castor IVA. [Plaintiff] is updating the design of this motor to support the general requirement of the strapon market.

Solid Strap-On Booster (SSB) Solid Rocket Motor The SSB Motor is a component of the evolutionary development of the Japanese H-II launch vehicle system. This booster is intended to provide an additional performance upgrade over the currently planned H-IIA upgrade. The SSB will be configured using a Castor IVA-XL solid rocket motor. [Plaintiff] intends to produce the SSB in their Defense and Launch Vehicles Division located in Brigham City, Utah, USA. [Plaintiff] is contracting with MHI for the development and qualification of the SSB attachment hardware, ordnance systems, nose cone and other booster systems. This SSB hardware will transform the Castor IVA-XL into the SSB configuration.

PX 25 at THI 2393 (emphasis added).

In addition, the SOW detailed Plaintiff's requirements under the contract:

3.0 Requirements

[Plaintiff] shall design qualify and produce hardware for the SSB configuration for MHI and the H-IIA program. [Plaintiff] shall produce the Castor IVA-XL and incorporate it into the SSB configuration. The program effort, broken into four program phases is contained below.

Id. at THI 2396.

The four program phases referenced in Section 3.0 Requirements related only to the SSB configuration, not the Castor® IVA-XL upgrade requirements. See PX 25 at A-4-9.

In July 1997, Plaintiff began to incur costs for the Development Effort for the Castor® IVA-XL motor. See Con. St. of Facts ¶ 58 (Stip.). Thereafter, Plaintiff and Mitsubishi continued to negotiate terms and pricing. Id. ¶ 59 (Stip.). On August 29, 1997, Mitsubishi issued a "Letter of Agreement" authorizing Plaintiff to proceed with the Mitsubishi Adaptation Effort, as set forth in the draft June 1997 SOW, in an amount not to exceed \$4,933,500. See, e.g., Ricord Decl. ¶ 10; Moore Decl. ¶ 42. On September 3, 1997, Plaintiff began

to record costs under various work orders, pursuant to the August 29, 1997 “Letter of Agreement.” See Con. St. Facts ¶ 60 (Stip.).

On November 10, 1997, the United States Department of State approved the Technical Assistance Agreement (“TAA”) between Plaintiff and Mitsubishi concerning the Castor® IVA-XL motor. Id. ¶ 62 (Stip.). On December 15, 1997, Plaintiff and Mitsubishi identified the specific assistance and technical information that Plaintiff would be providing Mitsubishi, under the H-IIA/SSB program. See Moore Decl. ¶ 43.

On January 15, 1998, a Preliminary Request by Plaintiff’s Propulsion Group was submitted to Plaintiff’s Board of Directors requesting approval of \$5,200,000 for “Castor® IVA-XL Solid Rocket Motor Tooling and Facilities.” See, e.g., Jacobs Decl. ¶ 16; Larsen Decl. ¶ 19. Thereafter, Plaintiff began to incur costs for the acquisition and fabrication of Production Equipment to produce the Castor® IVA-XL. See Con. St. of Facts ¶ 65 (Stip.). Through June 1998, Plaintiff charged \$1,017,264 to work order *619 numbers for the Castor® IVA-XL Development Effort and \$658,181 for Castor® IVA-XL Production Equipment. Id. ¶¶ 66–67 (Stip.).

On June 30, 1998, Mitsubishi issued a Purchase Order requiring Plaintiff to provide 28 SSBs, in accordance with a contract to be entered in September 1998. Id. ¶ 68 (Stip.). In response, Plaintiff opened separate work orders or charge numbers for the MHI Adaptation Effort. Id. ¶ 69 (Stip.). On July 6, 1998, Plaintiff also opened up a separate work order for reporting the costs of manufacturing and delivering 28 SSBs that were to be charged directly and exclusively to the Mitsubishi Contract. Id. ¶ 68 (Stip.). By September 1998, Plaintiff had incurred costs of \$1,751,364 for the Castor® IVA-XL motor Development Effort and \$1,587,353 in costs for Castor® IVA-XL Production Equipment. Id. ¶¶ 72–73 (Stip.).

On October 7, 1998, Plaintiff and Mitsubishi signed the “H-IIA SSB Motor Program Agreement” (“Mitsubishi Contract”). See Moore Decl. ¶ 47. The June 8, 1997 SOW was incorporated therein. See PX 25 at THI 02390 (Exhibit A of Mitsubishi Contract); see also id. at THI 02384 (“3-1 The scope of work to be completed by Plaintiff was specified in the Statement of Work (SOW) which is attached as Exhibit A”).

The October 7, 1998 Mitsubishi Contract provided:

This agreement (Agreement) is made and entered into as of September 1, 1998, by and between Mitsubishi Heavy Industries, Ltd. (Mitsubishi) and Thiokol Propulsion, A Division of Cordant Technologies Inc. (Thiokol).

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* * * * *

2-1 This Agreement covers the period starting from August 29, 1997 and ending on December 31, 2005.

PX 25 at THI 02383 (Preface).

Consistent with Mitsubishi's August 29, 1997 "Letter of Agreement," the Mitsubishi Contract also provided detailed price and payment terms for the Mitsubishi Adaption Effort, but did include a price for, or require payment of, Plaintiff's Development Effort and Production Equipment costs related to upgrading the Castor® IVA-XL for the commercial market. Id. at THI 02384. The absence of such a price evidences Plaintiff's agreement with Mitsubishi that no part of Plaintiff's Development Effort and Production Equipment costs were required under the Mitsubishi Contract, because the parties agreed that they would be treated as indirect costs. See Moore Decl. ¶¶ 47-48.

Likewise, the June 16, 1997 SOW incorporated into the Mitsubishi Contract specifically required Plaintiff to perform the MHI Adaption Effort, but did not contain a specific requirement for the Development Effort and Production Equipment necessary to upgrade the Castor® IVA-XL for the commercial market. See PX 49 at THI 02398-02400. The absence of such a requirement further evidences Plaintiff's agreement with Mitsubishi that no part of the Development Effort and Production Equipment costs were required under the Mitsubishi Contract, because the parties agreed that they would be treated as indirect costs. See Moore Decl. ¶¶ 47-48.

E. Plaintiff Incurred Costs For The Acquisition Or Fabrication Of Production Equipment.

Plaintiff's Production Equipment costs for the Castor® IVA-XL Motors consisted of: 1) production tooling, including forgings, fixtures, mandrels, jigs, lathes, cure carts, dollies, chocks, rings, rack storage, trunnions, and casting cores, 2) production equipment, including computers and trailers, and 3) facility modifications, including work platform and egress chutes. See Con. St. of Facts ¶ 81 (Stip.).

Since the Production Equipment fabricated or acquired and used in the production of Castor® IVA-XL motors could be sold to any buyer, it was not dedicated exclusively to the Mitsubishi Contract. Id. ¶¶ 82-83 (Stip.). The Production Equipment, however, did not represent all of the tooling and equipment that was used to manufacture the Castor® IVA-XL motors, since some production tooling and equipment had been transferred from Plaintiff's

Huntsville Facility to Plaintiff's*620 Utah facility in 1995. Id. ¶ 84 (Stip.).FN5 Plaintiff incurred \$4,928,839 in costs for the acquisition or fabrication of the Production Equipment that were depreciated, utilizing measured depreciation costs based upon time. Id. ¶¶ 88, 90 (Stip.). Plaintiff capitalized those costs and included them in indirect cost pools. See Larsen Decl. ¶ 30.

^{FN5}. Plaintiff classified depreciation costs of the transferred Production Equipment as indirect costs, and the Government did not object to this practice. See Cons.St. of Facts ¶ 84 (Stip.).

Plaintiff also acquired other equipment, including ground support and handling equipment, that was exclusively dedicated to the Mitsubishi Contract. See Con. St. of Facts ¶ 91 (Stip.). Plaintiff, however, did not capitalize those costs, since they were classified as direct costs of the Mitsubishi Contract. See Germaine Decl. ¶ 21.

F. The Government Determined That Plaintiff's Disclosed Cost Accounting Practices Were Compliant From 1985–1999.

Because Plaintiff did and continues to do significant business with the United States, Plaintiff is required to disclose cost accounting practices relating to R & D, tooling, equipment, and facilities costs. See Ayers Decl. ¶ 14. Plaintiff discloses its cost accounting practices on a standard form, which requests specific information regarding Plaintiff's cost accounting practices. See PX 49 (Cost Accounting Standard Board Disclosure Statement—CASB DS-1 (REV 2/96)).

Plaintiff's Cost Accounting Standard Board Disclosure Statement ("CAS Disclosure Statement") requests information on how the costs of certain functions that might be direct or indirect are classified, as well as for costs that are "sometimes direct/sometimes indirect[.]" Ayres Decl. ¶ 14(b) (citing PX 49 ¶ 3.2.0).

Plaintiff's CAS Disclosure Statement provides at 3.1.0:

Criteria for Determining How Costs are Charged to Federal Contracts or Similar Cost Objectives

Direct costs are those which are readily, economically, and consistently identifiable to a Federal contract or similar final cost objective. Indirect costs are those incurred for common or joint objectives or elements of costs for which it is not economically feasible to charge direct, or those not identifiable to a requirement of a specific final cost objective but are necessary for the overall operation of the business.

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Examples of application of the above criteria statement are contained in further detail under the continuation sheet pages for 2.5.0 and 3.2.1-3...

Definitions of Key Words in the Above Criteria Statement

Readily and Economically—When effort required and cost of identification in relationship to the benefit to be obtained by direct identification are reasonable...

* * * * *

Consistently—When costs are charged and accounted for in a manner compatible with other costs incurred for the same purpose in like circumstances.

Identifiable—When costs have a causal or beneficial relationship which is clear and exclusive to one final cost objective.

See Ayers Decl. ¶ 14(a) (citing PX 49 at Continuation Sheet III-4).

Paragraph 3.2.3 of Plaintiff's CAS Disclosure Statement identifies design engineering and design drafting, among others, as functions that are sometimes direct and sometimes indirect and whether these costs "are charged directly or indirectly based on the criteria outlined in 3.1.0." Ayres Decl. ¶ 14(b) (citing PX 49 at Continuation Sheet III-5); see also PX 49 at ¶ 3.2.3.

Part IV of the CAS Disclosure Statement lists indirect costs and requests information regarding the contractor's indirect cost pools. For example, a contractor "may have several pools such as manufacturing overhead, engineering overhead, material handling overhead, etc." Ayres Decl. ¶ 14(c) (citing PX 49 at ¶ 4.1.0).

Herein, Plaintiff also disclosed the practice of including depreciation costs in the various indirect cost pools. See Ayers Decl. ¶ 14(d) (citing PX 49 at Continuation Sheets IV-7 *621 and IV-8). Plaintiff also disclosed in this section that it incurred independent research and development ("IR & D") and bid and proposal ("B & P") costs and classified them as indirect costs. See Ayers Decl. ¶ 14(e) (citing PX 49 at Continuation Sheets IV-12).

Section V of the CAS Disclosure Statement lists various categories of tangible capital assets and depreciation costs, such as "building improvements," "machinery and equipment," and "tools." See PX 49 at ¶ 5.1.0. Plaintiff's disclosed practice was to use a "useful life based upon

replacement experience adjusted by expected changes in periods of usefulness,” e.g., “[m]ultiple use tools are capitalized based on the criteria outlined at 5.1.0... Program specific tools are charged direct to applicable contracts.” Ayers Decl. ¶ 14(f) (citing PX 49 at ¶ 5.1.0(k), Continuation Sheet V-5). Items having a cost exceeding \$5,000 and an estimated economic life of two years or more were capitalized and depreciated over the assets’ useful life. See Ayers Decl. ¶ 19.

Plaintiff consistently has applied these practices for classifying costs that could be either direct or indirect. See Ayers Decl. ¶¶ 15, 19 (citing PX at ¶ 3.1.0). Therefore, Plaintiff classified a cost that is normally an indirect cost as a direct cost only when: a) a contract specifically required that Plaintiff incur the cost; b) the contract paid for the cost; or c) at the time Plaintiff incurred the cost, the cost had no reasonably foreseeable benefit to more than one cost objective. *Id.* (emphasis in original).

Pursuant to Plaintiff’s disclosed accounting practices, whether the contracting party is the United States, a foreign government, or a commercial buyer is not relevant in the accounting of costs. For this reason, Plaintiff incurs IR & D, B & P, selling, and tangible capital item costs for contracts for all types of customers. Plaintiff classifies these costs as indirect and allocates them across all contracts, if the circumstances outlined above do not justify treatment as a direct cost. See Ayers Decl. ¶ 16.

From 1990 through 1997, a DACO periodically reviewed Plaintiff’s disclosed cost accounting practices and found such practices to be CAS compliant. See Cons.St. of Facts ¶ 16 (Stip.). Prior to the 1990’s, Plaintiff and the Government entered a number of contracts, under which the cost of R & D necessary to the performance of a contract specifically was excluded as a direct cost, but classified as an indirect cost. See Ayers Decl. ¶ 18. Plaintiff has applied these cost accounting practices to other government contracts since at least 1985. See Con. St. of Facts ¶¶ 17-25 (discussing Plaintiff’s cost accounting practices on other government contracts); see also, e.g., Ayers Decl. ¶¶ 18-26; Suker Decl. ¶¶ 3-5; Jacobs Decl. ¶ 6.

For example, in February 1985, Plaintiff entered into Contract No. F04704-85-C-0046, a fixed-price incentive-type contract, with the Air Force Systems Command for a Small ICBM Stage I prototype. See Ayers Decl. ¶ 20. This contract required the development, design, evaluation, manufacturing and testing of a functioning prototype. *Id.* The parties agreed that the contract would not fund the development of the prototype. *Id.* (citing “PX 50 at p. 2 at Line Item 0001 (line item outlines Plaintiff’s duty to perform but no comparable line item compensation)”). With the Government’s knowledge

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and consent, these development costs were classified as indirect IR & D and B & P costs. *Id.*

Plaintiff also contracted with NASA for the production of solid rocket motors used on the Space Shuttle. *Id.* ¶ 21. With NASA's knowledge and approval, Plaintiff capitalized the costs of facilities and equipment used solely for the performance of that contract and classified the resulting depreciation costs as an indirect cost that has been allocated across Plaintiff's entire business base. FN6 *Id.*

FN6. The Government asserts that this statement is "substantially inaccurate," because \$9.6 million of capital items located in Plaintiff's T-97 NASA facility bear Government property numbers, signifying that they were charged directly to Government costreimbursement contracts. See Cons.St. of Facts ¶ 20 (citing GX A.). The court does not accept this characterization, because it appears that Plaintiff properly capitalized \$205 million of facilities, tooling, and equipment used to perform that contract and classified the resulting depreciation as indirect costs. *Id.* (citing Suker Decl.).

*622 In addition, in 1990, Plaintiff capitalized the cost of certain tooling for the Castor® 120 motor to be sold to the Government and commercial customers, because the items were "multipurpose." See Cons.St. of Facts ¶ 21 (Stip.). The Defense Contract Audit Agency ("DCAA") initially disagreed, but ultimately accepted that the tooling was multipurpose, based upon the opinion of the DACO. *Id.* The DACO also concluded that a "tool could be considered multipurpose if there [was] any possibility that it might be used on some future program. Contracts for these programs did not have to be in place." *Id.* Thereafter, Plaintiff capitalized the costs of these tools and allocated the related depreciation costs as indirect costs over Plaintiff's entire business base. *Id.* In 1995, the DCAA again challenged Plaintiff's treatment of Castor® 120 tooling costs and referred the issue to the Air Force Office of Special Investigation ("OSI"). See Con. St. of Facts ¶ 23 (Stip.). In January 1996, the DACO provided OSI with a memorandum outlining the reasons why the capitalization of the Castor® 120 tooling was proper, as "hard" tooling, because Plaintiff intended to use it for development and production purposes and, therefore, had potential use to perform contracts for multiple customers. *Id.* The DACO concluded that the cost appropriately was capitalized and resulting depreciation properly classified as an indirect cost. *Id.* In December 1996, the DACO restated this position. *Id.* Thereafter, OSI concluded the investigation and no adverse action was taken against Plaintiff. *Id.*

In 1992, with respect to the ELV Castor® motor, DCAA did not question, and the DACO allowed Plaintiff's R & D costs necessary to the ultimate

performance of a specific contract as B & P costs, which were allocated as indirect costs. FN7 See Ayers Decl. ¶ 24.

FN7. The Government “substantially agrees, except that it is the DCMA that ultimately provides ‘approv[al]’ of cost accounting, with advice from DCAA.” See Cons.St. of Facts ¶ 23 (emphasis in original).

In 1998, Plaintiff began participating in the Integrated High Payoff Rocket Propulsion Technology (“IHRPT”) program, requiring the fabrication of a fullscale demonstration motor, using a combination of various component technologies developed with Plaintiff’s funding. See Ayers ¶ 25; see also Con. St. of Facts ¶ 24. The product of the IHRPT program was to be a fully assembled motor, delivered in place to the Government. *Id.* The Government provided \$4 million for development, but required that Plaintiff match that funding. As Plaintiff’s cover letter regarding the Phase I IHRPT proposal pledged:

In support of this program, Thiokol plans to accomplish all component development and related engineering design work, as well as the tooling design and manufacture, and motor static test with Thiokol’s discretionary Independent (IR & D) and Bid and Proposal (B & P) funds in FY 1999 and 2000. The established cost of this effort is approximately \$4 million.

Id. The Air Force, the DACO, and the DCAA auditors were aware and accepted Plaintiff’s classification of the company’s \$ 4 million contribution to fund as IR & D and B & P costs and provide advanced development of the nozzle and propellant components, tool design, manufacture and motor static testing, all of which was necessary to the fabrication of the full scale demonstration motor. *Id.*

Plaintiff has claimed reliance upon the aforementioned disclosed cost accounting practices and the Government’s acceptance thereof to allocate and allow costs incurred, formulate final indirect rate proposals, negotiate final indirect cost rates, and negotiate billing rates. See Ayers Decl. ¶ 26.

G. In 1999, The Government Disputed Plaintiff’s “Development Effort” And “Production Equipment” Cost Allocation For The Castor® IVA-XL Motors.

On March 10, 1999, DACO issued a written Notice of Intent to Disallow Costs certain costs. See Ayers Decl. ¶ 34; see also PX 31. Specifically, this Notice disallowed: 1) \$1,017,264 in Development Effort for FY 1998, 2) \$1,132,624 in Development Effort for FY 1998T, 3) an estimated \$1,000,000 in Development Effort for FY 1999, and 4) \$5,000,000 in Production

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Equipment, described*623 as “Special Tooling Costs.” See Ayers Decl. ¶ 34; see also PX 31 at GOV 0329, 0333. The March 10, 1999 Notice stated that the Development Effort and Production Equipment costs were “required by and specifically benefit the [Mitsubishi] Contract, and [that] these costs should be charged to the Castor® IVA–XL program.” PX 31 at GOV 0329. This was the first time that the DACO–Japan informed Plaintiff in writing that the costs of the Development Effort and the Production Equipment must be charged directly and exclusively to the Mitsubishi Contract, instead of as an indirect cost. See Cons.St. of Facts ¶ 109 (Stip.).

By the end of October 1999, Plaintiff incurred \$3,134,249 for the Castor® IVA–XL Development Effort that was allocated to Plaintiff indirect costs pools as B & P costs but should have been allocated as indirect IR & D costs because they were not incurred in order to prepare a specific proposal.^{FN8} See Con. St. of Facts ¶¶ 92–93 (Stip.). In contrast, Plaintiff incurred \$5,015,915 for the Mitsubishi Adaptation Effort that was allocated directly to the Mitsubishi Contract. Id.

^{FN8}. Plaintiff mistakenly classified the Development Effort as indirect B & P costs. Id. ¶ 93. Both parties, however, agree that under Plaintiff’s interpretation of the applicable regulations it should have been classified as IR & D. Id.

On May 10, 1999, Plaintiff submitted a certified claim and request for a contracting officer’s final decision allowing its Development Effort and Production Equipment costs as indirect costs. Id. ¶ 110 (Stip.). On May 14, 1999, a final decision was issued denying Plaintiff’s claim. Id. ¶ 111 (Stip.).

PROCEDURAL HISTORY

On July 2, 1999, Plaintiff filed a threecount Complaint in the United States Court of Federal Claims that was assigned to the Honorable Lawrence M. Baskir. See Compl. ¶¶ 58–91. The Complaint challenges the disallowance of Plaintiff’s Development Effort and Production Equipment costs under Contract Nos. NAS8–38100, PB10E9900N, F42610–94–C–0031, and DAA001–95–C–0016. Id. ¶ 4. Without explanation, the Complaint indicates that the parties agreed that Contract No. NAS8–38100 would be the “test” contract in this dispute. Id. ¶ 5.

Count I alleged that because the Development Effort costs were not required in the performance of the Mitsubishi Contract and, therefore, Plaintiff is entitled to account for the Development Effort as indirect costs under

Contract No. NAS8-38100 in the amount of \$3,149,888. Id. ¶¶ 58-66. FN9 Accordingly, Count I alleges that the Government's disallowance of its Development Effort costs, as direct costs of the Mitsubishi Contract, was "improper" under the FAR and CAS. Id. ¶¶ 62-63, 65.

FN9. Although Count I alleges that the total amount under all contracts that should have been allowed is \$3,149,888, it does not indicate what portion of that amount should have been allowed under Contract No. NAS8-38100. Id. ¶ 66.

Count II alleges that Plaintiff is entitled to allocate the depreciation of Production Equipment as indirect costs and that those costs should have been allowed under the "test contract." Id. ¶¶ 71-77. Count II alleges that the total amount that should have been allowed under all contracts was \$5,000,000, but again does not indicate what portion of that amount should have been allowed under the test contract. Id.

Count III alleges that the Government should be estopped from disallowing Plaintiff's classification of the Development Effort and Production Equipment costs as indirect costs, because Plaintiff relied on the Government's inaction. Specifically, Plaintiff relied to its detriment on the Government's failure to issue a Notice of Intent to Disallow Costs until after Plaintiff entered into the Mitsubishi Contract on October 7, 1998. See Compl. ¶¶ 82-83, 86-87, 90-91. Accordingly, Count III asserts that the Government is estopped from disallowing \$8,149,888 as indirect costs. Id. ¶ 91.

On October 15, 1999, the Government filed an Answer. On December 2, 1999, a Joint Preliminary Status Report was filed advising that the parties were unable to agree upon a settlement, but "will reevaluate settlement as an option as discovery proceeds." On January 19, 2000, the court issued a Scheduling *624 Order that set a deadline for conclusion of fact discovery by June 30, 2000, and a deadline of August 1, 2000, for Plaintiff to file any motion for summary judgment.

On May 10, 2000, at the request of the parties, the court issued a Provisional Protective Order, effective as of May 26, 2000, to establish procedures to protect against the disclosure of certain proprietary information. Subsequently, the court issued five orders FN10 modifying the January 19, 2000 Scheduling Order to afford the parties an opportunity to settle. On October 19, 2001, the parties filed a Joint Status Report and Motion for Scheduling Order informing the court that the parties were unable to reach a settlement.

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FN10. The court's Orders were filed on: July 6, 2000; October 19, 2000; January 10, 2001; March 2, 2001; and May 7, 2001.

On December 3, 2001, following a telephone status conference, the court issued an Order that the parties complete discovery by March 1, 2002; file a Joint Status Report by April 1, 2002; and file any dispositive motions by May 1, 2002. That Order also referenced the parties' request to have the case referred to a Settlement Judge to determine if the matter is amenable to Alternative Dispute Resolution (hereinafter "ADR").

On January 23, 2002, the court granted Plaintiff's January 16, 2002 Motion to Amend to reflect that Alliant Techsystems Inc., ATK Aerospace Group, acquired Thiokol Propulsion. On April 10, 2002, a Joint Status Report advised the court that the parties tentatively were scheduled to participate in ADR on June 25 and 26, 2002 and on July 9 and 10, 2002. Those efforts, however, were unproductive.

On June 3, 2002, a Joint Status Report advised the court that the parties scheduled expert depositions to commence during the week of June 24, 2002, because of a dispute over certain documents. This resulted in the cancellation of the ADR Conference scheduled for June 25 and 26, 2002. Although unclear from the record, it appears that ADR Conference scheduled for July 9 and 10, 2002 also did not take place.

On September 20, 2002, the court issued an Order scheduling an ADR Conference for October 23 and 24, 2002. On September 25, 2002, the Government filed a Notice of Withdrawal from Alternative Dispute Resolution. On October 7, 2002, the court issued an Order canceling the ADR Conference scheduled for October 23 and 24, 2002.

On January 14, 2003, a Joint Status Report advised the court that the parties were engaging in an effort to determine the appropriateness of summary judgment and developing appropriate stipulations of fact. On that date, the parties also reported plans to inform the court of their position regarding the appropriateness of summary judgment or trial by March 18, 2003. The parties, however, were unable to reach an agreement about the relevancy or admissibility of testimony by qualified experts.

On July 8, 2003, the court issued an Order entering a schedule agreed to by both parties in a Joint Status Report and Motion for Scheduling Order that required: 1) the Government to file any Motion for Summary Judgment no later than September 15, 2003; 2) Plaintiff to file any opposition no later than November 14, 2003; 3) the Government to file any Reply on December

15, 2003; 4) Plaintiff to file any Reply no later than January 15, 2004; and 5) any Consolidated Statement of Uncontroverted Facts be filed no later than February 13, 2004. Id.

On August 15, 2003, this case was reassigned to the undersigned judge.

* * * * *

On September 3, 2003, the Government filed a Motion For Summary Judgment Or, In The Alternative, For Summary Judgment Upon Counts I And II And To Dismiss Count III. On January 5, 2004, after receiving two extensions from the court, Plaintiff filed a Cross-Motion For Partial Summary Judgment And Opposition To Defendant's Motion For Partial Summary Judgment, together with a Consolidated Statement of Facts. On February 4, 2004, the Government filed a Reply thereto and an Opposition to Plaintiff's Cross-Motion For Partial Summary Judgment.

*625 On February 11, 2004, the National Defense Industrial Association ("NDIA") filed an amicus curiae brief in support of Plaintiff. The NDIA is a national organization of approximately 900 companies, many of which are members of the defense industry and routinely contract with the Government for goods and services.

On March 22, 2004, after receiving two extensions, Plaintiff filed a Reply In Support Of Its Cross-Motion For Partial Summary Judgment.

On July 14, 2004, the court granted a June 15, 2004 motion to substitute Plaintiff, ATK Thiokol, Inc., as the real party in interest, instead of Alliant Techsystems Inc. and ATK Aerospace Group.

On July 23, 2004, after two other extensions of time, the parties filed a Consolidated Statement of Facts.^{FN11} In addition, Plaintiff filed seven Declarations to which the Government objected as "vague and general opinions, characterizations of 'Thiokol's experience,' and legal conclusions, which merely repeat opinions and conclusory assertions in the cited affidavits." See Cons.St. of Facts ¶ 7 (Gov't Position). The Government, however, declined to produce counterdeclarations or proffer facts in rebuttal. Id. ¶ 6 (Pl.Reply).

^{FN11}. The July 23, 2004 Consolidated Statement of Facts supercedes the January 5, 2004 Statement of Facts, initially filed with Plaintiff's January 5, 2004 Cross-Motion.

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On July 23, 2004 Plaintiff filed two volumes of Exhibits in support of Plaintiff's Cross-Motion For Partial Summary Judgment and Plaintiff filed an Opposition to Defendant's Motion For Partial Summary Judgment Consolidated Statement of Facts.

On September 24, 2004, the court issued an Order granting Plaintiff's August 9, 2004 Motion for Oral Argument ("TR ___"). The court held an oral argument on October 19, 2004.

On January 28, 2005, the court invited the submission of amicus curiae briefs from bar associations, trade and industrial associations, law professors and other interested parties by April 15, 2005. The issue on which the court requested briefing was whether the FAR (48 C.F.R. § 31, Part 2) or Cost Accounting Standard (48 C.F.R., Part 9904) required technical or development effort costs to be direct or indirect costs. Thereafter, amicus curiae briefs were filed by the Aerospace Industries Association, representing major manufacturers of military, commercial, and business aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment, and Stephen D. Knight, an Adjunct Professor with the George Washington University School of Law, LL.M. Government Procurement Program, and Of Counsel to the firm of Smith, Pachter, McWhorter & Allen, PLC.

DISCUSSION

A. Jurisdiction.

The United States Court of Federal Claims has "jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort." 28 U.S.C. § 1491(a)(1). The Tucker Act, however, is "only a jurisdictional statute; it does not create any substantive right enforceable against the United States for money damages." *United States v. Mitchell*, 445 U.S. 535, 538, 100 S.Ct. 1349, 63 L.Ed.2d 607 (1980) (quoting *United States v. Testan*, 424 U.S. 392, 398, 96 S.Ct. 948, 47 L.Ed.2d 114 (1976)). Therefore, in order to come within the jurisdictional reach of the Tucker Act, a plaintiff must identify and plead a constitutional provision, federal statute, independent contractual relationship, and/or executive agency regulation that provides a substantive right to money damages. See *Todd v. United States*, 386 F.3d 1091, 1094 (Fed.Cir.2004) ("[J]urisdiction under the Tucker Act requires the litigant to

identify a substantive right for money damages against the United States separate from the Tucker Act.”); see also *Roth v. United States*, 378 F.3d 1371, 1384 (Fed.Cir.2004) (“Because the Tucker Act itself does not provide a substantive cause of action, ... a plaintiff must find *626 elsewhere a moneymandating source upon which to base a suit.”).

The United States Court of Federal Claims has “jurisdiction to render judgment upon any claim by or against, or dispute with, a contractor arising under ... the Contract Disputes Act of 1978, including a dispute concerning ... rights in tangible or intangible property, compliance with cost accounting standards, and other nonmonetary disputes on which a decision of the contracting officer has been issued under section 6 of that Act.” 28 U.S.C. § 1491(a)(2); see *Alliant Techsystems, Inc. v. United States*, 178 F.3d 1260, 1270 (Fed.Cir.1999) (holding that “the Tucker Act grants the United States Court of Federal Claims jurisdiction to grant nonmonetary relief in connection with contractor claims, including claims requesting an interpretation of contract terms.”).

The Contract Disputes Act provides that “claims” FN12 relating to a contract by a contractor or the Government shall be submitted to the contracting officer for a decision and that the contracting officer’s decision shall be in writing and furnished to the contractor, stating the reasons for the decision and informing the contractor of its rights thereunder. 41 U.S.C. § 605(a); see also *Alliant Techsystems*, 178 F.3d at 1267 (“A letter can be a final decision under the CDA even if it lacks the standard language announcing that it constitutes a final decision.”) (citing *Placeway Constr. Corp. v. United States*, 920 F.2d 903, 907 (Fed.Cir.1990)). That Act also provides that the “contracting officer’s decision on the claim shall be final and conclusive and not subject to review by any forum, tribunal, or Government agency, unless an appeal or suit is timely commenced as authorized by this chapter.” 41 U.S.C. § 605(b).

FN12. Although the Contract Disputes Act does not define “claim,” that term is defined in the Federal Acquisition Regulation as “a written demand or written assertion by one of the contracting parties seeking, as a matter of right, the payment of money in a sum certain, the adjustment or interpretation of contract terms, or other relief arising under or relating to the contract.” 48 C.F.R. § 2.101. For claims against the Government exceeding \$100,000, the contractor must certify that: the claim is made in good faith; the supporting data is accurate and complete; and the amount requested accurately reflects the amount for which the contractor believes the Government is liable. See 41 U.S.C. § 605(c)(1).

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The United States Court of Appeals for the Federal Circuit has “enforced the strict limits of the [Contract Disputes Act] as ‘jurisdictional prerequisites to any appeal.’ ” *England v. The Swanson Group, Inc.*, 353 F.3d 1375, 1379 (Fed.Cir.2004) (citing *Sharman Co. v. United States*, 2 F.3d 1564, 1569 n. 6 (Fed.Cir.1993), overruled on other grounds by *Reflectone, Inc. v. Dalton*, 60 F.3d 1572 (Fed.Cir.1995)). Accordingly, “jurisdiction over an appeal of a contracting officer’s decision is lacking unless the contractor’s claim is first presented to the contracting officer and that officer renders a final decision on the claim.” *Swanson Group*, 353 F.3d at 1379; see also *James M. Ellett Constr. Co. v. United States*, 93 F.3d 1537, 1541–42 (Fed.Cir.1996) (“Thus for the [United States Court of Federal Claims] to have jurisdiction under the [Contract Disputes Act], there must be both a valid claim, a term the act leaves undefined, and a contracting officer’s final decision on that claim.”).

In this case, there is no dispute that a contract existed between Plaintiff and the Government. See Cons.S. of Facts ¶ 111 (Stip.); Compl. ¶ 4; see also *Trauma Group v. United States*, 104 F.3d 1321, 1325 (Fed.Cir.1997) (establish jurisdiction, a plaintiff “must show that either an express or implied-in-fact contract underlies its claim.”). In addition, on May 10, 1999, Plaintiff’s claim against the Government was presented to the Contracting Officer and a Final Decision was rendered four days later on May 14, 1999. *Id.* ¶ 111 (Stip.). Accordingly, the court has determined that it has jurisdiction to adjudicate Plaintiff’s claims in this case.

B. Standards Of Review.

1. Standard Of Review On A Motion To Dismiss—RCFC 12(b)(6).

In ruling on a motion to dismiss, the court is “obligated to assume all factual allegations to be true and to draw all reasonable inferences in plaintiff’s favor.” *Henke v. United States*, 60 F.3d 795, 797 (citing *627*Scheuer v. Rhodes*, 416 U.S. 232, 236–37, 94 S.Ct. 1683, 40 L.Ed.2d 90 (1974)); see also *Sommers Oil Co. v. United States*, 241 F.3d 1375, 1378 (Fed.Cir.2001) (citations omitted) (“When reviewing a dismissal for failure to state a claim upon which relief can be granted under ... Rule 12(b)(6) ... [the court] must accept as true all the factual allegations in the complaint, and ... indulge all reasonable inferences in favor of the nonmovant.”). Dismissal for failure to state a claim under Rule 12(b)(6) “is proper only when a plaintiff can ‘prove no set of facts in support of his claim which would entitle him to relief.’ ” *Adams v. United States*, 391 F.3d 1212, 1218 (Fed.Cir.2004) (quoting *Leider v. United States*, 301 F.3d 1290, 1295 (Fed.Cir.2002)); see also RCFC 12(b)(6).

2. Standard Of Review On A Motion For Partial Summary Judgment—RCFC 56(c).

On a motion for summary judgment, if there is no genuine issue as to any material fact, the moving party is entitled to judgment as a matter of law. See *Moden v. United States*, 404 F.3d 1335, 1342 (Fed.Cir.2005) (“Summary judgment is only appropriate if the record shows that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.”); see also RCFC 56(c). In the United States Court of Federal Claims, summary judgment, albeit interlocutory in nature, may be rendered on the issue of liability alone, even if a genuine issue of fact exists as to the amount of damages. See *United States v. Winstar Corp.*, 518 U.S. 839, 910, 116 S.Ct. 2432, 135 L.Ed.2d 964 (1996) (affirming grant of partial summary judgment on contract liability and remanding the determination of the appropriate measure or amount of damages, if any.); see also RCFC 56(c).

Only genuine disputes of material facts that might affect the outcome of the suit will preclude entry of summary judgment. See *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247–48, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986) (“As to materiality, the substantive law will identify which facts are material. Only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment. Factual disputes that are irrelevant or unnecessary will not be counted... That is, while the materiality determination rests on the substantive law, it is the substantive law’s identification of which facts are critical and which facts are irrelevant that governs.”). The existence of “some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment[.]” *Id.* Therefore, there is no issue for the court to adjudicate unless the nonmoving party puts forth evidence sufficient for a jury to return a verdict for that party; but “if the evidence is merely colorable or is not significantly probative, summary judgment may be granted.” *Id.* at 249–50, 106 S.Ct. 2505 (citations omitted).

The burden of demonstrating the absence of any genuine issue of material fact is on the party moving for summary judgment. See *Celotex Corp. v. Catrett*, 477 U.S. 317, 325, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986) (holding the moving party must meet its burden “by ‘showing’—that is pointing out to the [trial court] that there is an absence of evidence to support the nonmoving party’s case”); see also *Riley & Ephriam Constr. Co., Inc.*, 408 F.3d 1369, 1371 (Fed.Cir.2005) (“The moving party bears the burden of demonstrating the absence of a genuine issue of material fact.”). A

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summary judgment may be made without supporting affidavits and rely “solely on the pleadings, depositions, answers to interrogatories, and admissions on file.” *Celotex Corp.*, 477 U.S. at 324, 106 S.Ct. 2548. Once the moving party demonstrates the absence of a genuine issue of material fact, however, the burden shifts to the nonmovant to establish the existence of a genuine issue that can only be resolved at trial. See *Novartis Corp. v. Ben Venue Laboratories*, 271 F.3d 1043, 1046 (Fed.Cir.2001) (explaining that, once the movant has demonstrated the absence of a genuine issue of material fact, “the burden shifts to the nonmovant to designate specific facts showing that there is a genuine issue for trial”).

Therefore, a trial court is required to resolve all doubt over factual issues in favor of *628 the nonmoving party. See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). And, all reasonable inferences and presumptions must be resolved in favor of the nonmoving party. See *Anderson*, 477 U.S. at 255, 106 S.Ct. 2505; see also *Moden*, 404 F.3d at 1342 (“[A]ll justifiable inferences [are drawn] in favor of the party opposing summary judgment.”).

The fact that both parties have moved for summary judgment does not relieve the trial court of responsibility to determine the appropriateness of summary disposition. See *Stratos Mobile Networks USA, LLC v. United States*, 213 F.3d 1375, 1379 (Fed.Cir.2000) (quoting *Prineville Sawmill Co., Inc. v. United States*, 859 F.2d 905, 911 (Fed.Cir.1988)) (“[The court] determines for itself whether the standards for summary judgment have been met.”). Summary judgment will not necessarily be granted to one party or another when both parties have filed motions. See *California v. United States*, 271 F.3d 1377, 1380 (Fed.Cir.2001) (“The mere fact that the parties have crossmoved for summary judgment does not impel a grant of at least one motion[.]”). The court must evaluate each party’s motion on its own merits. *Id.*

C. The Federal Acquisition Regulation System.

The Cost Accounting Standards and the Federal Acquisition Regulations serve different functions. See *Rumsfeld v. United Technologies Corp.* 315 F.3d 1361, 1365 (Fed.Cir.2003) (“As previous decisions of [the United States Court of Appeals for the Federal Circuit] have made clear, the Federal Acquisition Regulations (FAR) govern allowability, and CAS governs allocability of costs.”); see also *Rice v. Martin Marietta Corp.*, 13 F.3d 1563, 1565–67 (Fed.Cir.1993) (discussing the need to distinguish between the two concepts).

As the United States Court of Appeals for the Federal Circuit held in *Boeing N. Amer., Inc. v. Roche*, 298 F.3d 1274 (Fed.Cir.2002) (en banc):

[T]he concept of allocability is addressed to the question whether a sufficient “nexus” exists between the cost and a government contract. The concept of allowability is addressed to the question whether a particular item of cost should be recoverable as a matter of public “policy.”

Id. at 1281 (citations omitted) (emphasis added).

1. The Cost Accounting Standards Govern The “Allocability” Of Costs.

The Defense Production Act of 1950, as amended in 1970, established an independent five-member Cost Accounting Standards Board (“CAS Board”) to “promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts.” Pub.L. No. 91-379, § 719(g), 84 Stat. 796 (Aug. 15, 1970) (codified at 50 U.S.C.A. § 2168(g)). Thereafter, the CAS Board issued nineteen Cost Accounting Standards (“CAS”) that measure, assign, and allocate a variety of costs, together with regulations governing contract coverage and disclosure requirements. See *Boeing*, 298 F.3d at 1282-83.

On September 30, 1980, the CAS Board ceased operations, because Congress failed to appropriate funds. Section 719 of the Defense Production Act, however, was not repealed and the CAS, regulations and disclosure requirements survived. See Pub.L. 100-679, § 5, 102 Stat 4055 (Nov. 17, 1988) (establishing current CASB and indicating: “All cost accounting standards, waivers, exemptions, interpretations, modifications, rules, and regulations promulgated by the Cost Accounting Standards Board under section 719 of the Defense Production Act of 1950 (50 U.S.C.App. 2168) shall remain in effect unless and until amended, superseded, or rescinded by the Board pursuant to this section.”); see also Karen L. Manos, GOVERNMENT CONTRACT COSTS & PRICING, 1 GC-COSTS 2:C:2. On September 30, 1987, the FAR was amended to incorporate the CAS, and rules and regulations promulgated by the original CAS Board. See 52 FED. REG. 35,612 (Sept. 22, 1987).

In 1988, Congress enacted Office of Procurement Policy Act Amendments to reestablish the CAS Board within the Office of *629 Procurement Policy of the Office of Management and Budget. See Pub.L. No. 100-679 § 5, 102 Stat. 4055 (Nov. 17, 1988) (codified at 41 U.S.C. § 422 (2003)). In resurrecting the CAS Board, the Senate emphasized that:

[A]gencies, rather than the Board, should be responsible for determining the allowability of specific costs. In his testimony on S. 2215, the Comptroller General stated “We believe it is important to separate the cost allocability

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standards and the cost allowability principles. Allocability is an accounting issue and allowability is a procurement policy issue.” The Committee agrees with this distinction. Accordingly, Section 4 assigns only allocability functions to the Board. Allowability and other similar policy issues will be addressed by ... the agencies outside the purview of the CAS Board.

S.Rep. No. 100-424 (Jul. 8, 1988), reprinted in 1988 U.S.C.C.A.N. 5687, 5703; see also *Allegheny Teledyne, Inc. v. United States*, 316 F.3d 1366, 1370-71 (Fed.Cir.2003) (recognizing that the CAS regulates “the allocation of costs to cost objectives, but do not regulate issue of cost allowability or contract pricing.”); see also *id.* (quoting Cost Accounting Standards Board Restatement of Objectives, Policies and Concepts (May 1977), reprinted in Cost Accounting Standards Guide (CCH) ¶ 2915 (1984)) (“ ‘Allocability’ is an accounting concept involving the ascertainment of contract cost; it results from a relationship between a cost and a cost objective such that the cost objective appropriately bears all of a portion of that cost.”).

In 1992, the new CAS Board recodified the CAS rules and regulations reported in FAR Part 30 into 48 C.F.R. Parts 9903 and 9904.FN13 See 57 FED. REG. 14,148 (Apr. 17, 1992), as corrected by 57 FED. REG. 34,078 (Aug. 3, 1992).

FN13. In recodifying the CAS the new CAS Board specifically indicated:

This action ... results only in the reestablishment of previously promulgated, and currently applicable, rules and cost accounting standards. This rule represents an effort by the Board to finally reconcile the existing sets of cost accounting standards previously promulgated by other bodies.

See 57 FED. REG. 14,148 (Apr. 17, 1992), as corrected by 57 FED. REG. 34,078 (Aug. 3, 1992) (emphasis added).

2. The Federal Acquisition Regulations Govern The “Allowability” Of Costs.

The FAR were developed in accordance with the Office of Federal Procurement Policy Act of 1974, as amended by Pub.L. No. 96-83, and are the primary regulation for use by all federal agencies in their acquisition of supplies and services with appropriated funds. See 48 FED. REG. 42,102 (Sep. 19, 1983) (establishing the FAR); see also 69 FED. REG. 17,764 (Apr. 5, 2004) (providing that the FAR are promulgated by the Civilian Agency Council and Defense Acquisition Regulations Council and revising certain general cost provisions).

The FAR codified and published “uniform policies and procedures for acquisition by all executive agencies.” 48 C.F.R. § 1.101. Subpart 31.2 of the FAR govern the allowability of costs after costs have been allocated to a contract, as required by the CAS. See *Boeing North American, Inc. v. Roche*, 298 F.3d 1274, 1285 (Fed.Cir.2002). The general principles of allowability include: “(1) reasonableness; (2) allocability; (3) standards promulgated by the CAS Board, if applicable; otherwise generally accepted accounting principles and practices appropriate to the particular circumstances; (4) terms of the contract; (5)[and] any limitations set forth in this subpart.” 48 C.F.R. § 31.201.

Fiftytwo subsections in the FAR specify the allowability of certain costs. See, e.g., 48 C.F.R. § 31.205–11 (governing the allowability of depreciation costs); 48 C.F.R. § 31.205–18 (governing the allowability of IR & D and B & P costs); 48 C.F.R. § 31.205–25 (governing the allocation of manufacturing and production engineering costs); 48 C.F.R. § 31.205–40 (governing the allowability of special tooling costs).

3. Interpreting The Cost Accounting Standards And The Federal Acquisition Regulations.

The United States Court of Appeals for the Federal Circuit has held if there is any conflict between the CAS and the FAR as to an issue of allocability, the CAS governs.

*630 Allocability is an accounting concept involving the relationship between incurred costs and the activities or cost objectives (e.g., contracts) to which those costs are charged. Proper allocation of costs by a contractor is important because it may be necessary for the contractor to allocate costs among several government contracts or between government and nongovernment activities.

The concept of cost allowability concerns whether a particular cost can be recovered from the government in whole or in part. Cost allocability here is to be determined under the Cost Accounting Standards (“CAS”), [48 C.F.R. Parts 9903, 9904 (2001)]. Allowability of a cost is governed by the FAR regulations, i.e., the cost principles expressed in Part 31 of the FAR and pertinent agency supplements.

Although a cost may be allocable to a contract, the cost is not necessarily allowable. We have agreed with the general proposition that “costs may be assignable and allocable under CAS, but not allowable under [FAR].”

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And the FAR makes clear that “[w]hile the total cost of a contract includes all costs properly allocable to the contract, the allowable costs to the Government are limited to those allocable costs which are allowable pursuant to [FAR] part 31 and applicable agency supplements.” FAR § 31.201-1(b) (2001).

Boeing, 298 F.3d at 1280–81 (case citations omitted); see also *id.* at 1274 (citing *United States v. Boeing Co.*, 802 F.2d 1390, 1395 (Fed.Cir.1986); *Rice v. Martin Marietta Corp.*, 13 F.3d 1563, 1565 n. 2 (Fed.Cir.1993) (holding that, if there is any conflict between the CAS and the FAR as to an issue of allocability, the CAS governs)). In other words, “allocability is simply a determination of what portions of a cost are assigned to what party, whereas allowability is a determination of whether one party may apply or recover that cost.” *Allegheny Teledyne*, 316 F.3d at 1370–71.

Although the FAR may act as a ceiling on the allowability of costs allocated in accordance with CAS, the FAR may not make “the allowability of a cost contingent upon use of a cost measurement, allocation and assignment technique which conflict with the requirements of CAS.” *Kearfott Guidance & Navigation Corp. v. Rumsfeld*, 320 F.3d 1369, 1376 (Fed.Cir.2003) (discussing that the FAR controls allocation rather than allowability) (emphasis in original).

Where a case requires the interpretation of a FAR provision that implements a CAS, the court’s “task in interpreting the meaning of these FAR provisions is ultimately to ascertain the CAS Board’s intended meaning when it promulgated the CAS,” because the CAS is the source for the language and authority for these provisions of the FAR. See *Perry v. Martin Marietta Corp.*, 47 F.3d 1134, 1137 (Fed.Cir.1995) (same).

Therefore, in interpreting the CAS, the court must “ascertain the [Board’s] intended meaning when it promulgated the CAS.” *Allegheny Teledyne Inc.*, 316 F.3d at 1373 (citing *Perry*, 47 F.3d at 1137 (interpreting FAR 52.230-3 and 52.230-4 and the CAS clauses incorporated)). This analysis begins “by first looking at the text of the relevant provisions and ‘any guidance that the CAS Board has published to aid in interpretation.’ ” *Allegheny Teledyne*, 316 F.3d at 1373 (quoting *Perry*, 47 F.3d at 1137).FN14

FN14. Although an agency’s interpretation of its own regulations is entitled to considerable deference, deference to the DACO’s interpretation and application of the CAS and FAR in the Notice of Intent to Disallow Costs is not warranted, because the CAS and FAR are not Department of Defense regulations. See *Perry*, 47 F.3d at 1137 (citing *Newport News Shipbuilding & Dry Dock Co. v. Garrett*, 6 F.3d 1547, 1551 (Fed.Cir.1993) (rejecting the

Department of the Navy's argument that when it interprets the FAR, it is interpreting Department regulations)).

Where the CAS does not provide a definition of a particular term or phrase, the United States Court of Appeals for the Federal Circuit has advised trial courts to consult dictionaries or definitions in related regulations for interpretative guidance. See *Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361, 1369 –1370 (Fed.Cir.2003) (“We initially turn, therefore, to standard dictionary definitions and other pertinent regulations.”) (citing *631Estate of Cowart v. Nicklos Drilling Co., 505 U.S. 469, 477, 112 S.Ct. 2589, 120 L.Ed.2d 379 (1992) (relying on dictionary definition and related statutory provisions to interpret a statute)); see also *Wis. Dep’t of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 223, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992) (using BLACK’S LAW DICTIONARY to interpret a statute).

CAS Board guidance includes illustrations following the test of each regulation, CAS Board interpretations, and the CAS preambles to explain regulations in “nontechnical” language. See *Boeing Co. v. United States*, 862 F.2d 290 (Fed.Cir.1989) (relying on CAS 402, Interpretation No. 1); see also *Perry*, 47 F.3d at 1139 (citing 48 C.F.R. § 30.101(d) (1993) (“[Although] preambles are not regulatory[,] [they] are intended to explain why the Standards and related Rules and Regulations were written[.]”)).

D. The Court’s Resolution Of Pending Motions.

Two outstanding motions are resolved herein: the Government’s September 3, 2003 Motion for Summary Judgment or, in the Alternative, for Summary Judgment Upon Counts I and II and to Dismiss Count III; and ATK Thiokol’s January 5, 2004 Cross–Motion for Partial Summary Judgment and Opposition to Defendant’s Motion for Partial Summary Judgment. The Court’s resolution of the parties’ Cross–Motions for Summary Judgment on Counts I and II renders the Government’s Motion to Dismiss Count III moot.

The questions presented in the pending motions require the court to determine, as a matter of law, whether: 1) the technical and development effort that Plaintiff treated as IR & D was “required in the performance of” the Mitsubishi Contract, within the meaning of CAS 420 and FAR 32.205–18; and 2) the capitalization of tangible assets, including those necessary to produce the upgraded Castor® IVA–XL at Plaintiff’s Utah facility, and subsequent allocation of the depreciation of those capitalized assets as indirect costs, were proper under CAS 404, CAS 409, and FAR 31.205–11.

1. The Parties’ Cross–Motions For Summary Judgment On Count I.

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The court's resolution of the parties' crossmotions for summary judgment on Count I depends on whether Plaintiff properly allocated \$3 million in IR & D spent to upgrade the Castor® IVA-XL for the commercial market. Resolution of this issue turns on whether that expense was "required in the performance of a contract." See 48 C.F.R. § 9904.420; see also 44 FED. REG 55,123 (Sep. 25, 1979) (containing final rule with commentary).

a. The Government's Argument.

The Government contends that Plaintiff improperly classified the Development Effort as IR & D, as "required in the performance of" the Mitsubishi Contract, because CAS 420 and FAR 31.205-18 "expressly preclude, and were always intended to preclude, accounting for costs 'required in the performance of a contract' as IR & D costs." Gov't Reply at 2. The Government argues that the "common sense, pragmatic definition" of "required in the performance of a contract," as used in CAS 420 and FAR 31.205-18, must rest on the "practical necessities of contract performance, whether or not expressly required." Gov't Reply at 2, 6; see also Gov't Mot. at 12. In addition, the Government insists that "reading the governing regulatory phrase, 'required in the performance of a contract,' to mean required, as a practical matter, in order to perform a contract, is consistent both with the ordinary and natural usage and with other FAR provisions discussing contract performance requirements." Gov't Reply at 6-7.

The Government also argues that the Mitsubishi Contract "unambiguously obligated [Plaintiff] to incorporate the particular features of the postupgrade Castor® IVA-XL motors into the SSB motors for delivery to Mitsubishi." See Gov't Mot. at 14 (emphasis added). In the alternative, the Government contends that, even if "required in the performance of a contract" means explicitly required, Plaintiff's Development Effort was not IR & D because it was in fact explicitly required by the Mitsubishi Contract. See Gov't Reply at 5.

*632 b. Plaintiff's Argument.

Plaintiff counters that the "Development Effort" properly was classified as IR & D, because that effort was not "required in the performance of a contract" and, therefore, is IR & D allocable under CAS 420 and allowable under FAR 31.205-18 as an indirect cost. Pl. Cross Mot. and Op. at 15-33. Plaintiff contends that, when interpreted consistently, "definitions of direct and indirect costs, as well as the overall requirements of CAS and FAR," result in R & D effort being "required in the performance of a contract" only when a contract specifically requires "performance of the effort as shown by: (a) a specific contract line item with a price that requires the effort; (b) the

contract's SOW, technical specification or other contract term specifically requires performance of the effort as part of that contract; (c) the estimated costs used to develop the contract's price include the costs of the effort; or (d) some other clear manifestation that the parties intended the R & D to be performed as part of the contract or for the contract to pay the costs. The mere fact [that] an R & D effort 'benefits,' is 'necessary to' or is 'implicitly' required by a contract is not sufficient to establish that the effort is 'required in the performance of a contract.' " Pl. Cross Mot. and Op. at 17, 18.

In the alternative, Plaintiff suggests that if this interpretation of "required in the performance of a contract" is not accepted, nevertheless, Plaintiff is entitled to summary judgment, pursuant to the doctrine *contra proferentum*, because CAS 420 and FAR 31.205-18 inherently are ambiguous and, therefore, should be construed against the Government.

c. The Court's Resolution Of The Parties' Cross-Motions For Summary Judgment On Count I.

1. CAS 402 Requires The Consistent Allocation Of Costs.

Public Law 100-679 (41 U.S.C. § 422) requires that contractors "comply with Cost Accounting Standards (CAS) and to disclose in writing and follow consistently their cost accounting practices." See 48 C.F.R. § 9903.01; see also 48 C.F.R. § 9903.202-1-9 (specifying the requirement for and composition of a CAS Disclosure Statement and providing an illustration of the Disclosure Statement Form, CASB-DS-1). CAS 402 and CAS 420 are relevant to the allocation of the Plaintiff's disputed IR & D costs in this case.

The purpose of CAS 402, initially promulgated on February 29, 1972, is to prevent double billing:

The purpose of this standard is to require that each type of cost is allocated only once and on only one basis to any contract or other cost objective. The criteria for determining the allocation of costs to a product, contract, or other cost objective should be the same for all similar objectives. Adherence to these cost accounting concepts is necessary to guard against the overcharging of some cost objectives and to prevent double counting. Double counting occurs most commonly when cost items are allocated directly to a cost objective without eliminating like cost items from indirect cost pools which are allocated to that cost objective.

48 C.F.R. § 9904.402-20; see also 37 FED. REG. 4,139 (Feb. 29, 1972).

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To achieve this objective, CAS 402 requires contractors also to provide certain information in CAS Disclosure Statements:

The Disclosure Statement to be submitted by the contractor will require that he set forth his cost accounting practices with regard to the distinction between direct and indirect costs. In addition, for those types of cost which are sometimes accounted for as direct and sometimes accounted for as indirect, the contractor will set forth in his Disclosure Statement the specific criteria and circumstances for making such distinctions[.]

48 C.F.R. § 9904.402–50(b) (emphasis added).

Specifically, Part III—Direct v. Indirect Costs of the required CAS Board Disclosure Statement requires the completion of a continuation sheet, in the event that a contractor identifies a cost as “Sometimes direct/Sometimes indirect.” See 48 C.F.R. § 9903.202–9 at III-1 (“If Code E, Sometimes direct*633 /Sometimes indirect, is used, explain on a continuation sheet the circumstances under which both direct and indirect allocations are made.”).

The explanation provided by the contractor must comply with the requirement of CAS 402 that:

All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.

48 C.F.R. § 9904.402–40 (emphasis added).

CAS 402 further provides definitions to assist parties in determining whether a cost should be allocated directly or indirectly to a contract:

(3) Direct cost means any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

(5) Indirect cost means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

48 C.F.R. § 9904.402–30 (emphasis added).FN15 Whether a cost “is identified specifically with a particular final cost objective” or “not directly identified with a single final cost objective,” and, therefore, whether it is a direct or indirect cost is, determined by reference to the CAS Disclosure Statement. 48 C.F.R. § 9903.303 (“Contractors are cautioned that their disclosures must be complete and accurate; the practices disclosed may have significant impact on ways in which contractors will be required to comply with Cost Accounting Standards.”); see also 48 C.F.R. § 9904.402–50(b) (“In essence, the Disclosure Statement submitted by the contractor, by distinguishing between direct and indirect costs, and by describing the criteria and circumstances for allocating those items which are sometimes direct and sometimes indirect, will be determinative as to whether or not costs are incurred for the same purpose.”).

FN15. Prior to April 5, 2004, there was “a subtle but important difference between CAS 402 and the FAR in defining [a] ‘direct cost.’ The [CAS] define[d] ‘direct cost’ as ‘any cost which is identified specifically with a particular final cost objective;’ whereas, the FAR define[d] ‘direct cost’ as ‘any cost that can be identified specifically with a particular final cost objective.’ ” See Karen L. Manos, *GOVERNMENT CONTRACT COSTS & PRICING*, 1 GC–COSTS 63:B (emphasis added) (comparing 48 C.F.R. § 9904.402–30(a)(3) with the then existing FAR 31.202(a)). On April 5, 2004, however, the Civilian Agency Acquisition Council and the Defense Acquisition Regulation Council amended the FAR’s definition of “direct cost” to conform to the CAS definition.

Interpretation No. 1 of CAS 402, originally was promulgated with CAS 402 on February 29, 1972, addresses the primacy that contract provisions serve in determining whether a cost is incurred for “the same purpose, in like circumstances:”

(b) This interpretation deals with the way 9904.402 applies to the treatment of costs incurred in preparing, submitting, and supporting proposals. In essence, it is addressed to whether or not, under the Standard, all such costs are incurred for the same purpose, in like circumstances.

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(c) 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 *634 to that contract while other proposal costs relate to all work of the contractor.

48 C.F.R. § 9904.402-61 (emphasis added); see also 37 FED. REG 4139 (Feb. 29, 1972).

Interpretation No. 1, however, does not require that B & P costs “incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract” be treated as direct costs:

(d) This interpretation does not preclude the allocation, as indirect costs, of costs incurred in preparing all proposals. The cost accounting practices used by the contractor, however, must be followed consistently and the method used to reallocate such costs, of course, must provide an equitable distribution to all final cost objectives.

48 C.F.R. § 9904.402-61. In other words, under CAS 402 a contractor is permitted, but not required, to treat costs incurred as the result of specific contract provisions differently. *Id.*

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.” See *Boeing*, 862 F.2d at 293 (recognizing that allocating similar costs as direct or indirect depends on whether they were incurred pursuant to a “specific requirement in an existing contract” complies with CAS 402).

Applying CAS 402 Interpretation No. 1, the United States Court of Appeals for the Federal Circuit has distinguished between costs that specifically are required by a contract and costs that are only generated by a contract. *Id.* (determining that B & P costs required to complete an existing contract, but not “specifically required,” could be treated as indirect costs). In that case, Boeing was required to submit a proposal for a Phase II contract, as a requisite of a Phase I government contract. Boeing represented that the Phase I contract price only covered those proposal preparation costs

incurred during the period between receipt of the formal request for proposal and submission of the proposal. *Id.* at 291. Accordingly, Boeing treated B & P costs during that period as “direct costs” of the Phase I contract and the balance as “indirect costs.” The Government asserted that all of the B & P costs for the Phase II contract were “direct costs” of the Phase I contract, because the Phase II proposal was “specifically required” by the Phase I contract. Boeing countered that under CAS 402 Interpretation No. 1, only those costs specifically identified to the Phase I contract properly were “direct costs” of that contract. *Id.*

The United States Court of Appeals for the Federal Circuit agreed, relying on traditional contract interpretation, determining that the contracting parties intended only that the costs incurred during the period between receipt of the formal request for proposal and submission of the proposal specifically were required by the existing contract. *Id.* at 293.

Plaintiff was consistent in the allocation of IR & D as indirect costs in both government and commercial contracts unless they specifically were required by a contract. See *Ayers Decl.* ¶ 14 (same); see also *Con. St. Of Facts* at ¶¶ 17–25 (discussing Plaintiff’s cost accounting practices on other government contracts); *Ayers Decl.* ¶¶ 18–26; *Suker Decl.* ¶¶ 3–5; *Jacobs Decl.* ¶ 6. Plaintiff’s treatment of the “Development Costs” regarding the Mitsubishi was consistent with established practice.

2. CAS 420 Controls The Allocation Of Independent Research And Development And Bid And Proposal Costs.

[1] In addition to complying with CAS 402, where, as here, incurred costs are related to IR & D and B & P, the allocation of those costs also must comply with CAS 420.

a. The “Debate” Concerning “Required In The Performance Of A Contract” Language In CAS 420.

CAS 420, promulgated on September 25, 1979, and effective on March 15, 1980, governs the allocation of IR & *635D and B & P costs. See 44 FED. REG. 30,347 (Sep. 25, 1979)(promulgating final rule with commentary). CAS 420 defines IR & D and B & P costs as follows:

(2) Bid and proposal (B & P) cost means the cost incurred in preparing, submitting, or supporting any bid or proposal which effort is neither sponsored by a grant, nor required in the performance of a contract.

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* * * * *

(6) Independent research and development means the cost of effort which is neither sponsored by a grant, nor required in the performance of a contract, and which falls within any of the following three areas:

(i) Basic and applied research,(ii) Development, and(iii) Systems and other concept formulation studies.

See 48 C.F.R. § 9904.420–30 (emphasis added).

Whereas CAS 420 controls the allocation of I & RD and B & P costs, FAR 31.205–18 controls whether IR & D and B & P costs are allowable. See 48 C.F.R. § 31.205–18. FAR 31.205–18 defines IR & D and B & P as follows:

Bid and proposal (B & P) costs means the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or nonGovernment contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement, or required in the performance of a contract.

* * * * *

Independent research and development (IR & D) means a contractor's IR & D cost that consists of projects falling within the four following areas: (1) Basis research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. The term does not include the costs of effort sponsored by a grant or required in the performance of a contract. IR & D effort shall not include technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.

48 C.F.R. § 31.205–18 (emphasis added).

Although CAS 420 and FAR 31.205–18 serve different functions, under both regulations IR & D and B & P costs do not include costs “required in the performance of a contract.” Neither regulation, however, defines “required in the performance of a contract.” The absence of such a definition apparently caused a “considerable debate” regarding whether only those costs that are explicitly required are excluded from the definition of IR & D and B & P or whether all costs implicitly required are excluded. See, e.g., *Mayman v. Martin Marietta Corp.*, 894 F.Supp. 218, 222 (D.Md.1995) (“[T]here is considerable debate over whether a particular task is ‘required’ by a contract and therefore cannot be billed to IR & D. One view is that a contractor can bill to IR & D

any work not explicitly called for in the contract. An alternate view is that a contract includes everything implicitly necessary to carry it out.”) (citing John W. Chierichella, “IR & D vs. Contract Effort,” CP & A REPORT 3, at 8–12 (Feb.1990)); United States v. Newport News Shipbuilding, Inc., 276 F.Supp.2d 539 (E.D.Va.2003) (noting the “debate”). Arguably, the “debate” is exacerbated by the fact that no decision of the United States Court of Appeals for the Federal Circuit, the United States Court of Federal Claims, nor Board of Contract Appeals has interpreted in the abstract the meaning of “required in the performance of a contract,” as used in FAR 31.205–18 and CAS 420.

The Cross–Motions for Summary Judgment on Count I invite the court to resolve this long standing “debate.” As a matter of law, any uncertainty regarding the proper scope of IR & D, however, ended when the CAS Board promulgated CAS 420 on September 25, 1979. See 44 FED. REG. 30,347 (Sep. 25, 1979) (promulgating final rule with commentary).

b. The Regulatory History Of CAS 420.

Although the CAS Board’s decision not to define “required in the performance of a contract” has provided fertile ground for advocacy*636 regarding the allocation and allowability of IR & D costs, it is settled law that the court’s proper role is to ascertain the CAS Board’s meaning of “required in the performance of a contract,” when CAS 420 was promulgated on September 27, 1979. See Perry, 47 F.3d at 1137 (holding that where a FAR implements a CAS, the sole task in is to determine the CAS Board’s intent when it promulgated the CAS).

It is clear that FAR 31.205–18(b) was intended to implement and, therefore, specifically incorporates CAS 420:

(b) Composition and allocation of costs. The requirements of 48 CFR 9904.420, Accounting for independent research and development costs and bid and proposal costs, are incorporated in their entirety and shall apply as follows—

(1) Fully–CAS–covered contracts. Contracts that are fullyCAScovered shall be subject to all requirements of 48 CFR 9904.420.

(2) Modified CAScovered and nonCAScovered contracts. Contracts that are not CAScovered or that contain terms or conditions requiring modified CAS coverage shall be subject to all requirements of 48 CFR 9904.420 except 48 CFR 9904.420–50(e)(2) and 48 CFR 9904.420–50(f)(2), which are not then applicable. However, nonCAScovered or modified CAScovered contracts

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awarded at a time the contractor has CAS covered contracts requiring compliance with 48 CFR 9904.420, shall be subject to all the requirements of 48 CFR 9904.420.

48 C.F.R. § 31.205-18(b)(1)(2) (emphasis added).

Although CAS 420 was not issued until 1979, the CAS Board began consideration of a Cost Accounting Standard addressing IR & D and B & P on June 20, 1972. See Pl. Cross-Mot and Opp. Ex. 11 (“CASB Staff Paper Independent Research and Development, Bidding and Proposal and Advance Contract Costs” (June 20, 1979)). In December, 1975, the CAS Board staff recommended the promulgation of a Cost Accounting Standard addressing IR & D and B & P costs:

II. NEED FOR A STANDARD

Over the past fifteen years considerable effort has been put forth by both Government and other interested parties as to what constitutes IR & D and B & P activities and costs; how these costs should be accounted for, i.e., how they should be accumulated and allocated to cost objectives.

The continuing discussion has resulted in a self-perpetuating flow of proposals and counterproposals as to the best method for handling these costs.

Recent legislation passed by the Congress did not completely rectify the divergence in policies of DOD, NASA and AEC (ERDA) that had existed in the past.

The Staff after having completed an exhaustive study of the subject is of the opinion that a Standard should be promulgated to correct the many divergences in practice by both the Government and defense contractors.

The opinion of the Staff is further supported by the Comptroller General's report on “The Feasibility of Applying Uniform Cost Accounting Standards to Negotiated Defense Contracts.” (January 1970) The Feasibility Study cited many examples of problem areas regarding the accounting for IR & D and B & P costs. The problems related to: (1) the distinction between IR & D and B & P activities and costs, (2) the composition of IR & D and B & P costs, (3) the proper method for allocation of these costs on a common basis resulting in an appropriate assignment of final cost objectives.

See Pl. Cross-Mot. and Opp. Ex. 15 at 3-4 (“CASB Staff Paper Identification, Composition and Allocation of Independent Research and Development (IR

& D) and Bid and Proposal (B & P) Costs” (Dec.1975)) (emphasis added).

Although the CAS Board staff was aware of a number of problems with the ASPR’s treatment of IR & D and B & P costs, nevertheless, they concluded that the ASPR definitions were “suitable for a cost accounting Standard without change.” Id. at 12. Therefore, the CAS Board staff prepared a *637 draft CAS that incorporated in the definition of IR & D, the ASPR limitation “[t]hat technical effort which is not sponsored by, or required in the performance of, a contract or grant.” Id. at 53. The draft CAS, however, did not contain a similar limitation for B & P costs. Id. at 51–52.

When CAS 420 was promulgated on September 25, 1979, the CAS Board intended that the definitions of IR & D and B & P would be consistent with the definitions of IR & D and B & P, as used in other agency procurement regulations. See 44 FED. REG. 30,347 (Sep. 25, 1979) (“The definitions of IR & D and B & P costs in the proposed Standard were intended to be consistent with those currently in use in agency procurement regulations.”). Significantly, in contrast to the CAS Board staff’s draft, when CAS 420 was promulgated, CAS 420 included the language that “neither sponsored by a grant, nor required in the performance of a contract,” not only in the definition of IR & D but also in the definition of B & P. See 48 C.F.R. § 9904.420 (emphasis added). Therefore, the CAS Board was aware that the meaning of “required in the performance of a contract ” was an issue, but nevertheless elected to incorporate that limitation into both the IR & D and B & P definitions:

(1) Background

Work on the development of this Standard was initiated based on the General Accounting Office Report on the Feasibility of Applying Uniform Cost Accounting Standards to Negotiated Defense Contracts. The report referenced problem areas concerned with (1) the allocation of incurred costs to IR & D and B & P projects (2) the allocation of such costs to cost objectives, and (3) the definition of IR & D and B & P work tasks.

See 44 FED. REG. 55,123 (Sep. 26, 1979).

The “debate” about the meaning of “required in the performance of a contract” continued when a change to the definition of IR & D was proposed. See Pl. Cross-Mot. and Opp. Ex. 1 at 1(ASPR 15.205–35(c) defining IR & D as “that research and development which is not sponsored by a contract, grant, or other arrangement.” (emphasis added)). Specifically, in 1967 the ASPR Committee, FN16 proposed replacing “not sponsored by” with “not

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sponsored by, or in support of, a contract or grant.” See Pl. Cross-Mot. and Opp. Ex. 2 at 1 (“ASPR Committee 1967 draft of ASPR 15-205.35”) (emphasis added); see also Pl. Cross-Mot. and Opp. Ex. 3 (“ASPR Committee’s 1968 revised draft of ASPR 15-205.35”).

FN16. The ASPR Committee, the predecessor to the current Defense Acquisitions Regulatory Council, was a joint triservice committee established under the Assistant Secretary of Defense (Installations and Logistics) to monitor and develop rules affecting Department of Defense Procurement. Major Norman L. Roberts, *Private and Public International Law Aspects of Government Contracts*, MIL. L. REV., April 1967, at 1, 6 n. 6, 9. The Committee was comprised of one policy and one legal member from the Army, Navy, Air Force and Defense Supply Agency and two members appointed by the Secretary of Defense, one of whom acted as the chairman. See DOD Instruction No. 5126.3 (Dec. 20, 1961).

The Council of Defense and Space Industry Association (“COSIA”) expressed concern regarding the proposed change:

Under paragraph (a), “Definition,” of 15-205.35, we note that IR & D is ... “that technical effort which is not sponsored by, or in support of, a contract or grant ...” The words ... “, or in support of,” are not in the current ASPR definition and are believed to be a source for future misrepresentation. We do not believe that the Government intends that a contractor’s IR & D programs must be completely unrelated to various technologies that are also under its Government contracts. We believe that the words ... “, in support of” ... can be construed to preclude such related IR & D effort as an allowable cost since it may be broadly related and therefore thought to be ... “, in support of,” a particular contract or grant. Because both the Government and industry clearly do not intend to have IR & D effort defined as including that specific effort required to be performed as part of the scope of a particular contract or grant, we believe that the intent can be more clearly expressed by eliminating the phrase... “, or in support of[.]”

*638 See Pl. Cross-Mot. and Opp. Ex. 4 at 5-6 (“CODSIA April 25, 1968 letter to ASPR”). The ASPR Committee agreed that this concern was valid and subsequently removed “in support of” from the proposed regulation. See Pl. Cross-Mot. and Opp. Ex. 6 at 2.

On July 20, 1971, CODSIA proposed that IR & D be defined as “that technical effort which is not sponsored by, or specifically required by contract provisions in performance of, a contract or grant.” Pl. Cross-Mot and Opp. Ex. 9 at 1 (“CODSIA revised draft of ASPR 15-205.35”) (emphasis added).

The ASPR Committee, however, did not adopt CODSIA's recommendation. Instead, on September 1, 1971, the ASPR Committee published Defense Procurement Circular No. 90, amending the definition of IR & D to include "that technical effort which is not sponsored by, or required in the performance of a contract or grant." Pl. Cross-Mot. and Opp. Ex. 10 at 3 ("DPC No. 90."). Accordingly, the ASPR Committee rejected language, "in support of," that would have given the definition a broad meaning and language and adopted, "specifically required by contract provisions," to limit the phrase with a narrower meaning. More importantly, the ASPR Committee 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 ASPR Committee also did not define "required in the performance of a contract or grant" and, thereby continued the debate over whether "required in the performance of a contract," as used in ASPR 15-205.35 excludes only costs explicitly "required in the performance of a contract" or excludes all costs implicitly "required in the performance of a contract." See, e.g., Appeal of Gen. Dynamics Corp., 1966 WL 443 (A.S.B.C.A.), 66-1 BCA P 5680, ASBCA No. 10254 ("At a minimum, [ASPR 15-205.35(c)] was intended to insure that a contractor performing research and development work would not be paid twice for its effort, i.e., once under a contract covering the work directly, and a second time, in part at least, by an overhead markup resulting from research and development costs applied to all of the Government contracts which the contractor had.")

Nevertheless, the CAS Board, having determined that ASPR 15-205.35 suitable for use as a standard without change, did not define or offer an interpretation of "required in the performance of a contract," when that phrase was incorporated into the definitions of IR & D, and, more importantly, B & P when CAS 420 was promulgated. See 48 C.F.R. § 9904.420-30 (defining IR & D as "cost of effort which is neither sponsored by a grant, nor required in the performance of a contract" and B & P as cost "which is neither sponsored by a grant, nor required in the performance of a contract") (emphasis added). Obviously, the CAS Board did not need to promulgate a definition or interpretation of "required in the performance of a contract," because CAS 420 was not promulgated in a vacuum. See *Exxon Corp. v. United States*, 88 F.3d 968, 975 (Fed.Cir.1996) ("We nonetheless are mindful that a regulatory provision must not be read in a vacuum, but instead in light of the entire law and its object and policy.") (citing *John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 510 U.S. 86, 93-95, 114 S.Ct. 517, 126 L.Ed.2d 524 (1993)). In other words, CAS 420 must be read in light of the regulatory framework in which it was promulgated.

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Therefore, “required in the performance of a contract” is to be interpreted in light of CAS 402, and Interpretation No. 1, thereto, since the CAS Board decided to retain both when CAS 420 was promulgated. See *Glover v. West*, 185 F.3d 1328, 1332 (Fed.Cir.1999) (“Furthermore, [courts] attempt to give full effect to all words contained within that statute or regulation, thereby rendering superfluous as little of the statutory or regulatory language as possible.”) (citing *Tallman v. Brown*, 105 F.3d 613, 616 (Fed.Cir.1997); *Union Pac. Corp. v. United States*, 5 F.3d 523, 526 (Fed.Cir.1993)).

CAS 402 and Interpretation No. 1 subsequently were retained when the CAS Board recodified the CAS in 1992. See 57 FED. REG. 14,148 (recodifying the CAS to “provide for a single set unified set of rules and Cost Accounting Standards” as part of an effort to “finally reconcile the existing sets of cost accounting standards”). Accordingly, the CAS Board’s retention of CAS 402 and *639 Interpretation No. 1 when it promulgated CAS 420 in 1979 was not an oversight.

More importantly, whether B & P costs arising from a specific contract are identified with that contract and, therefore, direct costs under a contractor’s cost accounting practice that distinguishes direct from indirect costs on that basis, is a matter of contract interpretation. See *Boeing*, 862 F.2d at 292–93 (interpreting contract to determine whether B & P costs related to a Phase II contract proposal specifically were required by or merely generated by a Phase I contract including a Phase II proposal). Costs generated by or as a result of a contract are not considered specifically identified with the contract and, therefore, may be allocated indirectly. *Id.* The CAS Board did not intend “required in the performance of a contract” to have a static meaning independent of the contracting parties’ intent; rather, consistent with CAS 402, whether a B & P cost is “required in the performance of a contract” requires a determination of the contracting parties’ intent. *Id.*

Although Interpretation No. 1 specifically addresses proposal costs, nothing therein suggests that the use of the parties’ intent to determine whether B & P costs were “required in the performance of a contract” should not extend to determining whether IR & D costs, which are nearly indistinguishable from B & P costs, were “required in the performance of a contract.” See 48 C.F.R. § 9904.402–61(b) (“This interpretation deals with the way 9904.402–40 applies to the treatment of costs incurred in preparing, submitting, and supporting proposals.”); see also *Aerojet–Gen. Corp. v. United States*, 215 Ct.Cl. 223, 568 F.2d 729, 731 (1977) (recognizing that IR & D costs are those costs not “directly sponsored by a contract” and explaining that IR & D and B & P costs are very similar). The CAS Board elected to limit IR & D and B & P

costs with the phrase “required in the performance of a contract.” Therefore, under both definitions, costs that are “required in the performance of a contract” are excluded and must be allocated directly to the contract under which they were required. On the other hand, if IR & D and B & P costs are not “required in the performance” of a contract, they properly are allocated as indirect costs.

The retention of CAS 402 and Interpretation No. 1, therefore, clarifies that the meaning of “required in the performance of a contract” is not fixed. Indeed, as previously noted, the ASPR Committee rejected two proposals that would have given the phrase “required in the performance of a contract” a meaning completely independent of a specific contract. Instead, whether a cost is “required in the performance of a contract” is controlled by the contracting parties’ intent, as determined by traditional contract interpretation on a casebycase basis.

3. Plaintiff Properly Allocated Its Independent Research And Development Costs To The 1997 Mitsubishi Heavy Industries Contract And, Therefore, Plaintiff’s Development Effort Costs Should Have Been Allowed.

[2] The Mitsubishi Contract clearly evidences that the parties did not intend the IR & D costs associated with upgrading the Castor® IVA-XL for the commercial market to be specifically identified with the contract.

Specifically, the October 7, 1998, Mitsubishi Contract provides:

WHEREAS [Plaintiff] desires to sell Goods for the H-IIA Program, and

WHEREAS MHI desires to purchase Goods from [Plaintiff] in conformity in all respects with the provisions stipulated herein and with the provisions referred to in or related Terms and Conditions attached hereto and subsequent purchase orders with related drawings and specifications and

WHEREAS MHI and [Plaintiff] desire to establish Contract of Goods.

2-4 Each of the following documents in an integral part of the Contract between MHI and [Plaintiff] and shall be binding upon both parties through the contract period.

(1) Agreement AM109-937

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(2) Purchase Orders

(3) Statement of Work (SOW), Drawing(s) and Specification(s)
Exhibit A

(4) AM109-638 Special Terms and Conditions Exhibit E

(5) GC-P-1225 General Terms and Conditions Exhibit F

(6) MSH4506 Quality Assurance Requirements for MHI Supplies
Space Systems Exhibit G

*640 3. Scope of Work

3-1 The scope of work to be completed by [Plaintiff] is specified in the Statement of Work ("SOW"), which is attached as Exhibit A.

PX 25 at THI 2383-84 (emphasis added).

The scope of the SOW provides:

[Plaintiff] ... is a United States company specializing as a supplier of solid rocket motors, engineering, launch support hardware, and launch operation services... [MHI] is a Japanese company that is responsible for the development, production, and integration of launch vehicles, specifically, the H-II and H-IIA for the Japanese Space Agency, NASDA. This Statement of Work (SOW) forms the basis of the work to be performed by [Plaintiff] in conjunction with and for MHI in support of the development, qualification and use of the Castor IVA-XL, as a solid strapon booster (SSB) to the H-IIA launch vehicle.

2.0 Definitions

Castor IVA-XL Solid Rocket Motor The Castor IVA-XL is a solid rocket motor developed by [Plaintiff] for use in the commercial space launch vehicle market place. The Castor IVA-XL is an extended length version of the Castor IVA. [Plaintiff] is updating the design of this motor to support the general requirement of the strapon market.

Solid Strap-On Booster (SSB) Solid Rocket Motor The SSB Motor is a component of the evolutionary development of the Japanese H-II launch vehicle system. This booster is intended to provide an additional performance upgrade over the currently planned H-IIA upgrade. The SSB

will be configured using a Castor IVA-XL solid rocket motor. [Plaintiff] intends to produce the SSB in their Defense and Launch Vehicles Division located in Brigham City, Utah, USA. [Plaintiff] is contracting with MHI for the development and qualification of the SSB attachment hardware, ordnance systems, nose cone and other booster systems. This SSB hardware will transform the Castor IVA-XL into the SSB configuration.

PX 25 at THI 2393 (emphasis added)

The definition of Castor® IVA-XL Solid Rocket Motor in the SOW obligated Plaintiff to “bring to the table” the Castor® IVA-XL Solid Rocket Motor, as updated for the “strapon market.” In contrast, the contracting parties’ intended costs to further “develop and qualify” that product with “attachment hardware, ordnance systems, nose cone and other booster systems,” and produce a solid strapon booster to be used with the Japanese H-II launch vehicle system specifically to be identified with the Mitsubishi Contract. In other words, the upgrade, and the associated costs, were considered a precondition to the performance of the “Adaption Effort,” the cost of which the parties intended to be identified with the Mitsubishi Contract. See PX 25 at THI 2384, THI 3787, THI 2390; see also Moore Decl. ¶¶ 47–48 (discussing the drafting of specific contract provisions by the Plaintiff’s to ensure that the contract did not specifically require the Development Effort).

In addition, although the Mitsubishi Contract contains a detailed price structure it does not contain a specific price for the “Development Effort,” necessary to upgrade the Castor® IVA-XL for the general commercial market. Finally, the SOW incorporated into the Mitsubishi Contract and avoided any specific reference to the “Development Effort.” See PX 25 at THI 2384, 2398–2400.

Pursuant to Plaintiff’s disclosed accounting practices, IR & D costs typically are indirect costs and are allocated “as a direct cost only when: (a) a contract specifically required that Plaintiff incur the cost; (b) the contract paid for the cost; or (c) at the time Plaintiff incurred the cost, the cost had no reasonably foreseeable benefit to more than one cost objective.” See Ayers Decl. ¶¶ 15, 19 (citing PX ¶ 3.1.0) (emphasis in original). That practice repeatedly was determined by the *641 Government to be CAS compliant. See Cons. St. of Facts ¶ 16 (Stip.). Since Plaintiff was required to comply with prior disclosed accounting practices, it was appropriate for Plaintiff to allocate “Development Effort” as indirect costs, because the Mitsubishi Contract did not specifically require or pay for the Development Effort, and at the time Plaintiff incurred the cost, a commercial market for the Castor® IVA-XL appeared viable. See 48 C.F.R. § 9903.01.

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Because the Castor® IVA-XL IR & D was a precondition to the work “required in the performance of [the] contract,” was not paid for by the Mitsubishi Contract, and a commercial market for the Castor® IVA-XL appeared viable, the court has determined that Plaintiff’s allocation complied with CAS 402. Therefore, Plaintiff properly allocated \$3,134,249 for updating the Castor® IVA-XL as indirect costs for fiscal years 1997 through 1999 across all contracts, both government and commercial. See *Boeing*, 862 F.2d at 293 (recognizing that costs of “benefit [to] all business of a contractor rather than a specific existing contract ... as indirect overhead is logical.”). Since the Government does not contend that Plaintiff’s “Development Costs” were unreasonable, therefore, the court concludes they were allowable under FAR 31.205-18(c). See 48 C.F.R. § 31.205-18(c) (“[C]osts for IR & D and B & P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.”); see also *Boeing*, 298 F.3d at 1281 (holding that a cost “may be allocable to a contract, [] the cost may be unallowable if it is unreasonable”). Accordingly, the Contracting Officer improperly denied Plaintiff’s claim for \$3,134,249.

For these reasons, the court has determined that whether IR & D costs are “required in the performance of a contract,” within the meaning of CAS 420, is determined by the contracting parties’ intent. Accordingly, the court declines to interpret “required in the performance of a contract” 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 “Sometimes direct/ Sometimes indirect” costs. Nor will the court interpret “required in the performance of a contract” 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. Cf. *Voracek v. Nicholson*, 421 F.3d 1299, 1304 (Fed.Cir.2005) (“We note that similar terms used in different parts of the same statute or regulation presumptively have the same meaning.”) (citing *Gustafson v. Lloyd Co.*, 513 U.S. 561, 570, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995)) (acknowledging that “identical words used in different parts of the same act are intended to have the same meaning” under the “normal rule of statutory construction” (quoting *Dep’t of Revenue of Or. v. ACF Indus., Inc.*, 510 U.S. 332, 342, 114 S.Ct. 843, 127 L.Ed.2d 165 (1994))).

In addition, the Government’s argument that the FAR determination of allowability governs the CAS determination of allocability directly contradicts accepted principles of construction. At the oral argument, the Government advised the court:

GOVERNMENT'S COUNSEL: So in effect the FAR, the FAR standard, is in effect the gateway, the hurdle to get through, and if you can't get through that, then you are not even talking about IR & D in effect.

TR 6.

GOVERNMENT'S COUNSEL: [T]he CAS analysis really occurs after you have determined that something is an allowable cost and it belongs in that CAS category that you are dealing with. So you look at CAS 420 and reference IR & D once you have determined that a cost is allowable. You look at CAS 420 to determine how to allocate it. So a CAS disclosure statement presumes that the costs that it is discussing are allowable in the various categories of this discussion. Here we don't reach that because the FAR says that it is not IR & D if it is required in the performance of the contract. So you don't reach your *642 CAS disclosure statement because it is not even IR & D.

TR 16–17 (emphasis added).

The United States Court of Appeals for the Federal Circuit, however, has instructed trial courts the reverse analysis is required:

[C]ost allowability may turn on whether the cost is allocable. On the other hand, even when a cost is allocable, it is not necessarily allowable.

Boeing, 298 F.3d at 1274. No where in this en banc decision does the appellate court hold that the analysis advocated by the Government in this case is proper.

2. The Parties' Cross-Motions For Summary Judgment On Count II.

[3] The court's disposition of the parties' crossmotions for summary judgment on Count II depends on whether Plaintiff properly capitalized and allocated the cost of tangible assets necessary to produce the Castor® IVA-XL at its Utah facility, under CAS 404 and 409, and, therefore, were allowable under FAR 31.205-11.

a. The Government's Argument.

The Government argues that Plaintiff improperly allocated "Production Costs" as indirect costs. As an initial matter, the Government does not rely on the "special tooling" rationale used by the DACO in disallowing Plaintiff's

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“Production Costs.” See Gov’t Mot. at 6, 7 (“We have chosen not to rely upon the ‘special tooling’ rationale in this motion since CAS 420 is dispositive and there might exist factual disputes concerning how [Plaintiff] has used the Utah facility.”); see also 48 C.F.R. § 31.205-40 (allowing special tooling, as defined by 48 C.F.R. § 45.101, and requiring such tooling to be allocated directly to the specific government contract or contracts for which it was acquired). The Government’s reluctance to move for summary judgment on a “special tooling” theory appears to be based on the belief that the actual, as opposed to possible, uses to which tangible assets are put determines whether equipment is “special tooling” and, therefore, that a potential factual dispute may exist regarding the actual use of the tangible assets at issue in this case precluding summary judgment. *Id.* Instead, the Government argues that the disputed Production Costs are R & D “required in the performance” of the Mitsubishi Contract and, therefore, under CAS 420 and FAR 31.205-18 should have been allocated as direct costs of the MHI contract. See Gov’t Mot. at 8-17. Therefore, the Government argues that it was improper for Plaintiff to capitalize, depreciate, and allocate “Production Costs” under CAS 404 and 409 and FAR 31.205-11. See Gov’t Reply at 20. The Government also argues that CAS 404 and 409 that govern the capitalization and subsequent depreciation of tangible capital assets, are applicable only to the extent that the Production Costs in question meet FAR 31.205-25’s definition of “manufacturing and production engineering effort” (“MPE”). *Id.* at 21. Here the Government’s argument is that allocation of Plaintiff’s Production Costs as indirect costs is contingent on those Production Costs meeting FAR 31.205-25’s definition of MPE, rather than FAR 31.205-18’s definition of R & D. *Id.* (“The FAR’s definition of R & D and MPE are mutually exclusive.”). According to the Government, Plaintiff’s Production Costs are IR & D within the meaning of CAS 420 and FAR 31.205-18 and, CAS 404 and 409, do not apply. *Id.* Thus, the Government argues that Plaintiff’s Production Costs are IR & D rather than MPE, because “the approximately \$5 million spent by [Plaintiff] for new tools and other production assets” was for the “development of the upgraded Castor motor for future production and delivery to Mitsubishi.” *Id.* at 23 (emphasis in original).

In the alternative, the Government argues that, “should [Plaintiff] choose to argue now that the upgraded Castor® IVA-XL rocket motor that Plaintiff was required to develop for delivery to Mitsubishi was not really a ‘new’ product,” summary judgment would be precluded by “a factual dispute as to the newness of the upgraded motor.” *Id.*

b. Plaintiff’s Argument.

Plaintiff counters \$4,928,839 of Production Equipment related to the acquisition of *643 tangible assets necessary to produce the Castor® IVA-XL was properly capitalized and depreciated and properly allocated those costs to indirect cost pools. See Cross Mot. at 58–64. Plaintiff’s argument is based on the fact that FAR 31.205–11 requires contractors to comply with CAS 409, mandating the depreciation of tangible capital assets, as defined by CAS 404, and allocation of that depreciation as indirect costs. See Cross Mot. at 58–59; see also Pl. Reply at 27.

Plaintiff responds that the Government’s argument that CAS 420 and FAR 31.205–18 control is misplaced, because those regulations are irrelevant to Production Equipment. See Cross. Mot. at 61 (“Government’s arguments that depreciation costs must be considered direct costs because they relate to tangible assets ‘necessary to,’ related to, implicitly required or needed to avoid breaching a contract are irrelevant under CAS.”). Plaintiff argues that the FAR and CAS treat R & D, MPE, and tangible capital assets as distinct costs, subject to different accounting procedures. See Pl. Reply at 27, 28.

c. The Court’s Resolution Of The Parties’ Cross-Motions For Partial Summary Judgment.

1. CAS 404 And CAS 409 Control The Capitalization And Depreciation of Tangible Capital Assets.

CAS 404 requires contractors to “establish and adhere to policies with respect to the capitalization of tangible assets which satisfy criteria set forth [therein].” 48 C.F.R. § 9904.404–20. More importantly, CAS 404 requires the capitalization of tangible assets when these minimum criteria are met:

(b) The contractor’s policy shall designate economic and physical characteristics for capitalization of tangible assets.

(1) The contractor’s policy shall designate a minimum service life criterion, which shall not exceed 2 years, but which may be a shorter period. The policy shall also designate a minimum acquisition cost criterion which shall not exceed \$5,000, but which may be a smaller amount.

(4) The contractor’s policy may designate higher minimum dollar limitations for original complement of low cost equipment and for betterments and improvements than the limitation established in accordance with paragraph (b)(1) of this subsection, provided such higher limitations are reasonable in the contractor’s circumstances.

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* * * * *

(c) Tangible assets shall be capitalized when both of the criteria in the contractor's policy as required in paragraph (b)(1) of this subsection are met, except that assets described in subparagraph (b)(4) of this subsection shall be capitalized in accordance with the criteria established in accordance with that paragraph.

48 C.F.R. § 9904.404–40(emphasis added).

In addition, CAS 404 provides:

(d) Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g., betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized with appropriate accounting for replaced asset accountability units. However, costs incurred for repairs and maintenance to a tangible capital asset which either restore the asset to, or maintain it at, its normal or expected service life or production capacity shall be treated as costs of the current period.

48 C.F.R. § 9904.404–40.

CAS 409 authorizes the depreciation of tangible capital assets. See 48 C.F.R. § 9904.409–40. CAS 409 also authorizes the allocation of depreciation costs as indirect costs, unless the depreciation meets one of two exception, neither of which apply in this case:

(b) The annual depreciation cost of a tangible capital asset (or group of assets) shall be allocated to cost objectives for which it provides service in accordance with the following criteria:

(1) Depreciation cost may be charged directly to cost objectives only if such *644 charges are made on the basis of usage and only if depreciation costs of all like assets used for similar purposes are charged in the same manner.

(2) Where tangible capital assets are part of, or function as, an organizational unit whose costs are charged to other cost objectives based on measurement of the services provided by the organizational unit, the depreciation cost of such assets shall be included as part of the cost of the organizational unit.

(3) Depreciation costs which are not allocated in accordance with paragraph (b) (1) or (2) of this subsection, shall be included in appropriate indirect cost pools.

48 C.F.R. § 9904.409–40 (emphasis added).

Finally, FAR 31.205–11 provides:

(a) Depreciation on a contractor’s plant, equipment, and other capital facilities is an allowable contract cost...

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, shall adhere to the requirement of that standard for all fully CAS covered contracts and may elect to adopt the standard for all other contracts.

48 C.F.R. § 31.205–11 (emphasis added).

2. Plaintiff Properly Allocated The Depreciation Of Tangible Capital Assets And, Therefore, Plaintiff’s Production Equipment Costs Should Have Been Allowed.

In this case, the production tooling (e.g., forgings, fixtures, mandrels, jigs, lathes, cure carts, dollies, chocks, rings, rack storage, trunnions and casting cores), equipment (computers and trailers) and facility modifications (e.g., work platform and egress chutes) acquired to produce the Castor® IVA–XL at Plaintiff’s Utah facility and comprising Plaintiff’s “Production Equipment” costs are all tangible assets. See Cons.St. of Facts ¶¶ 81, 85. This production tooling is considered “hard tooling,” because it is usable for the production of Castor® IVA–XL motors that could be sold to any commercial customer. Id. ¶ 82. Similarly, the equipment and facilities modifications could be used to produce Castor® IVA–XL motors for any commercial customer. Id. ¶ 83.

Plaintiff determined the service life of these assets was greater than two years and the cost was greater than \$5,000. See, e.g., Larsen Decl. 27; Germaine Decl. ¶ 19, 20. Accordingly, in accordance with Plaintiff’s capitalization policy and CAS 404, the production tooling, equipment and facilities necessary to produce the Castor® IVA–XL at the Utah facility was properly capitalized. See 48 C.F.R. § 9904.404–40(c); see also Larsen Decl. ¶¶ 24, 27. Once capitalized, Plaintiff was required to depreciate those assets and allocate that depreciation as an indirect costs in accordance with CAS 409 and FAR 31.205.11(b). See 48 C.F.R. § 31.205–11(b).

The court is not persuaded by the Government’s argument that CAS 404 and CAS 409 are applicable only to the extent that the disputed Production Costs satisfy FAR 31.205–25’s definition of “manufacturing and production engineering effort,” rather than FAR 31.205–18’s definition of IR & D. The

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Government's interpretation would make the application of CAS 404 and CAS 409 contingent upon FAR 31.205-18 and FAR 31.205-25. Such an interpretation would require the court to treat FAR 31.205-18 and FAR 31.205-25 as rules of allocation, rather than allowability. See *Kearfott Guidance & Navigation*, 320 F.3d at 1375 (Fed.Cir.2003) (discussing the invalidity of FAR acting as rules of allocation). Moreover, the Government's argument is based on the incorrect premise that Plaintiff's Production Equipment costs must be either IR & D or MPE. See Gov't Reply at 21 ("Costs of development effort are subject to the IR & D cost principle or the MPE cost principle, but not both."). The Government fails to recognize that under FAR 31.205-11, depreciation costs are a distinct category of allowable cost and misconstrues FAR 31.205-18's definition of "development," in an attempt to treat tangible assets as development effort. Compare FAR 31.205-11 (allowing depreciation costs); FAR 31.205-18 (allowing IR & D and B & P costs); FAR 31.205-25 (allowing MPE costs) with 48 C.F.R. § 31.205-18(a) (defining development as the "systematic use, under whatever name, of scientific and technical knowledge").

*645 For these reasons, the court has determined Plaintiff properly allocated Production Equipment expenditures as an indirect cost. See *Boeing*, 862 F.2d at 293. The Government has not contested these costs as unreasonable. See *Boeing*, 298 F.3d at 1281. Therefore, under FAR 31.205-11, those costs were allowable. Accordingly, the Contracting Officer improperly denied Plaintiff's claim for \$4,928,839.

CONCLUSION

The Plaintiff's Cross-Motion for Partial Summary Judgment on Counts I and II is GRANTED. The Government's Motion for Summary Judgment or, in the Alternative, for Summary Judgment on Counts I and II and to Dismiss Count III is DENIED.

United States District Court,
E.D. Virginia,
Alexandria Division.
UNITED STATES of America, Plaintiff,

v.

NEWPORT NEWS SHIPBUILDING, INC., Defendant.

No. CIV.A. 03-142-A.
Aug. 14, 2003.

Government sued shipbuilder that held government contracts for construction of military transport vessels, claiming that shipbuilder violated Federal Acquisition Regulation (FAR) and False Claims Act (FCA) by charging efforts to develop commercial transport vessels as Independent Research and Development (IR&D), as indirect expense allocable to government contracts. Shipbuilder moved for summary judgment. The District Court, Ellis, J., held that(1) general practice of charging efforts to IR&D, to extent that efforts were mandated under commercial contracts, was FAR violation; (2) there were fact issues as to whether certain efforts were properly allocated to IR&D; (3) fact issues as to whether IR&D allocations were made knowingly or recklessly, precluded summary judgment of liability under FCA; (4) fact issues precluded summary judgment whether shipbuilder violated FCA by not disclosing its practice of charging IR&D; and (5) there were fact issues precluding summary judgment that shipbuilder reasonably relied on counsel in charging IR&D.

Motion denied.

West Headnotes

[1] Public Contracts 316H 273

316H Public Contracts
316HV Construction and Operation
316Hk271 Compensation
316Hk273 k. Cost-plus contracts. Most Cited Cases

Appendices

United States 393 70(18)

393 United States

393III Contracts

393k70 Construction and Operation of Contracts

393k70(15) Compensation

393k70(18) k. Cost basis and cost-plus. Most Cited Cases

In determining whether government contractor has performed Independent Research and Development (IR&D), costs of which may be allocated as an indirect expense among contractors' various government contracts, Federal Acquisition Regulation (FAR) denying IR&D status to costs associated with efforts "required in the performance of a contract" includes efforts which are not explicitly stated in the contract, but are nonetheless necessary to perform the contract and thus implicitly required by it. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[2] Public Contracts 316H 273

316H Public Contracts

316HV Construction and Operation

316Hk271 Compensation

316Hk273 k. Cost-plus contracts. Most Cited Cases

United States 393 70(18)

393 United States

393III Contracts

393k70 Construction and Operation of Contracts

393k70(15) Compensation

393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Government contractor may not charge research and design efforts as Independent Research and Development (IR&D), allocable as indirect expenses under government contracts, rather than charging them to particular contract, simply because efforts are of benefit to more than one existing contract. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[3] Public Contracts 316H 273

316H Public Contracts

316HV Construction and Operation

316Hk271 Compensation

316Hk273 k. Cost-plus contracts. Most Cited Cases

United States 393 70(18)

- 393 United States
 - 393III Contracts
 - 393k70 Construction and Operation of Contracts
 - 393k70(15) Compensation
 - 393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Independent Research and Development (IR&D) efforts, allocated as indirect expenses over contractor's various government contracts, must be charged as direct expenses to any particular contract that requires those efforts, once contract is signed. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[4] Public Contracts 316H 273

- 316H Public Contracts
 - 316HV Construction and Operation
 - 316Hk271 Compensation
 - 316Hk273 k. Cost-plus contracts. Most Cited Cases

United States 393 70(18)

- 393 United States
 - 393III Contracts
 - 393k70 Construction and Operation of Contracts
 - 393k70(15) Compensation
 - 393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Exclusion in regulation allowing government contract to allocate as indirect expenses chargeable to government contracts Independent Research and Development (IR&D) efforts, when efforts are "required in the performance of a contract," prohibits contractor from charging government for research and development expenses of general nature for which contractor receives compensation under any non-government contract. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[5] Public Contracts 316H 273

- 316H Public Contracts
 - 316HV Construction and Operation
 - 316Hk271 Compensation
 - 316Hk273 k. Cost-plus contracts. Most Cited Cases

Appendices

United States 393 70(18)

393 United States
393III Contracts
393k70 Construction and Operation of Contracts
393k70(15) Compensation
393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Shipbuilder's general practice, of treating research and development expenses incurred in developing new line of commercial transport vessels as Independent Research and Development (IR&D), chargeable as indirect expense to government contracts for military vessels, when work in question was called for under two commercial contracts to provide transport vessels, violated Federal Acquisition Regulation prohibiting charging as IR&D for efforts "required in the performance of a contract." 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[6] Public Contracts 316H 273

316H Public Contracts
316HV Construction and Operation
316Hk271 Compensation
316Hk273 k. Cost-plus contracts. Most Cited Cases

United States 393 70(18)

393 United States
393III Contracts
393k70 Construction and Operation of Contracts
393k70(15) Compensation
393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Letter of intent to enter into contract for construction of commercial transport vessel, which was not binding contract under Virginia law, did not trigger requirement that government contractor cease treating its efforts to develop commercial transport vessel as Independent Research and Development (IR&D), chargeable as indirect expense to its various government contracts, and begin charging commercial contract. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[7] Federal Civil Procedure 170A 2492

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2492 k. Contract cases in general. Most Cited Cases

Material issues of fact, as to whether certain efforts of shipbuilder in developing commercial transport vessel predated signing of commercial contract for vessels or were otherwise not allocable to commercial contracts, precluded summary judgment that all efforts were improperly charged to those contracts as indirect Independent Research and Development (IR&D) expenses, rather than being charged to commercial contracts. 48 C.F.R. § 31.205-18(a); § 231.205-18(c)(iii)(B) (2001).

[8] United States 393 120.1

393 United States
393VIII Claims Against United States
393k120 Making or Presentation of False Claims and Other Offenses Relating to Claims
393k120.1 k. In general. Most Cited Cases

Term “knowingly,” as used in False Claims Act (FCA), applies when there is action taking in deliberate ignorance of or reckless disregard of truth. 31 U.S.C.A. § 3729(a)(1, 2, 7), (b).

[9] Federal Civil Procedure 170A 2498.4

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2498.4 k. False claims and qui tam actions. Most Cited Cases

Material issues of fact, as to whether expenses incurred by shipbuilder deemed Independent Research and Development (IR&D) and charged as indirect expense to government contracts qualified as IR&D, precluded summary judgment that contractor knowingly submitted false information to government, in violation of False Claims Act (FCA). 31 U.S.C.A. § 3729(a) (1, 2, 7), (b).

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[10] Federal Civil Procedure 170A 2498.4

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2498.4 k. False claims and qui tam actions. Most Cited Cases

Material issues of fact, as to whether research and development efforts involving development of commercial transport vessel constituted Independent Research and Development (IR&D) properly allocable to government military vessel contracts as indirect expense, precluded summary judgment that shipbuilder knowingly submitted false claims to government, in violation of False Claims Act (FCA), by charging efforts to develop commercial transport vessel to military transport vessels contracts, as IR&D. 31 U.S.C.A. § 3729(a)(1, 2, 7), (b).

[11] Federal Civil Procedure 170A 2498.4

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2498.4 k. False claims and qui tam actions. Most Cited Cases

Material issues of fact, as to whether shipbuilder acted recklessly in charging efforts to develop commercial transport vessel as Independent Research and Development (IR&D) as indirect expense allocable to government military vessel contracts, precluded summary judgment whether contractor submitted false claims in violation of False Claims Act (FCA). 31 U.S.C.A. § 3729(a)(1, 2, 7), (b).

[12] Federal Civil Procedure 170A 2498.4

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2498.4 k. False claims and qui tam actions.
Most Cited Cases

Material issues of fact, as to whether shipbuilder adequately disclosed accounting practice of charging commercial transport vessel development efforts as Independent Research and Development (IR&D) constituting indirect expense allocable to government military vessel contracts, precluded summary judgment whether shipbuilder knowingly submitted false claims to government in violation of False Claims Act (FCA). 31 U.S.C.A. § 3729(a)(1, 2, 7), (b).

[13] Federal Civil Procedure 170A 2498.4

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2498.4 k. False claims and qui tam actions. Most Cited Cases

Material issues of fact, as to whether shipbuilder reasonably relied on counsel which approved accounting practice of charging commercial transport vessel development efforts as indirect Independent Research and Development (IR&D) expense under various government military transport vessel contracts, precluded summary judgment that shipbuilder submitted false claims in violation of False Claims Act (FCA). 31 U.S.C.A. § 3729(a)(1, 2, 7), (b).

*⁵⁴¹ Craig Paul Wittman, Office of the United States Attorney, Peter D. Keisler, Assistant Attorney General, U.S. Dept. of Justice, Civil Div., Paul J. McNulty, United States Attorney, Eastern Dist. of Virginia, Michael F. Hertz, Alan E. Kleinburd, David Sadoff, J. Chris Larson, Joel D. Hesch, U.S. Dept. of Justice, Civil Div., Commercial Litigation Branch, Fraud Section, Norfolk, VA, for Plaintiffs.

James J. McCullough, Deneen J. Melander, David Scott Gallacher, Fried Frank Harris Shriver & Jacobson, Washington, D.C., for Defendants.

MEMORANDUM OPINION

ELLIS, District Judge.

At issue on summary judgment in this False Claims Act (FCA) case ^{FN1} is whether Newport News Shipbuilding, Inc. (NNS) violated the Federal Acquisition Regulation (FAR) by misclassifying as Independent Research and Development (IR & D) approximately \$74 million that was allegedly spent in connection with the design and construction of double-hulled

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tankers for commercial customers. Resolution of this question requires the interpretation and application of a long-questioned aspect of the FAR's definition of IR & D, specifically the exclusion from IR & D of efforts "required in the performance of a contract." 48 C.F.R. § 31.205-18(a).

^{FN1}. The government also asserts related contractual and common law claims. The first amended complaint contains the following claims:

Count I: Presentation of False Claims, 31 U.S.C. § 3729(a)(1)

Count II: Use of False Statements, 31 U.S.C. § 3729(a)(2)

Count III: Use of False Records to Decrease Obligation,
31 U.S.C. § 3729(a)(7)

Count IV: Unjust Enrichment

Count V: Payment Under Mistake of Fact

Count VI: Breach of Contract

Also at issue on summary judgment is whether the FCA claims must be dismissed on the ground that the undisputed evidence establishes that NNS did not "knowingly" submit false claims, as required by the FCA. 31 U.S.C. § 3729(a).

Following an initial hearing on these motions on Friday, July 18, 2003, supplemental briefing was requested and the hearing continued on Monday, July 21, 2003, at which time the motions were decided from the bench and an order issued.^{FN2} This memorandum opinion elucidates the bases for those bench rulings.

^{FN2}. See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. July 21, 2003) (Order).

*542 I.

Defendant NNS is a major defense contractor whose chief business is the design, construction, repair, overhaul and re-fueling of nuclear-powered aircraft carriers and submarines for the United States Navy. During the time period relevant to this action, most of NNS's yearly revenues, between 85% and 99%, came from its contracts with the Navy. Most the contracts are flexibly-priced contracts, under which NNS charges the government on an ongoing basis based on its reasonable, allocable, and allowable costs,

as determined according to the FAR 48 C.F.R. §§ 1.000 et seq. These costs include (i) direct costs that are directly identified with and charged to a specific contract, such as material and labor costs, and (ii) indirect costs that are allocable to more than one contract, including overhead and general administrative costs, which must be allocated to the various applicable contracts. IR & D costs, the subject of this dispute, are indirect costs.

For the period between 1994 and 1999, NNS submitted invoices for progress payments on a bi-weekly or monthly basis. At the end of each year, NNS submitted a final indirect cost proposal, which certified that the submitted indirect costs were allowable in accordance with the FAR. The central question at issue here is whether NNS's claims for progress payments and year-end certifications submitted from 1994 and 1999 were false, because they contained IR & D charges for efforts related to NNS's Double Eagle commercial tanker program that were not allowable as IR & D under the FAR.

Although both parties agree on some of the essential facts in this dispute, and although there is a voluminous factual record accompanying the summary judgment motions, there remain disputed factual issues material to certain aspects of the case. As the following summary indicates, substantial factual questions remain regarding such central facts as (i) the nature and intent of NNS's Double Eagle class design efforts, (ii) the content of the advice NNS received regarding the regulation and its charging practices, (iii) whether NNS followed that advice, and (iv) when and to what extent NNS disclosed its IR & D charging practices regarding the Double Eagle IR & D to the government.

A. *NNS's Double Eagle tanker program*

The genesis of this dispute is NNS's ultimately unsuccessful attempt to re-enter the commercial shipbuilding market. Although it had earlier withdrawn from the commercial shipbuilding market, NNS, in the early 1990's, decided to return to commercial shipbuilding, specifically to build double hulled oil tankers to be known as Double Eagle tankers. NNS asserts that this decision to design, market, and sell the Double Eagle tankers was part of a larger effort undertaken by NNS to transform itself into a world-class shipbuilder capable of competing with shipbuilding yards in Asia and Europe. NNS argues that the intent, from the outset, was to invest significantly to create a "class design" for the Double Eagle tankers and to transform its shipbuilding operations to become more competitive and efficient. Thus, NNS paints a picture of a tanker class design effort that was independent from the efforts undertaken to fulfill the specific Double Eagle contracts, which contracts materialized after the commencement of the class design effort.

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The government's view is quite different; it disputes the existence of a truly independent class design effort, contending that NNS simply created "contract-level" plans for a "proposed class" of ships which it intended to market to potential customers, and that it chose to pursue a class design in order to shift design costs *543 from money-losing commercial contracts into general IR & D chargeable to government contracts. Thus, the government does not agree that NNS worked to develop a generic class design separate and independent from the specific commercial contracts received by NNS to build the Double Eagle tankers.

By March 1994, NNS had completed some market research and preliminary design work on the Double Eagle tanker, and, at that time, began to seek funding for the project and to market the new tankers to potential customers. On March 15, 1994, NNS issued a press release publicly announcing its Double Eagle tanker program. On March 18, 1994, NNS submitted a proposal for funding under the United States Advanced Research Projects Agency (ARPA)'s Maritech Program, setting out its plan to enter the commercial shipbuilding market with the a "42,000 dwt product tanker" as the "initial target market ship," and stating that "NNS has already developed a concept design for such a ship, the Double Eagle 333." And, on March 21 and 22, 1994, NNS presented a model of the Double Eagle tanker at an industry trade show, and quickly thereafter became involved in discussions with various potential commercial customers for its new tankers.

Beginning on January 4, 1993, NNS charged the costs of its preliminary design efforts for what became the Double Eagle tanker project to various IR & D accounts. On May 12, 1994 NNS issued IR & D Job Order 2858, the first IR & D job order to contain charges disputed in this matter. Job Order 2858, entitled "Develop Product Carrier Design Process," was intended to capture the costs of NNS's efforts to "complete the preliminary design of the Newport News Standard Products Carrier and to establish the process for transferring from preliminary design to detail design."

On May 20, 1994, shortly after Job Order 2858 was issued, NNS signed a letter of intent (LOI) with Eletson Corporation, a Greek shipper, to negotiate contracts for the construction of four Double Eagle tankers suitable for the international tanker market at a price of \$36 million each. This price represented a premium of \$3 to \$4 million per ship over the then-prevailing market price for comparable ships built in Asia and elsewhere. According to the government, NNS had not prepared a cost breakdown prior to signing the letter of intent; NNS, however, disputes this contention. At any rate, a cost estimate spreadsheet was prepared in this general time frame,

alt-hough it is unclear whether this occurred before or after the LOI was signed. This cost estimate indicates that NNS would lose money at the \$36 million price, even assuming NNS received an \$8 million in funding from the Maritech Program and various other cost-saving assumptions.^{FN3}

^{FN3}. More specifically, the spreadsheet indicates that, if NNS were to build six of the proposed ships, the “book cost” per ship would be approximately \$59 million; the “possible cost,” assuming an \$8 million Maritech grant, 25% productivity improvement, and other cost savings, was estimated to be approximately \$45 million per ship; the “future cost,” assuming future improvements, would amount to approximately \$41 million per ship, and the “potential cost,” assuming yet further reductions in cost, was estimated to be approximately \$38 million per ship. According to NNS, it was notified of a \$3 million Maritech award on May 25, 1994.

The government asserts that NNS thereafter decided to budget the design and planning effort required for the Eletson ships under IR & D. In this regard, the cost estimate prepared at the time of the Eletson LOI budgeted 120,000 hours of engineering for the first Eletson ship, and only 9,000 to 5,000 for the next three ships. Thus, the initial cost estimate appears⁵⁴⁴ to have allocated the cost of the initial design and planning effort directly to the Eletson contracts. By contrast, a later NNS budget dated May 1995 allocates only 10,000 hours of engineering for the first Eletson ship and 5,000 to 3,000 engineering hours for the next three ships. For its part, NNS contends that it had always planned to continue charging the design and planning costs for the Double Eagle class design to IR & D, even after contracts for individual Double Eagle tankers were signed. According to NNS, its plan throughout was to charge directly to the Eletson contracts only those design and planning efforts necessary to customize the class design to Eletson’s specifications. In other words, NNS contends that its intent was always to use the output of its generic Double Eagle class design efforts in constructing the Eletson ships, to the extent the Eletson ships were identical to the class design.

As noted, the government contends that NNS did not engage in any class design effort independent of the effort to design and build the Eletson ships. In this regard, the government points out that the concept design for the Double Eagle tanker class marketed by NNS was substantially modified by NNS in response to its ongoing negotiations with Eletson. According to an NNS internal report, Eletson requested several changes to the concept design to make the ship appropriate for the international market, including

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a reduction in ship speed from 16 knots to 14.5 knots, a wider beam, and a centralized pump room. For its part, NNS contends that these changes were not “substantial” modifications.^{FN4} Moreover, while NNS concedes that the class design was modified to incorporate some of Eletson’s requirements, NNS nonetheless contends that Eletson’s requirements were incorporated in the class design only to the extent that market research indicated that the marketplace agreed the modifications were necessary. According to NNS, Eletson’s requests for modifications that were not useful to the class design were not included in the class design and the design and engineering costs associated with those modifications were not charged to IR & D, but were charged to the Eletson ships directly.

^{FN4}. As discussed *infra*, however, the modifications Eletson required for the international market, particularly the reduction in operating ship speed, were substantial enough to merit the development of a separate design class for domestic tankers after NNS signed the Van Ommeren contracts.

On October 31, 1994, NNS signed four separate contracts with four corporations affiliated with Eletson for the construction of four Double Eagle tankers. Each contract specified that NNS would “design, construct, equip and complete one (1) 46,500 metric ton deadweight single screw diesel driven oil/petroleum carrier” in accordance with specifications incorporated into the contract. All four contracts also specified a “purchase price” of \$36 million, which some included “the expenses for basic designs and supply of drawings, inspections, tests, surveys, classification of the Vessel and all required certificates other than Class and the technical services required to be rendered to the Purchaser under the terms of the Contract.”

On November 2, 1994, shortly after the Eletson contracts were signed, NNS established Job Orders 647C and 648C (Hull Job Orders) for “costs specifically for the construction” of the tankers. The Hull Job Orders indicated that “all costs for planning and development of the Standard Double Eagle Tanker Program (including complete detail design, developing product model and build strategy and purchase order preparation up to placement)” *545 should be charged to IR & D Job Order 2858, not the Hull Job Orders.

On November 21, 1994 NNS modified and expanded IR & D Job Order 2858. The original project objective, established May 12, 1994, was “to complete the preliminary design ... and establish a process for transferring from preliminary design to detail design.” The modified objective was “to develop a ‘world class’ design” for a “double hulled ... petroleum product tanker,”

resulting in a “complete” design, “including model testing, detail drawings, detail specifications, and particulars for all equipment,” as well as a “build strategy.” Then, on March 13, 1995, NNS further modified Job Order 2858, changing the title to “Development of the Double Eagle Class of Product Carriers,” and stating as the objective the “research and development of the Double Eagle 300 Class of vessels” including “design, prototyping, development, testing, and evaluation to provide completed designs to be used to produce the new class of ships for sale.” Whereas the government stresses that the March 13, 1995 modification is the first time that Job Order 2858 referenced a “class design,” NNS disputes the significance of this change in terminology, arguing that NNS’s the purpose of Job Order 2858 was always to record the costs of creating a class design for a series of commercial tankers.

In 1994, NNS charged IR & D Job Order 2858 for the cost of 78,619 engineering hours and 9,529 production hours. The government contends that these charges were incurred to prepare drawings and Detail Specifications necessary to negotiate contracts with Eletson, and to respond to Eletson’s requests for modifications of the design. NNS contends that these charges were part of its ongoing Double Eagle “class design” efforts and its larger efforts to modernize and transform its shipbuilding techniques.

In September of 1994, NNS began contract negotiations with Van Ommeren Shipping, Inc. Van Ommeren was interested in tankers for use in the domestic trade, and as such wanted ships built to standards and specifications different from those of the Double Eagle ships being designed and built for Eletson. For example, Van Ommeren required tankers with an operating ship speed of 16 knots rather than 14.5 knots, and this change in turn required considerable redesign of the Eletson Double Eagle tanker. A February 7, 1995 Memo from M.L. Powell, NNS’s director of new product engineering, estimated that modifying the Double Eagle plans to meet Van Ommeren’s specifications would require 86,565 engineering hours and more than 50,000 computer design hours. Indeed, the ships requested by Van Ommeren differed so greatly from those being designed and built for Eletson that NNS classified them as a second class, namely “Domestic Double Eagle tankers,” and began referring to the Eletson ships as “International Double Eagle tankers.”

On March 17, 1995 NNS signed a letter of intent with Van Ommeren to continue good faith negotiations to reach a contract for five Domestic Double Eagle tankers for a price of \$40.7 million per vessel. On August 31,

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1995, NNS issued IR & D Job Order 2875, titled “Development of the U.S. Flag Double Eagle Class of Product Carriers,” intended to include costs for the “design, prototyping, development, testing and evaluation to provide a complete design for a new class of ships for sale.”

On November 21, 1995, NNS entered into five separate contracts with Van Ommeren for Domestic Double Eagle tankers, at the price of \$42.9 million per ship. Each contract specified that NNS would “design, construct, equip and complete one (1) single screw diesel driven crude oil and *546 oil products carrier.” Each contract also specified that the “Contract Price shall include the expenses for the supply of drawings, inspections, tests, surveys, classification of the Vessel, the technical services required to be rendered to the purchaser under the terms of this Contract and all required certificates other than documentation.”

A January 19, 1996 NNS memo contains the “recommended Contract Price Breakdown and Budgets” for the Van Ommeren tankers. It budgets only 10,000 engineering hours for the first ship and 3,500 for each of the following four ships, far less than the total engineering hours estimated in the February 7, 1995 Powell memorandum, while explaining in a footnote to these figures that the “Detail design [will be] charged to IR & D.” Thus, as with the Eletson tankers, the bulk of the detailed design work necessary to develop the Van Ommeren tankers, i.e., the Domestic Double Eagle class tanker, was charged to IR & D Job Order 2875, not the individual Hull Job Orders for the five Van Ommeren tankers.

Despite negotiations with other potential commercial customers, NNS did not reach any further agreements to build Double Eagle tankers. Finally, in March 16, 1998, NNS decided to abandon its commercial tanker venture and announced that it was leaving the commercial shipbuilding market. On March 25, 1998, NNS issued IR & D Job Order 3102, entitled “Completion of Double Eagle Design,” to accumulate the costs “to complete the International and Domestic Double Eagle Tanker designs to support the disposition of material and to document the designs sufficient for the sale or future use of such designs.” As of April 1, 1998, IR & D Job Order 3102 superceded Orders 2858 and 2875. The government contends that further engineering efforts for the International and Domestic Double Eagle tankers built under the Eletson and Van Ommeren contracts were charged under 3102, while NNS maintains that 3102 was created after the ships had been substantially completed and that none of the tasks charged to 3102 were performed in furtherance of the contracts to build the nine ships, but rather were tasks required to finish the class designs so these designs

could be preserved in corporate memory and possibly transferred, sold, or resuscitated at some later date.

In total, NNS charged over \$33 million to the International Double Eagle IR & D Job Order 2858, over \$40 million to the Domestic Double Eagle IR & D Job Order 2875, and over \$2 million to the Completion of Double Eagle Design Job Order 3102. All of these charges were allocated to IR & D, and thus placed in NNS's general overhead and allocated to all of its work. As a result, the vast majority of the IR & D costs under Job Orders 2858, 2875, and 3102 were billed to the government pursuant to NNS's flexibly priced government contracts. Specifically, the government points out that the record reflects that 1,640,990 hours of design and engineering work attributable to the Eletson and Van Ommeren ships and contracts were charged to the government as IR & D, while only 216,710 hours of engineering work were charged directly to the individual contracts. Thus, the government contends that of all the engineering work necessary to build the Eletson and Van Ommeren ships, only 12% was directly charged to the contracts.

NNS, for its part, disputes the government's classification of all of this engineering work as necessary to build the ships and also provides somewhat different figures for the breakdown in hours. NNS cites its expert Dr. Fisher to the effect that 1,758,424 hours of engineering effort were charged to the class design under the three IR & D job orders, while 219,696 *547 hours of engineering effort were charged to individual hulls under contract.

B. NNS's Decision to Continue Charging Double Eagle Design Effort as IR & D

To prevail on its claims under the False Claims Act, the government must show not only that NNS misclassified Double Eagle design costs as IR & D under the FAR, but also that NNS did so "knowingly." 31 U.S.C. § 3729(a). Thus, the record contains extensive evidence, much of it in dispute, regarding NNS's decision to continue charging Double Eagle design costs as IR & D after NNS signed commercial contracts with Eletson and Van Ommeren to build the ships. At issue, in particular, on the question of whether false claims were "knowingly submitted, is the nature and content of the advice NNS sought and received regarding the IR & D classification, the reasonableness of NNS's reliance on that advice, and when and to what extent NNS disclosed its accounting practices to the government."

As more fully discussed *infra*, efforts "required in the performance of a contract" may not be charged as IR & D under the FAR. 48 C.F.R. § 31.205-18.

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Thus, once NNS signed the Eletson contracts, NNS faced the question whether it could properly continue to charge its Double Eagle design efforts under IR & D. According to NNS, once the contracts were signed it set out to determine whether the existence of these contracts altered the IR & D analysis and required more restrictive use of the IR & D category. In this regard, NNS solicited opinions and advice from two sources, namely its Assistant General Counsel, Doyle Huneycutt, and an outside expert, William T. Keevan, the managing partner in Arthur Andersen's Government Contracting Consulting Services Group.

Huneycutt indicates in an affidavit that, "based upon what [he] considered to be a thorough and diligent legal review," he advised the management of NNS that "it would be appropriate to account for the costs of designing a new class of Double Eagle tanker ships as Independent Research and Development." Huneycutt further avers that he was aware of "considerable confusion within the industry" concerning the interpretation of the FAR's exclusion from IR & D of work "required in the performance of a contract." The record does not contain further specifics regarding the basis of Huneycutt's conclusions, nor further details of the content of the advice he provided to NNS.^{FN5}

^{FN5}. The current record is sparse because the government initially failed to depose Huneycutt on these questions, believing, not without some cause, that NNS was asserting attorney-client privilege with regard to Huneycutt's advice and not relying on an advice-of-counsel defense. Although the government's motion in limine to exclude evidence regarding Huneycutt's advice was denied, the government was granted further discovery on this issue, including the opportunity to depose Huneycutt. See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. July 21, 2003) (Order).

A March 15, 1995 memorandum written by Ronald Ward, NNS's Vice President of Contracts, asserts that "[t]he point at which charging to IR & D stops and direct charging to the contract begins, is perhaps the most difficult to determine from the regulations," and that "multiple interpretations are possible." The memorandum states that there is (1) a "restrictive interpretation," according to which "once the product development is sufficient to result in the sale of a product, the seller has a contractual commitment to do everything else necessary to permit the building and delivery of the product to the buyer," and can no longer charge such efforts as IR & D; and (2) a "liberal interpretation," under which, "even after there is a contractual requirement to complete the product development*548 /

design, any development/design that is generic in nature and applicable to the product as it will be offered to other potential customers is allowable as IR & D.” Ward further noted in his memorandum that the government was advancing the restrictive interpretation in the then-ongoing *Mayman* case,^{FN6} and he concluded that “NNS is at liberty to make its own reasonable interpretation of the regulations.”

^{FN6}. An opinion in that case, denying the defendant’s motion to dismiss, was issued shortly thereafter on April 27, 1995. See *United States ex rel. Mayman v. Martin Marietta*, 894 F.Supp. 218, 222 (D.Md.1995).

At the time the Ward memorandum was issued, in mid-March 1995, NNS retained an outside expert, William T. Keevan,^{FN7} to review its IR & D accounting practices. After several months of review by Keevan and his associates, Keevan presented his findings and conclusions at a meeting with NNS management on August 16, 1995. The parties dispute both the specific content and the general character of Keevan’s advice to NNS, which was delivered orally but never reduced to a writing.

^{FN7}. Keevan, the managing partner of Arthur Anderson’s Government Contracting Consulting Services Group, has significant experience with government contracting and the FAR. He was the principal author of the auditing chapter of the American Institute of Certified Public Accountants (AICPA) publication *Audits of Federal Government Contractors* and directed the 1986 *Study of Government Audit and Other Oversight Activities related to Defense Contractors* for the President’s Blue Ribbon Commission on Defense Management (the “Packard Commission”). Keevan was twice the AICPA’s nominee to the Cost Accounting Standards Board, and was a member of the Advisory Board of *Government Costs, Pricing, & Accounting Report*. Before being retained by NNS, Keevan had worked on a number of other engagements involving the interpretation of FAR 31.205-18 and had collected and reviewed over thirty IR & D and B & P policies for various government contractors.

According to NNS, the evidence indicates that Keevan and Arthur Andersen approved NNS’s Double Eagle IR & D charging practices. Relying on Keevan’s deposition testimony and the affidavits of NNS managers, NNS asserts that Keevan provided the following specific advice: First, he laid out three factors he relied on to determine whether an effort was “required in the performance of a contract” and thus not chargeable to IR & D, (i) whether the effort was found in the contract’s statement of the work, (ii) whether the effort was included in the price of the contract, and (iii) whether the effort was a deliverable of the contract. Second, Keevan applied these

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factors to the Eletson contracts and concluded that the Double Eagle class design efforts being charged under IR & D were not required by the Eletson contracts, (a) because the contract called for the delivery of constructed ships, not the delivery of a design, (b) because the \$36 million price did not include design costs, and (c) because the class design was not a deliverable under the contract. Third, Keevan testified that he advised NNS that the Eletson contracts' references to "design" were intended only to clarify that the buyers would not supply the design and that NNS would maintain all intellectual property rights to the Double Eagle tanker design upon completion of the contract. Next, Keevan testified that he explained to NNS that the government often takes an opposing view of the regulation and that the Defense Contract Audit Agency (DCAA) FN8 might challenge *549 NNS's charging the costs to IR & D. Nonetheless, Keevan testified that he told NNS that he considered his interpretation of the FAR to be in line with the applicable law, including specifically the then-recent decision in *United States ex rel. Mayman v. Martin Marietta Corp.*, 894 F.Supp. 218 (D.Md.1995). Finally, Keevan further stated that in addition to this advice to NNS, he offered various recommendations, including that NNS's formal IR & D written policy should be updated, that NNS should consider disclosing its IR & D policy to the government, and that a management group be formed to monitor IR & D and B & P charging.

FN8. DCAA is a separate agency in the Department of Defense, and serves as the accounting branch of DOD. One of DCAA's functions is to audit defense contractors' books and records to establish what costs are allowable under the FAR. See *United States v. Newport News Shipbuilding and Dry Dock Co.*, 862 F.2d 464, 465 (4th Cir.1988).

The government disputes NNS's characterization of Keevan's review of NNS's Double Eagle IR & D charging policies, arguing that Keevan's approval was qualified and contained strong warnings. The government relies largely on a contemporaneous Arthur Andersen memorandum, which appears to be an outline of Arthur Andersen's review of NNS's charging practices. FN9 The outline does not describe the three factor test for "required in the performance of a contract" described by Keevan in his depositions. Yet, in a section entitled "IR & D vs. Eletson contract costs," the outline does note a qualified approval of NNS's approach and lists a number of specific "issues," as follows:

FN9. NNS not only disputes the government's characterization, but also disputes that the outline is an accurate reflection of the advice Keevan provided NNS at the meeting. At his deposition, Keevan denied that he relied

on or read the outline at the August 16, 1995 meeting and report, but did concede that the document was prepared for him, that he had it with him when he made his remarks, and that it served as a “memory jogger.”

(i) In general, we believe that NNS’s approach to accounting for the design effort is theoretically appropriate (subject to the disclosure discussed below). [bold in original]

(ii) The Government in a current high profile concurrent IR & D case [the *Mayman* case] is taking the position that if effort under IR & D must be performed to successfully meet contract requirements, that effort should be charged to the contract. Under this interpretation, NNS must charge the design effort to the contract ...

(iii) The Eletson contract states that NNS will “*design, construct, equip, and complete*” the tanker (emphasis added). This supports the Government’s position.

(iv) NNS should consider disclosing its approach to the Government ... [bold in original]

(v) As the ship enters the production phase, there will be more potential for mischarging due to confusion and uncertainty that may arise among employees ... Examples of current Eletson “gray areas” include:

- ABS qualifications
- Procurement
- Future design changes to product class tankers
- Jameston Metal Marine Sales

The Arthur Andersen outline also states that “NNS has not notified the Government of its accounting treatment.” Finally, the memorandum states that an issue to be discussed during the “Wrap-up” of the meeting was the “[f]ormat and timing of the AA LLP report, if any.” As noted above, no written report was generated as a result of the Arthur Andersen review.

NNS presents a series of documents to support its contention that NNS disclosed to the government that it was continuing to charge design efforts as IR & D after the award of the Eletson contracts on October 31, 1994. Thus, for example, in a November 28, 1994 letter to the Naval *550 Surface Warfare center, NNS stated that “[o]ur intent is to continue use of the single IR & D account to collect the costs of this project.” Although this letter did make

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it into DCAA's files on NNS, the letter was not addressed to DCAA nor did it clearly reference the existing contracts with Eletson, which had been signed one month earlier, or describe the types of Eletson-related charges that were then routinely labeled as IR & D.

Next, NNS notes the March 15, 1995 version of IR & D Job Order 2858 states that "THIS JOB ORDER *DOES NOT* INCLUDE THE COSTS OF EFFORT SPONSORED BY A GRANT OR REQUIRED IN THE PERFORMANCE OF A CONTRACT," and that "[a]fter award of a shipbuilding contract, effort to modify the Class Design developed under this job order (or to develop new designs) which will *not* be incorporated into the Class Design, *must* be charged to the Hull and Cost Class and *not* to IR & D or B & P." NNS asserts that DCAA had a copy of this job order in its files by December 21, 1995.

Furthermore, NNS relies on its February 21, 1996 memorandum summarizing a meeting between NNS management and Tom Segroves, the resident DCAA auditor. This memorandum reflects that Segroves stated at that time that DCAA "may have some concerns regarding IR & D." In response, NNS claims it informed Segroves that NNS could provide DCAA with copies of NNS's specific charging instructions and the formal IR & D policy and procedure once it issued. The memorandum lists IR & D charging as only one of many outstanding issues between NNS and DCAA, and makes no specific reference to the Double Eagle class design project or the Eletson and Van Ommeren contracts.

Finally, NNS cites a July 9, 1997 meeting between DCAA and NNS, the subject of which appears to have been DCAA's "concerns" regarding "[w]hat NNS [was] charging to IR & D" with regard to the Double Eagle tankers. The minutes of this meeting indicate that NNS set forth its class design justification for charging design efforts for the Double Eagle tankers under IR & D, and that a discussion of the implementation and implications of the class design IR & D charges then ensued between DCAA and NNS. The DCAA auditors followed up with a number of specific questions, clearly indicating that DCAA by this time was involved in an investigation of the Double Eagle IR & D charges. The minutes also reflect that DCAA requested certain information from NNS, namely "[c]hange orders to the international and domestic contracts," the section function and quality codes used from 1994-1997, Arthur Andersen's opinion regarding IR & D Job Orders 2858 and 2875, cost figures related to the conceptual design of the tankers prior to the May 1994 Eletson LOI, and responses to DCAA's earlier information requests dated July 1, 1996 and April 14, 1997.

C. Procedural History

The government initiated this action on February 3, 2003, asserting violations of the False Claims Act, 31 U.S.C. §§ 3729(a)(1), (2) & (7), unjust enrichment, and payment under mistake of fact. The complaint was amended on April 21, 2003, to add a claim for breach of contract.

The matter has been intensely litigated throughout. On March 14, 2003, NNS's motion to dismiss the complaint on the ground that the government had not stated its FCA claims with sufficient particularity was denied.^{FN10} And, on April 11, *551 2003, NNS's motion to dismiss claims barred by the FCA's statute of limitations was granted in part, barring any claims which were submitted and paid prior to December 15, 1995.^{FN11} Subsequently, NNS filed a motion to dismiss to strike the government's quasi-contractual claims, while the government filed a motion to strike affirmative defenses. In the interests of avoiding further piecemeal pleadings, these motions were deferred pending the parties' submission of summary judgment motions, and a schedule for such motions was set.^{FN12} Pursuant to that schedule, the parties submitted cross motions for summary judgment, which were argued orally on July 18, 2003.

^{FN10.} See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. March 14, 2003) (Order).

^{FN11.} See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D. Va. April 11, 2003) (Order). Significantly, NNS's year-end certifications of its indirect costs incurred during 1994 and 1995 were submitted on December 7, 1995 and September 30, 1996, respectively. Thus, none of the government's claims based on NNS's year-end certifications of its indirect costs are barred by the statute of limitations.

^{FN12.} See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. May 2, 2003) (Order).

The government moved for partial summary judgment on the question whether NNS's classification of the disputed Double Eagle tanker program costs as IR & D was a violation of the FAR. For its part, NNS moved for summary judgment on all counts, contending to the contrary that its classification of those costs was entirely proper under the FAR. In the alternative, NNS moved for summary judgment on the FCA claims, arguing that even assuming the IR & D costs were improper under the FAR, the undisputed evidence established the NNS did not "knowingly" submit false claims, as required by the FCA. 31 U.S.C. § 3729(a).^{FN13} Thus, resolution of

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these cross motions for summary judgment requires a consideration of (i) the falsity element of the FCA counts, namely whether some or all of NNS's IR & D charges were proper under the FAR or not, and (ii) the knowledge element of the FCA counts, namely whether NNS submitted any such false claims "knowingly," as required by the FCA. Each is discussed separately below.

^{FN13} The parties also presented several additional motions. In the event the FCA claims were dismissed, NNS moved that for dismissal of the contractual and common law claims without prejudice to be heard by the board of contracts appeals pursuant to the Contracts Disputes Act. 41 U.S.C. §§ 601–613. NNS also moved for dismissal of the quasi-contractual counts for unjust enrichment and payment under mistake of fact given the existence of express contracts. The government presented three motions in limine, regarding (i) the use of a summary exhibit, (ii) the exclusion of a defense expert witness, and (iii) the exclusion of evidence relating to the advice of NNS's in-house counsel, all of which were opposed. These motions were addressed in open court and are not discussed in this Memorandum Opinion.

II.

To prevail on its FCA claims, the government must show that NNS "knowingly present[ed] or cause[d] to be presented, to an officer or employee of the United States Government ... a false or fraudulent claim for payment or approval." 31 U.S.C. § 3729(a)(1).^{FN14} Thus, as an essential element of its FCA claims, the government must show that NNS knew that the disputed IR & D charges were improper under the FAR and therefore false. The falsity of the disputed IR & D charges is also an essential element of the governments unjust*552 enrichment, payment under mistake of fact, and breach of contract claims. More specifically, these cross motions for summary judgment turn, in part, on whether the Double Eagle design and engineering costs NNS charged as IR & D under Job Orders 2858, 2875, and 3102 are allowable under 48 C.F.R. § 31.205–18, the FAR definition of IR & D.

^{FN14} The government's related false claims counts require proof that NNS knowingly made or used a false record or statement either to have a false claim paid by the government, 31 U.S.C. § 3729(a)(2), or to conceal, avoid, or decrease an obligation to pay the government, 31 U.S.C. § 3729(a)(7).

Consideration of this question must of course begin with an examination of the governing regulatory language. In this respect, the FAR defines IR & D as follows:

Independent research and development (IR & D) means a contractor's IR & D cost that consists of projects falling within the four following areas: (1) Basic research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. The term does not include the costs of effort sponsored by a grant or required in the performance of a contract...

48 C.F.R. § 31.205-18. The question presented then is whether the efforts NNS charged as Double Eagle IR & D were "required in the performance of a contract," specifically the Eleton and Van Ommeren contracts. If so, the claims submitted by NNS to the government for reimbursement of those charges were in violation of the FAR. If not, then NNS's Double Eagle IR & D charges were proper, and the claims against NNS should be dismissed.

The phrase "required in the performance of contract," although seemingly straightforward, has been the subject of "considerable debate" and conflicting interpretations over the years. See *Mayman*, 894 F.Supp. at 222. The phrase may be read narrowly, excluding from IR & D only those efforts "explicitly called for in the contract," or it may be read more broadly, to exclude additionally "everything implicitly necessary to carry it out." *Id.* (emphasis added). Not surprisingly, civilian contractors have generally advocated the narrower interpretation of the exclusionary phrase, resulting in a broader scope of allowable IR & D charges, while the government has generally advocated the broader interpretation of the exclusionary phrase, resulting in a narrower scope of allowable IR & D charges.^{FN15} A third approach to interpreting the phrase, resulting in the broadest possible scope for IR & D charges, focuses not on whether the effort is implicitly or explicitly required by the contract, but whether the effort is attributable to and required by a single contract, or whether the effort stands to benefit multiple existing contracts, or potential future contracts.^{FN16} Under this interpretation, the existence of *553 multiple contracts, as here, would suffice to allow labeling as IR & D all charges common to more than one contract.

^{FN15}. See Thomas P. Barletta & Gerard E. Wimberly, Jr., Allowability of Independent Research and Development Costs under FAR 31.205-18: A Proposal for Regulatory Reform, 29 Pub. Cont. L.J. 113, 118-19 (1999) (noting that the line between contract research and development and independent research and development has been a matter of debate since 1970 and noting that the government "has tended" to endorse the implicit requirement reading, while "industry and most commentators have generally" endorsed the explicit requirement reading). Here, the government has advocated a reading of the phrase to include efforts implicitly necessary to perform the contract, while also arguing that many of the efforts charged

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as IR & D were explicitly required by the contract. NNS has advocated Keevan's interpretation, which focuses on the explicit requirements of the contract, namely whether the effort is designated in the statement of work, included in the contract price, or is a deliverable under the contract.

^{FN16} For example, the defendant in *Mayman* argued that the tasks charged to IR & D were relevant to potential future contracts, and thus should be billed as IR & D and not to one contract. See *Mayman*, 894 F.Supp. at 222. NNS advances a similar argument in its latest pleadings.

Despite the long controversy over the proper interpretation and application of the regulatory phrase "required in the performance of a contract," the case law on this issue is sparse and ultimately not helpful. The *Mayman* case, the only published decision on the phrase's meaning, ultimately did not reach and decide the question presented here. *Mayman* involved a contract between the United States Navy and Martin Marietta Corporation to design and build a full-scale model of a target missile for missile defense testing. The government charged Martin Marietta with submitting false claims, alleging that Martin Marietta intentionally underbid the research and development contract and then impermissibly charged necessary research and design efforts to IR & D, rather than to the contract, as the FAR required. More specifically, the government claimed that the six tasks at issue, which Martin Marietta charged as IR & D, were required by the government's contract with Martin Marietta to design and build the target missile prototype. Yet, Martin Marietta sought a threshold dismissal, arguing that the six tasks, while required by that contract, could nonetheless be properly charged as IR & D because they had potential applicability to other future contracts. See *Mayman*, 894 F.Supp. at 221–22.

In denying Martin Marietta's motion to dismiss, the *Mayman* court noted that the facts, as alleged, did not require resolution of the implicit or explicit requirement question, since it was undisputed that the six tasks in issue were required by Martin Marietta's research and design contract with the government. *Id.* at 222. The *Mayman* opinion thus never reached or decided the question presented here, namely whether the phrase in the FAR excluding from IR & D charges for efforts "required in the performance of a contract" reached those efforts implicitly required by the contract, as well as those explicitly required. The court explicitly set aside this question, while rejecting Martin Marietta's contention that potential benefit to future contracts was sufficient to qualify an effort as IR & D. *Id.*

A more recent, unpublished case involved the consideration of parallel language in the FAR's definition of Bid and Proposal (B & P) costs. See

United States ex rel. Bagley v. TRW, Inc., 2000 WL 33400196 (C.D.Cal.2000). The FAR's definition of B & P similarly excludes from B & P "the costs of effort sponsored by a grant or cooperative agreement, or required in the performance of a contract." 48 C.F.R. § 31.205-18. (emphasis added). In *Bagley*, the defendant and another company entered into a Memorandum of Agreement (MOA) to create a limited partnership to develop a satellite-based telephone network. *Id.* at *2. Under the MOA, the defendant was allocated the task of developing a firm, fixed price proposal to build and sell the system to the partnership. *Id.* The *Bagley* court concluded that defendant's efforts in preparing the proposal were "required in the performance of a contract," namely the MOA, and as such were improperly charged as indirect B & P and passed off to the government. *Id.*; see also *Boeing Co. v. United States*, 862 F.2d 290, 293 (Fed.Cir.1989) (holding that "B & P costs are normally allocable to an indirect account," but that "B & P costs arising from a specific requirement in an existing contract may be reallocated from the indirect cost account to the direct cost account"). The *Bagley* opinion, similar to *Mayman*, did not address the explicit or implicit interpretation, nor did it involve more than more than one existing contract requiring the effort. In addition, the *Bagley* opinion rejected that defendant's argument that "required in the performance of *554 a contract" means "actually paid for by a contract in which the buyer was required to pay." *Id.* at *6.

As there is no controlling Fourth Circuit precedent interpreting the relevant regulatory language, and the sparse case law on the subject provides little guidance, the language of the regulation itself must provide the authoritative guide to its meaning. Indeed, it is well established that "statutory analysis begins with 'the language of the statute.'" *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438, 119 S.Ct. 755, 142 L.Ed.2d 881 (1999). Moreover, "in the absence of an indication to the contrary, words in a statute are assumed to bear their 'ordinary, contemporary, common meaning.'" *Walters v. Metropolitan Educ. Enter.*, 519 U.S. 202, 207, 117 S.Ct. 660, 136 L.Ed.2d 644 (1997). These principles, applied to the FAR's plain language, yield the following conclusions:

[1] First, the exclusion from IR & D of the cost of efforts "required in the performance of a contract" must be read to include efforts which are not explicitly stated in the contract, but are nonetheless necessary to perform the contract and thus implicitly required by it. This follows from the plain language of the regulation itself. This language does not exclude from IR & D those efforts "required by" a contract, a phrase that might be read to refer only to efforts explicitly called for in the contract. Instead, the regulatory language excludes from IR & D all efforts "required in the performance of

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a contract.” This locution plainly focuses the inquiry on all efforts required in *performing* the contract, not simply on efforts explicitly called for by the contract, whether designated in the contract’s statement of work or required as an explicit deliverable. Although the regulation might have been even more explicit in its intent to reach implicit requirements, the plain meaning of “required in the performance of a contract” includes those efforts that are implicitly required to perform the work as well as those efforts explicitly called for in the contract.

[2] Second, it is clear that the plain language of the regulation does not allow charging of research and design efforts as IR & D simply because they are a benefit to more than one existing contract. In this regard, NNS argues, unpersuasively, that because the FAR refers to the efforts “required in the performance of a contract,” efforts that are required by more than one contract are legitimately charged as IR & D. NNS is reading too much into the indefinite article,^{FN17} the regulation does not exclude only those efforts “required in the performance of a single contract,” or “only one contract”; it excludes from IR & D all efforts required in the performance of “a contract.” Moreover, the approach advocated by NNS could lead to the anomalous result that the signing of the first contract requiring the effort would render the effort no longer chargeable as IR & D, but the signing of a subsequent, additional contract would render the effort again chargeable as IR & D, perhaps even retroactively. There is no support, nor reason in principle, for such a complicated scheme in the regulatory language, which simply excludes effort “required in the performance *555 of a contract.” Instead, the more natural plain meaning of this phrase is that effort required in the performance of any contract cannot be IR & D, and that efforts required in the performance of multiple contracts are not, for that reason alone, IR & D chargeable to the government.^{FN18}

^{FN17}. NNS’s reliance on *Mayman* to support its reading of the regulation is not persuasive. The *Mayman* decision states that where a task is “simultaneously required by more than one *existing* contract” the defendant’s argument “might be sound,” and the contractor “might split the costs proportionally between the various contracts or bill the costs as indirect.” *Mayman*, 894 F.Supp. at 222. Yet, this statement is unauthoritative and clearly dicta, as the defendant in *Mayman* did not have another existing contract. *Id.* Furthermore, the *Mayman* decision itself hardly endorses this reading of the FAR; indeed it notes in the preceding sentence that the defendant’s interpretation “does not appear to be correct.” *Id.*

^{FN18}. The *Mayman* decision correctly rejects a yet more tenuous proposition, namely that an effort required by a contract may nonetheless be charged as IR & D so long as it offers a potential benefit to future contracts. See *Mayman*, 894 F.Supp. at 222. As *Mayman* noted, “scientific research is rarely so narrow that it fails to benefit other projects, and thus research inevitably benefits other contemplated contracts.” *Id.*

[3] The practical effect of this reading of the “required in the performance of a contract” exclusion is to create a temporal dividing line between IR & D and direct work that must be billed to a contract at the point the contract requiring the effort is signed. Prior to such a contract, the research and design effort is independent, and is eligible to be charged as IR & D, provided it otherwise fits the IR & D definition. Once a contract is signed, however, research and design efforts that are explicitly or implicitly required in the performance of that contract may no longer be charged as IR & D. Thus, for example, a shipbuilding contractor may engage in independent research and development to design a new radio antenna for a ship class and, provided other requirements are met, may charge that effort to IR & D. However, once a contract for such a ship is signed, any further radio antenna design effort that is incorporated into that ship may no longer be charged as IR & D, even if that further design effort benefits the entire ship class. And this is so whether or not the contract explicitly requires the shipbuilder to design the new radio antenna and whether or not the contract explicitly names the new radio antenna design as a “deliverable” of the contract. In sum, once a contract is signed the performance of which requires, implicitly or explicitly, a certain effort, that effort may thereafter no longer be charged as IR & D even if it also stands to benefit other existing contracts, potential future contracts, or a class design.

The regulatory history of FAR § 31.205–18 supports this plain language reading of the phrase “required in the performance of a contract.” This phrase was added to the Armed Services Procurement Regulation (ASPR) by Defense Procurement Circular 90 (DC-90) in 1971. Prior to the addition of the phrase, the ASPR excluded from IR & D only that was “sponsored by a contract, grant, or other arrangement.” 32 C.F.R. § 15.205–35(c) (1969). The government apparently considered this to be too narrow and proposed in a 1969 draft that the regulation be amended to exclude effort “sponsored by, or in support of, a contract or grant.” An industry group, the Council of Defense and Space Industry Associations (CODSIA), opposed this formulation as overly broad. Ultimately, the government proposed to substitute the phrase “required in the performance of” for the phrase “in support of.” ^{FN19} The stated purpose of this substitution was to indicate

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that “any work which must be accomplished in order to fulfill contractual requirements is a contract cost,” not IR & D.^{FN20} CODSIA objected to *556 this formulation as well, arguing that yet narrower language should be employed to exclude from IR & D only that effort “specifically required by contract provisions in performance of” a contract or grant.^{FN21} This industry suggestion was rejected, and the “required in the performance of” language was implemented by DC-90 in 1971 and remains in effect in the current FAR.^{FN22} Thus, the regulatory history plainly suggests not only that the “required in the performance of a contract” provision was intended to cover work implicitly required by a contract, but also that the industry recommendation that the exclusion be limited to efforts “specifically required by contract provisions” was considered and rejected.

^{FN19}. See Thomas P. Barletta & Gerard E. Wimberly, Jr., Allowability of Independent Research and Development Costs under FAR 31.205-18: A Proposal for Regulatory Reform, 29 Pub. Cont. L.J. 113, 115-118 (reviewing relevant regulatory history); see also J.M. Malloy, Deputy Asst. Sec. of Defense, Memorandum to ASPR Committee, “ASPR 68-14, Independent Research and Development (IR & D) and Bid and Proposal (B & P) Costs,” at 181-82 (January 9, 1969).

^{FN20}. See Malloy, *supra*, at 181.

^{FN21}. See Barletta & Wimberly, *supra*, at 118.

^{FN22}. A 1992 revision of the FAR changed the provision from “sponsored by, or required in the performance of a contract or grant” to “sponsored by a grant or required in the performance of a contract,” the current formulation. See 48 C.F.R. § 31.205-18; Barletta & Wimberly, *supra*, at 118.

The rejection of NNS’s reading of the FAR also finds support in the regulation’s purpose and intent. The purpose of government funding of certain IR & D efforts is apparent from the language in the regulation defining what types of IR & D are allowable as IR & D. In this regard, the FAR previously limited IR & D costs chargeable to the government to those projects “with a potential relationship to a military function or operation,” 48 C.F.R. § 231.205-18(c)(1) (1990). Yet, this restriction was eliminated in 1991, and allowable IR & D costs are now limited to those for projects that are of potential interest to DOD, including activities intended to accomplish any of the following:

(1) Enable superior performance of future U.S. weapon systems and components.

- (2) Reduce acquisition costs and life-cycle costs of military systems.
- (3) Strengthen the defense industrial and technology base of the United States.
- (4) Enhance the industrial competitiveness of the United States.
- (5) Promote the development of technologies identified as critical under 10 U.S.C. 2522.
- (6) Increase the development and promotion of efficient and effective applications of dual-use technologies.
- (7) Provide efficient and effective technologies for achieving such environmental benefits as: Improved environmental data gathering, environmental cleanup and restoration, pollution reduction in manufacturing, environmental conservation, and environmentally safe management of facilities.

48 C.F.R. § 231.205-18(c)(iii)(B). Thus, allowable IR & D costs include not only those with a direct potential benefit to the military, but also those which strengthen the “defense industrial and technology base” and enhance “industrial competitiveness.” In other words, the FAR indicates that the government intends, to a certain extent, to subsidize its contractors’ general commercial research and development efforts in order to promote the strength, competitiveness, and efficiency of those contractors.

[4] The exclusion from IR & D of those efforts “required in the performance of a contract” must be read in light of this general regulatory purpose. Clearly, then, it is not intended to preclude government subsidization of all commercial IR & D effort. Instead, it must be read to place reasonable bounds on the IR & D charges *557 the government will subsidize that are consistent with the general purposes of IR & D allowability as evidenced by § 231.205-18(c)(iii)(B). At the least, the “required in the performance of a contract” phrase must therefore be read to prevent double payment, that is, the subsidization by the government of efforts that will be paid for by an existing contract. If a contractor has already found a commercial customer who will pay for the particular research and design work, or signed a specific contract with the government to perform that work, there is no apparent purpose in providing further payment for that work in the form of IR & D reimbursements from the government. See *Mayman*, 894 F.Supp. at 221-22 (holding that IR & D is funded by the government “to support cutting edge research which is not ‘sponsored by,

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or required in the performance of ‘any specific, existing contract’ and that the phrase “required in the performance of a contract” should be read “to prevent ... intentional underbidding and cost shifting of contract-specific work to IR & D”).^{FN23}

^{FN23.} Of course, this anti-cost-shifting principal largely begs the question of what work is allowable as IR & D and what work is a “contract-specific” work that should not be “shifted” to the government as IR & D.

Further, as the *Mayman* decision noted, the phrase “required in the performance of a contract” must be read to avoid “absurd situations” where the government would have no control over the amount and type of effort being charged as IR & D. *See Mayman*, 894 F.Supp. at 222, 223. In other words, the FAR clearly indicates the government’s intent that allowable IR & D charges be limited and circumscribed; thus, any reading of the phrase “required in the performance of a contract” which renders IR & D charges essentially unbounded must be rejected as untrue to the regulatory intent.

In light of the apparent purpose of the phrase “required in the performance of a contract,” NNS’s claim that the explicit language of the contract guides the IR & D determination is unpersuasive, because contractors are free to draft their contracts with commercial customers as they see fit and might choose to draft contracts in an artful manner to divert or pass on to the government the contract’s research and design costs. For example, parties might draft commercial contracts that designated certain “deliverables,” but remained silent on the research and development efforts necessary to produce those deliverables, thereby potentially rendering all such research and design efforts chargeable to the government as IR & D notwithstanding the fact that those efforts were necessary to build the ship. NNS’s construction of the regulation allows contractors to render virtually all research and development IR & D, whether it was actually independent or not. Similarly, if the existence of multiple contracts that benefitted from a given design effort were sufficient to render that design effort IR & D, as NNS maintains, parties could manipulate the form and number of contracts to their advantage by favoring multiple contracts where possible. In this case, for example, NNS’s agreement with Eletson to build four ships was formalized in four separate contracts with four different Eletson affiliates. It is unclear why NNS’s decision to draft four contracts for four ships instead of one contract for four ships should be relevant to the question whether efforts necessary to build the four ships qualify as IR & D.

By contrast, the functional approach adopted here—reading the FAR to exclude from IR & D implicit as well as explicit requirements of a contract—

not only comports with the plain language of the regulation and the regulatory history, but also *558 helps avoid potential abuses of the IR & D system by rendering the IR & D determination less susceptible to artful contract design. Moreover, the result reached here sharpens the temporal dividing line between preliminary independent research and contract-specific work. Once a contract exists requiring the performance of a given research and design effort, that effort is no longer chargeable as IR & D. This dividing line comports with the purpose of the IR & D subsidization allowed by the FAR because the existence of a commercial contract requiring the research and design work at issue suggests that there is a commercial market demand for the work and the government no longer need subsidize it.

[5] With the proper interpretation of the regulatory phrase “required in the performance of a contract” established, it remains to apply the regulation to the facts at bar. A review of the factual record, contested as it is, nonetheless indicates that NNS’s treatment of the Double Eagle tanker IR & D charges were not, in the main, compliant with the FAR. The bulk of NNS’s design efforts with regard to the Double Eagle tankers were clearly “required in the performance” of NNS’s contracts with Eletson and Van Ommeren. It is undisputed that these contracts called for the delivery of ships whose design had not yet been completed. Thus, there is no question that a substantial portion of the Double Eagle research and design effort NNS charged as IR & D was necessary in order for NNS to perform the contracts requiring the delivery of Double Eagle tankers, and therefore these efforts should not have been charged as IR & D.

Indeed, it is doubtful whether the bulk of NNS’s IR & D charges would have been allowable even were the FAR read to exclude from IR & D only those efforts explicitly required by the contract. Both the Eletson and the Van Ommeren contracts plainly and specifically required NNS to “*design, construct, equip and complete*” the tankers (emphasis added). The Eletson contracts further state that the contract price includes “the expenses for *basic designs ...*” (emphasis added). Thus, these contracts explicitly require NNS to design the ships, not simply construct them. NNS’s arguments to the contrary are not persuasive.^{FN24} In the end, it is clear that some design efforts charged as IR & D were both explicitly and implicitly required by the Eletson and Van Ommeren contracts and thus were improperly charged as IR & D.

^{FN24}. NNS argues that the contract language regarding design simply indicated that NNS, not the purchasers, was responsible for supplying the design of the ships, and that NNS would retain the rights to the design after completion of the contracts. In other words, NNS contends that the design

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was not a “deliverable” of the contract. Even if true, this does not alter the fact that the contracts explicitly required NNS to design the ships.

NNS’s efforts to establish “class designs” independent of the specific shipbuilding contracts do not change this analysis. Even assuming NNS was concurrently involved in a larger class design effort, intended to create International and Double Eagle ship designs for future contracts independent of the Eletson and Van Ommeren contracts, the fact that the research and design efforts required by the existing contracts would also benefit such class design efforts does not change the fact that those efforts were “required in the performance of a contract” and thus no longer chargeable as IR & D. In other words, the fact that given design efforts were required not only by the specific shipbuilding contracts but also by an internal effort to create an independent class design does not alter the fact that they were required in the performance of *559 an existing contract. NNS’s independent class design efforts do not render the required efforts IR & D any more than the existence of an additional contract requiring the same effort would do so.

Although it is clear that NNS’s general practice of charging Double Eagle research and design efforts as IR & D after NNS signed the Eletson and Van Ommeren contracts was not in compliance with the FAR, significant questions remain as to whether any of the efforts charged as IR & D were not required in the performance of those contracts and thus were chargeable as IR & D. In other words, factual questions remain whether NNS’s Double Eagle IR & D charges were wholly in error or were at least partially accurate.

[6][7] For example, a review of the record suggests that at least some of the disputed IR & D charges were proper because they were incurred before the existence of a requiring contract. Thus, the record indicates that Job Order 2858 was opened on May 12, 1994, eight days before the LOI between NNS and Eletson was signed on May 20, 1994 and more than five months before the Eletson contracts were signed on October 13, 1994. Thus, any costs charged to Job Order 2858 prior to October 31, 1994 predate the contract requiring the IR & D effort and are allowable as IR & D provided they are otherwise qualified.^{FN25} The amount of such costs is not clear on the current record. Similarly, NNS created IR & D Job Order 2875 on August 31, 1995 to charge efforts to design the Domestic Double Eagle tankers almost two months before the contracts with Van Ommeren requiring NNS to construct those tankers were signed on November 21, 1995. Again, the current record does not reflect to what extent Domestic Double Eagle design efforts, which were not required by the Eletson contracts, were charged as IR & D before the Van Ommeren contracts were entered into.

^{FN25.} The government asserts that the May 20, 1994 LOI is itself a contract which implicitly requires NNS to undertake the research and design efforts necessary to develop the concept design into a sufficiently detailed design to support the contract. Yet, the LOI simply reflects the parties' agreement "to continue good faith negotiations" toward a contract. This is merely an "agreement to agree in the future," and therefore, under Virginia law, not an enforceable contract. See *Beazer Homes v. VMIF/Anden Southbridge Venture, LP*, 235 F.Supp.2d 485, 490 (E.D.Va.2002); *W.J. Schafer Assoc., Inc. v. Cordant, Inc.*, 254 Va. 514, 519–20, 493 S.E.2d 512 (1997). Thus, while certain design efforts charged by NNS after the LOI and prior to the contract may have been necessary to continue good faith negotiations with Eletson, they were not "required in the performance of a contract." The March 17, 1995 LOI between NNS and Van Ommeren contains a similar, non-enforceable agreement. Cf. *Bagley*, 2000 WL 33400196, at *2 (noting that the Memorandum of Agreement in that case was, by its terms, a legally binding contract which required the defendant to develop a fixed price proposal, and holding that efforts taken to fulfill that obligation were "required in the performance of a contract," and thus not chargeable as indirect B & P).

Furthermore, as noted above, the parties sharply dispute whether NNS was engaged in an independent effort to create "class designs" for tankers, or whether the "class design" efforts constituted a marketing effort which ceased with the assignment of actual contracts. This dispute is irrelevant to the majority of NNS's Double Eagle IR & D charges, as those efforts required by the shipbuilding contracts are not allowable as IR & D even if they also furthered a legitimate class design project. At the margins, however, the existence of a class design effort remains relevant. There may be efforts taken by NNS in furtherance of the class design beyond those required by the contracts which would be allowable as IR & D. For example, NNS contends that IR & D Job Order *560 3102, for "Completion of Double Eagle Design," collected the costs of efforts to complete the Double Eagle designs for future sale or use, and that those efforts were not required by the Eletson and Van Ommeren contracts. NNS argues that by the time Job Order 3102 was opened in May 1998, the design efforts required by the Eletson and Van Ommeren contracts were substantially complete. For its part, the government contends that the charges under Job Order 3102 consisted of further efforts necessary to perform the shipbuilding contracts.

In sum, while it is clear that NNS's general practice of charging Double Eagle design efforts to the government as IR & D after signing contracts to build the Double Eagle tankers was impermissible under the FAR, there

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remain disputed issues of material fact regarding whether specific IR & D charges were nonetheless proper. Accordingly, by Order dated July 21, 2003, the government's motion for partial summary judgment was granted in part, insofar as the phrase "required in the performance of a contract" encompasses all efforts of a contractor that are necessary to perform a contract, whether or not those efforts are explicitly required by the contract in the statement of work or elsewhere and whether or not those efforts are also intended to benefit a "class design." See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. July 21, 2003) (Order). Yet, because disputed issues of material fact remain regarding whether some of the costs charged by NNS as Double Eagle IR & D may be proper, the government's motion for partial summary judgment was otherwise denied. In addition, NNS's motion for summary judgment on all counts, on the ground that all IR & D charging were proper, was denied. *Id.*

III.

NNS has also moved for summary judgment on the FCA counts on the ground that the government has adduced no evidence in the voluminous summary judgment record sufficient to carry its trial burden of proving by a preponderance of the evidence that NNS "knowingly" submitted false claims.^{FN26} To prevail on its motion for summary judgment, NNS must show that "there is no genuine issue as to any material fact and that [it] is entitled to a judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). In considering NNS's motion, the government's evidence must be viewed favorably, and all justifiable inferences drawn in its favor. See *Anderson v. Liberty Lobby*, 477 U.S. 242, 255, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). However, the government must offer more than a mere scintilla of evidence supporting its claim that NNS acted knowingly; rather, the evidence must be sufficient that a reasonable fact-finder could decide the knowledge issue in favor of the government. *Id.* at 248-51, 106 S.Ct. 2505.

^{FN26}. The government must ultimately show that NNS "knowingly present [ed] or cause[d] to be presented, to an officer or employee of the United States Government ... a false or fraudulent claim for payment or approval." 31 U.S.C. § 3729(a)(1) (emphasis added). The government's related false claims counts also require proof that NNS acted "knowingly," either in "mak[ing], us[ing] or caus[ing] to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government," or to "decrease an obligation to pay or transmit money or property to the Government." 31 U.S.C. § 3729(a)(2) & (7).

[8] The term “knowingly,” for the purposes of the FCA, is defined to mean

... that a person, with respect to information—

*561 (1) has actual knowledge of the information;

(2) acts in deliberate ignorance of the truth or falsity of the information; or

(3) acts in reckless disregard of the truth or falsity of the information, and no proof of specific intent to defraud is required.

31 U.S.C. § 3729(b).^{FN27} Thus, the government need not necessarily show that NNS actually knew that its claims for IR & D were false; the government may also prevail if it can show that NNS acted in “deliberate ignorance of” or “in reckless disregard of” the truth or falsity of the information.^{FN28} Put differently, a showing that the claims were false does not obviate the need to show that the contractor actually knew the claims were false, or acted with reckless disregard or in deliberate ignorance of their falsity. Thus, NNS contends (i) that the ambiguity of the regulatory language renders it impossible for NNS to have had the requisite knowledge that its claims were false and (ii) that NNS’s disclosure of the material facts regarding its IR & D policies to the government and its reliance on the advice of professionals negate any notion that it acted with reckless disregard or deliberate ignorance of the falsity of its claims.

^{FN27}. Notwithstanding statutory language that refers to actual knowledge of the information, rather than actual knowledge of its falsity, the statute is nonetheless universally read to require actual knowledge of the falsity of the information or deliberate ignorance or reckless disregard of the truth or falsity of the information. See, e.g., *United States ex rel. Becker v. Westinghouse Savannah River Co.*, 305 F.3d 284, 288 (4th Cir.2002); *Commercial Contractors, Inc. v. United States*, 154 F.3d 1357, 1362 (Fed. Cir.1998); *United States ex rel. Oliver v. The Parsons Co.*, 195 F.3d 457, 464 (9th Cir.1999).

^{FN28}. NNS, relying on Ninth Circuit precedent, argues for a more stringent formulation of the FCA intent requirement, namely that “the requisite intent is the knowing presentation of what is known to be false,” *United States ex rel. Hagood v. Sonoma County Water Agency (Hagood I)*, 929 F.2d 1416, 1421 (9th Cir.1991), and that “[t]he statutory phrase ‘known to be false’ does not mean incorrect as a matter of proper accounting methods, its means a lie.” *Hagood v. Sonoma County Water Agency (Hagood II)*, 81 F.3d 1465, 1478 (9th

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Cir.1996). Yet, this reading is not consistent with the statute, which clearly provides that deliberate ignorance or reckless disregard are sufficient. See 31 U.S.C. § 3729(b). Moreover, NNS's interpretation of the Hagood I & Hagood II holdings has been rejected in a more recent Ninth Circuit case, where that court noted that, "[w]hile some of our cases may contain extraneous comments that might be read out of context to suggest that the FCA requires an intentional lie to trigger liability," the statutory language controls and "deliberate ignorance" or "reckless disregard" is sufficient. *United States ex rel. Plumbers & Steamfitters Local Union No. 38 v. C.W. Roen Const. Co.*, 183 F.3d 1088, 1092–93 (9th Cir.1999).

[9] In considering the record on NNS's knowledge, it is important to note that there are two general categories of disputed IR & D costs at issue. The first category includes those costs which, according to NNS, were undertaken in furtherance of the independent class design effort, but which, based on the ruling here, may not be charged as IR & D because they were at least implicitly, if not also explicitly, required in the performance of the individual commercial shipbuilding contracts. The second category includes those costs which, according to the government, would not qualify as IR & D even under NNS's own interpretation of the FAR, or indeed under any reasonable interpretation of the FAR.

With regard to the second category, the government asserts that certain costs charged as IR & D included costs attributable to matters explicitly called for in the shipbuilding contract as a "deliverable" and thus not properly charged as IR & D under any interpretation of the FAR. For ⁵⁶²example, NNS contracted with the American Bureau of Shipping (ABS) to perform certain tests, including the Dynamic Load Analysis, the Spectral Fatigue Analysis, and the SafeHull Analysis, on the Eletson ships. According to the government, these tests were both ship-specific and explicitly required by the Eletson contracts and yet, NNS billed the costs of these tests as IR & D. Similarly, the government asserts that the Eletson contracts explicitly required NNS to produce and deliver ship-specific "As-Built" drawings of the Eletson ships and that NNS improperly charged the cost of revising drawings to create the "As-Built" drawings as IR & D. The government also asserts that "a significant part" of the IR & D costs charged to Job Order 2858 were overtime charges required by the Eletson production schedule and hence were clearly contract-specific and not chargeable as IR & D under any reasonable interpretation of the FAR.

NNS disputes the factual bases of these assertions, arguing, in essence, that all of these charge were attributable to the independent class design and

not contract specific. Moreover, the amount of IR & D charges attributable to any of these disputed efforts is not clearly stated in the current record. In short, there are factual disputes concerning whether NNS submitted claims for IR & D that included charges that were clearly improper under any interpretation of the FAR, including NNS's interpretation. Thus, with respect to this second category of disputed IR & D costs, the government has clearly demonstrated that there is a triable issue of fact on whether NNS acted with the requisite "knowledge." Significantly, the parties dispute whether this second category even exists; but were the undisputed record to reflect any claim that included such charges, it would follow that in submitting such patently impermissible claims NNS acted, at the least, with "reckless disregard" and hence "knowingly."

[10] The issue of NNS's knowledge with respect to the first category of claims—those which might be have been allowable as IR & D had NNS prevailed on its interpretation of the FAR—is also not amenable to resolution on summary judgment. With regard to actual knowledge of the falsity of this category of claims, NNS contends that it could not have known they were false at the time they were submitted given the ongoing debate regarding the interpretation of the phrase "required in the performance of a contract." For its part, the government asserts that, given the plain meaning of the regulation, NNS must have known that its interpretation of the regulation was false. Yet, even assuming the government is correct that the phrase "required in the performance of" had a clear meaning at the time of the 1972 revision, the complete record indicates that the meaning of the phrase and its application have been the subject of considerable debate since the mid-1970s. Significantly, this debate unfolded not only between the government and industry, but among different governmental agencies, as well.^{FN29}

^{FN29}. The record indicates that the GAO's interpretation of the phrase began to diverge from the Department of the Defense's and the Navy's interpretation in the mid-1970s. In 1974, the GAO issued a Report to Congress criticizing Pratt & Whitney's charging of design efforts for commercial aircraft engines to IR & D. See GAO Report to Congress B-164912, "Independent Research and Development Allocations should Not Absorb Costs of Commercial Development Work" at i (December 10, 1974). The GAO concluded that the charges were improper because Pratt & Whitney had contracts to deliver the engines. *Id.* at 11. The GAO further asserted that "the 1972 revision excludes not only technical effort explicitly required by a research and development contract but also that effort implied by the terms of—that is, 'required in the performance of'—a production contract." *Id.* at 10-11. Thus, according to the GAO, "research and development ceases to be independent when the

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performer contracts to deliver a still-to-be-developed article to a purchaser's requirements." *Id.* at 11. In its comment on a draft of the 1974 GAO Report, the Navy agreed that the GAO's interpretation of the 1972 revision was correct, yet asserted that the post-1972 IR & D efforts charged by Pratt & Whitney were nonetheless properly charged as IR & D because they concerned engine improvements "over and above and beyond" what was "called for in existing commercial orders." *Id.* at 31.

A 1977 GAO Report indicates that the intergovernmental debate had widened. See GAO Report to Congress PSAD-77-57, "Need to Prevent Department of Defense from Paying Some Costs for Aircraft Engines That Contractors Should Pay" at 14-15 (February 28, 1977). This report noted that "contractors were unwilling to certify that their IR & D programs did not contain technical effort implicitly required by the terms of a contract" and that "contractors believe that 'implicitly' covers such a broad spectrum that almost any effort could be considered unallowable as IR & D." *Id.* at 14. For its part, the GAO rejected the contractors' concerns as unfounded and recommended that the FAR, then known as the ASPR, be revised to adopt specifically the "implicitly required" approach. *Id.* Notably, however, the DOD sided with the contractors, arguing that such a revision was inadvisable because it would "leave a great deal of impreciseness in the definition," and recommended awaiting the results of a "new ASPR study" which "may provide a better definition that will not be subject to misinterpretation." *Id.* at 15. Thus, not only did the GAO and the DOD disagree about the best interpretation of the IR & D definition, both agencies believed by 1974 that the IR & D definition was ambiguous and ought to be clarified. Such clarification was never issued.

*563 The record further indicates that the debate regarding the proper interpretation of the regulatory phrase "required in the performance of a contract" has been an ongoing and unresolved question since that time.
^{FN30} As discussed *supra*, the *Mayman* decision set aside the explicit/implicit requirement issue without resolving it. See *Mayman*, 894 F.Supp. at 222. Nor has any other published opinion squarely addressed this question. Finally, the record contains no indication of consistent government enforcement of the FAR phrase "required in the performance of a contract" that might have signaled to NNS the proper interpretation of the phrase.

^{FN30}. See *Mayman*, 894 F.Supp. at 222 (noting that "there is considerable debate over whether a particular task is 'required' by a contract and thus cannot be billed to IR & D"); Barletta & Wimberly, *supra* n. 8 at 118-19 (noting that "the split persists"); John W. Chierichella, IR & D vs. Contract Effort, 90-2

Costs, Pricing & Acct. Rep. 3, 8 (1990) (noting that “[t]o date, no amendment to the IR & D cost principle, and, for that matter, no decisional law, has definitively answered the questions that have engendered this sustained intra-Governmental debate and confusion”).

In sum, this history of agency and industry dispute and doubt over the proper interpretation and application of the FAR definition of IR & D arguably points persuasively away from a conclusion that NNS must have known, at any time between 1994 and 1999, that its general Double Eagle charging practices were in violation of the FAR.^{FN31} Yet, the plain language *564 of the disputed provision and its legislative history suggest the contrary. Because the current record on this issue must be viewed in the light most favorable to the government as the non-movant^{FN32} and because it is clear that this issue merits further factual development, it is therefore not amenable to summary disposition.

^{FN31}. A recent Eighth Circuit case, *Minnesota Assoc. of Nurse Anesthetists v. Allina Health System Corp.*, 276 F.3d 1032 (8th Cir.2002), provides an illuminating contrast. In that case, the Eighth Circuit panel held that the defendants could not rely on a purported ambiguity in the relevant regulation allegedly created by a Health Care Financing Administration (HCFA) memorandum, when a further memorandum issued months later and received by the defendants unequivocally clarified the issue. *Id.* at 1053–54. The panel noted that “[i]f the Association shows the defendants certified compliance with the regulation knowing that the HCFA interpreted the regulations in a certain way and that their actions did not satisfy the requirements of the regulation as the HCFA interpreted it, any possible ambiguity of the regulations is water under the bridge.” *Id.* at 1053. Unlike the *Minnesota Association* case, in this matter there is no evidence suggesting that the defendants received a definitive agency interpretation to resolve and remove the apparent ambiguity of the relevant regulation, which as noted above, dates back at least to the 1977 GAO Report to Congress.

^{FN32}. See *Anderson*, 477 U.S. at 255, 106 S.Ct. 2505.

[11] Similarly, a material factual dispute remains with respect to the question whether NNS acted with reckless disregard in submitting its Double Eagle IR & D claims. The government asserts that NNS acted with reckless disregard by proceeding to charge \$74 million as IR & D based on a tenuous interpretation of the regulation without disclosing its interpretation to the government and verifying its accuracy. NNS, for its part, argues that its disclosure of its IR & D policies and its reliance on the advice of experts negate any notion that it acted with reckless disregard. A careful review of

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the record indicates that material factual questions remain concerning both issues and that summary judgment in favor of NNS is not warranted on the current record.

[12] A contractor's disclosure of its accounting practices to the government is relevant, not because government knowledge of a misrepresentation shields a contractor from liability, but because evidence of disclosure may "point [] persuasively away from any conclusion that [the contractor] made a knowing mis-representation." *X Corp. v. Doe*, 816 F.Supp. 1086, 1094 (E.D.Va.1993); *Becker*, 305 F.3d at 289 (holding that "we join our sister circuits and hold that the government's knowledge of the facts underlying an allegedly false statement can negate the scienter required for an FCA violation"). In other words, disclosure of accounting practices may establish that the defendant did not "knowingly" submit false claims, but rather made "concerted and conscientious efforts to ensure compliance." *X Corp.*, 816 F.Supp. at 1093.

Disclosure is not required to avoid liability under the FCA in every instance where a contractor relies on an interpretation of a disputed or ambiguous regulation. Yet, the more questionable or tenuous the contractor's interpretation appears, the more likely a failure to disclose may serve as evidence that the contractor acted with the requisite reckless disregard of the regulatory propriety of its accounting procedures. Indeed, "when the contractor's purported interpretation ... borders on the frivolous, the contractor must raise the interpretation issue with the government contracting officials or risk liability under the FCA." *Commercial Contractors, Inc. v. United States*, 154 F.3d 1357, 1366 (Fed.Cir.1998). In other words, both the clarity of the regulation and the reasonableness of a contractor's interpretation are relevant in deciding whether a failure to disclose charging practices is indicative of a reckless disregard of their falsity.

An examination of the record on NNS's disclosure of its Double Eagle IR & D charging policy indicates that a material factual dispute remains regarding the nature and extent of any such disclosure. As earlier noted, NNS has submitted a series of documents intended to establish that NNS fully and properly disclosed its Double Eagle IR & D charging policies to the government. Yet, these documents fall short of conclusively establishing that disclosure occurred. For example, NNS's November 28, 1994 letter to the Naval Service Warfare Center (NSWC) states that NNS was intending to continue charging "the costs of this project" to IR & D; yet this letter does not mention the Eleton*⁵⁶⁵ contracts signed one month earlier, nor does it set forth the IR & D charging policy that NNS had developed by that time

with regard to class design and contract-specific efforts.^{FN33} Next, the March 15, 1995 version of NNS's IR & D Job Order 2858 sets forth NNS's Double Eagle IR & D charging policy, albeit in a somewhat convoluted manner, yet it too falls short by providing no indication that class design efforts were adjusted for, if not tailored to, the Eletson ships, nor does it reflect that a second class design would shortly be developed for the ships to be produced under the Van Ommeren contracts. And, while the record includes evidence of a February 21, 1996 discussion between NNS management and Tom Segroves of DCAA about Segroves' "concerns regarding IR & D," it is not clear that Segroves' IR & D concerns at this point were related to the Double Eagle IR & D charges. Finally, the record indicates that a detailed discussion occurred on July 8, 1997 between DCAA and NNS with regard to NNS's Double Eagle charging policies. Yet, the fact that the DCAA auditors at this meeting were posing basic questions and requesting documentation regarding Double Eagle IR & D practices is, at the least, a plausible basis to conclude that NNS had not disclosed its charging policy prior to that meeting, nor, indeed, prior to DCAA's initiation of an investigation of the Double Eagle IR & D charges. Thus, while NNS has made a substantial case for disclosure, the evidence in this record does not conclusively establish that NNS made a full, forthright disclosure to DCAA of its Double Eagle IR & D charging policies sufficient to contradict any finding that NNS was acting with reckless disregard with respect to the allowability of its Double Eagle IR & D charges under the FAR. Thus, the disclosure issue also merits further factual development.

^{FN33}. Significantly, NNS sent the November 28, 1994 letter to NSWC, not DCAA. Although NSWC ultimately forwarded the letter to DCAA, NNS's failure to address the letter to DCAA undermines the weight of this letter as evidence of disclosure. See *X Corp.*, 816 F.Supp. at 1094 (holding that disclosure evidence is relevant because of its implication with regard to scienter). In other words, because NNS did not direct the letter to DCAA, it is unclear (i) whether NNS is entitled to a favorable inference that it was not concealing its IR & D policy from DCAA or (ii) whether DCAA actually took notice of the letter.

[13] Quite apart from disclosure, good faith reliance on the advice of counsel may contradict any suggestion that a contractor "knowingly" submitted a false claim, or did so with deliberate ignorance or reckless disregard. To establish the defense of good faith reliance on professional advice, a contractor must show (i) full disclosure of all pertinent facts to an expert, and (ii) good faith reliance on the expert's advice. *United States v. Butler*, 211 F.3d 826, 833 (4th Cir.2000). Clearly, if a contractor seeks the

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advice of counsel in good faith, provides full and accurate information, receives advice which can be reasonably relied upon, and, in turn, faithfully follows that advice, it cannot be said that the defendant “knowingly” submitted false information or acted with deliberate ignorance or reckless disregard of its falsity, even if that advice turns out in fact to be false. Yet, evidence of reliance on the advice of counsel and outside experts does not necessarily bar a fact-finder from finding that the contractor acted with reckless disregard; the contractor might have acted recklessly in relying on the advice because, for example, the advice may be shown to be patently unreasonable and thus not worthy of reliance or because the contractors’ compliance with that advice was recklessly incomplete.

*566 The record on this question falls short of establishing conclusively that NNS relied in good faith on, and fully carried out, the advice of its in-house counsel and outside experts. This question, too, merits further factual inquiry at trial.

Although the parties agree that Keevan advised NNS that NNS should disclose its charging policies to the government,^{FN34} it is unclear, as just discussed, whether such disclosure occurred. Until this question is resolved, it cannot be determined whether NNS in fact followed Keevan’s advice in good faith. Additionally, the parties dispute whether NNS acted reasonably in relying on Keevan’s three factor test and his application of the test to the Eletson contracts. The government contends that NNS’s reliance on Keevan’s test was reckless because the test is utterly without foundation. The government also argues that NNS was reckless in relying on Keevan’s application of the test to the commercial tanker contracts, specifically Keevan’s conclusion that the contracts did not explicitly call for design work, even though both sets of contracts specifically required NNS to “design, construct and complete” the tankers, and the Eletson contracts further specified that the contract price included “the expenses for *basic design* ...” (emphasis added). For its part, NNS contends that it was reasonable in relying on an expert with so much experience in the field. Finally, owing to the lack of a formal report detailing Arthur Andersen’s conclusions and advice, the parties dispute both the content and the nature of the actual advice provided. NNS relies on testimony by Keevan and senior management, while the government relies on the contemporaneous Arthur Andersen outline memorandum. This dispute regarding the content of the advice is obviously material to the reliance issue.^{FN35}

^{FN34}. The parties differ concerning the force of the advice to disclose, with NNS arguing that it was advised only that it “should consider” disclosing

its approach, while the government focuses on the statement in the memorandum indicating that NNS's approach is "theoretically appropriate (subject to the disclosure discussed below)."

^{FN35}. Similarly, the lack of record evidence regarding the precise nature, content, and timing of Huneycutt's advice to NNS likewise leaves material questions of fact unsettled with regard to NNS's reliance on its in-house counsel's advice.

In sum, just as with the disclosure question, material factual disputes remain with regard to the reliance issue. In other words, NNS has failed to establish conclusively that it relied in good faith on the advice of its experts, while the government, for its part, has adduced sufficient evidence upon which a reasonable fact-finder might conclude that NNS acted with reckless disregard as to the impermissibility under the FAR of its Double Eagle IR & D charges. Accordingly, NNS's motion for summary judgment on the FCA claims on the ground that the government failed to produce sufficient evidence to create a triable issue on the knowledge element of the FCA claims must be denied.

An appropriate order has issued.^{FN36}

^{FN36}. See *United States v. Newport News Shipbuilding, Inc.*, Civil Action No. 03-142-A (E.D.Va. July 21, 2003) (Order).

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94-2 BCA P 26894, ASBCA No. 41135, 1994 WL 472066 (A.S.B.C.A.)

ASBCA
Appeal of Unisys Corporation
Under Contract No. F04701-86-C-0007 et al.
April 26, 1994

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OPINION BY ADMINISTRATIVE JUDGE WATKINS

This appeal involves an alleged violation of Cost Accounting Standards (CAS) 402, CAS 405 and Unisys' Cost Accounting Standards Board Disclosure Statement required by Pub.L. 91-379. CAS 402 is concerned with consistency in allocating costs incurred for the same purpose while CAS 405 is concerned with accounting for unallowable costs. Unisys' Disclosure Statement sets out the criteria for determining how costs are charged to Government contracts or similar cost objectives.

The Government contends that the costs recorded after UNISYS' cost plus fixed fee (CPFF) subcontract funding expired should have been charged to cost overruns (unallowable) rather than to independent research and development (IR & D, sometimes IRAD) costs and bid and proposal (B & P) costs (partially allowable as overhead on other contracts). Subsequent contracts would be burdened, to the extent negotiated, with the B & P and IR & D in the burden pool. The captioned contract is one such subsequent contract.

Appellant claims that the subcontract was amended to provide that the work at issue was subject to an option which was not exercised. Appellant therefore asserts that it had no contractual obligation to perform the work. Appellant also asserts that the contractually required work performed subsequent to the expiration of funding was not the same work as that performed prior to the expiration of funding and subsequently should be recorded properly as IR & D and B & P costs.

The Government audited subsequent cost type contracts and the captioned contract was taken as a test case. A two-day hearing was held in Los Angeles, California. Both parties have filed post-hearing briefs and reply briefs. We decide entitlement only.

FINDINGS OF FACT

1. The Federal Aviation Administration (FAA) awarded contracts to IBM and Hughes Aircraft Corporation (HAC) to perform a Design Competition Phase (DCP) preparatory to ultimate procurement of the Advanced Automation System (AAS) the purpose of which was to update the nationwide air space management system. These contracts were CPFF with incremental funding. (Tr. 1/148)

2. In forming its "team" for this work, HAC entered into a subcontract on 11 October 1984 with Unisys which followed the form of the prime contract; i.e., CPFF with incremental funding (tr. 1/10-11, 18-19, 147-49; R4, tab 21). There was a requirement under this subcontract to submit to HAC an AAS acquisition phase proposal early in the contract (tr. 1/149). This requirement was deleted in 1986 (tr. 1/150; R4, tab 21). Unisys also awarded a subcontract to Sanders to be a member of the "team" assembled to perform the work for the DCP. Neither IEM, HAC nor Sanders is involved in this appeal.

3. On being awarded the subcontract, Unisys established a cost accounting system for the work. A direct work order system was established in

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which a three letter code was used as the primary cost collection center. This primary three letter code (AAS) was on all work orders. Sub-tasks were identified by various symbols which were periodically changed as subcontract amendments were added. (Tr. 1/149)

4. CAS applied to the subcontract. CAS 402 provides:

402.3 Definitions.

* * * * *

(2) Cost Objective. A function, organizational subdivision, contract or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost to processes, products, jobs, capitalized projects, etc.

(3) Direct Cost. Any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

(4) Final Cost Objective. A cost objective which has allocated to it both direct and indirect costs, and, in the contractor's accumulation system, is one of the final accumulation points.

(5) Indirect Cost. Any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

* * * * *

402.40 Fundamental Requirement.

All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective.

Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.

(R4, tab 17)

5. CAS 405 provides:

405.30 Definitions.

(2) Expressly unallowable cost.—A particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.

(4) Unallowable cost.—Any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements, or settlements under a Government contract to which it is allocable.

405.40 Fundamental Requirements.

(f) Where the total of the allocable and otherwise allowable costs exceeds a limitation-of-cost or ceiling-price provision in a contract, full direct and indirect cost allocation shall be made to the contract cost objective, in accordance with established cost accounting practices and Standards which regularly govern a given entity's allocations to Government contract cost objectives. In any determination of unallowable cost overrun, the amount thereof shall be identified in terms of the excess of allowable costs over the ceiling amount, rather than through specific identification of particular cost items or cost elements.

(R4, tab 16)

6. The definitions for B & P and IR & D are found in FAR 31.205-18, Independent research and development and bid and proposal costs:

(a) Definitions:

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* * * * *

“Bid and proposal (B & P) costs,” as used in this subdivision, means the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement or required in contract performance.

* * * * *

“Independent research and development (IR & D)” means a contractor’s IR & D cost that is not sponsored by, or required in the performance of, a contract or grant and that consists of projects falling within the four following areas: (1) basic research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. IR & D effort shall not include technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.

7. Unisys’ Disclosure Statement provides the following:

3.1.0 Criteria for Determining How Costs are Charged to Government Contracts or Similar Cost Objectives:

Each activity within Command and Control Division [Unisys] is designated as a direct or indirect activity. Personnel assigned to a respective activity charge their time accordingly. (A direct activity would be a contract, bid and proposal effort and independent research and development efforts.)

Work orders are assigned to each activity. Costs which can be specifically identified to the direct activity (final cost objective) and only benefit that effort are [sic] charged direct through the work order assigned to the activity. Occasionally, direct personnel will perform functions which benefit more than one cost objective. On these occasions, charges are made to the appropriate indirect work order (the burden expense pool or the G & A expense pool), and are subsequently charged to the final cost objective through the use of the appropriate allocation base.

(NOTE: For calculations of overhead rates, the bid and proposal labor and IR & D labor, the allocated overhead costs and related other B & P and IR & D costs are transferred to general and administrative costs and allocated over the G & A base.)

(Exh. A-1)

8. Several contracts are involved in this appeal. One such contract, F04701-86-C-0007, dated 8 October 1986, is between appellant and the U.S. Air Force Space Division, Los Angeles, California. This contract incorporated by reference the Allowable Cost and Payment Clause (FAR 52.216-7, April 1984), the Cost Accounting Standards Clause (FAR 52.230-3, April 1984) and the Administration of Cost Accounting Standards Clause (FAR 52.230-4, April 1984). (R4, tabs 1, 2, 8, 12)

9. Work proceeded on the Unisys subcontract with HAC through the end of 1987 with all cost of the work being charged to the subcontract using the three letter code as the primary cost collection method on the work orders thus coded. This three letter code was "AAS." Work orders also had a sub-task code which gave a specific record of the task performed. (Tr. 1/149) The Government does not challenge any of the charges thus recorded through the end of 1987.

10. There were separate work orders to accumulate contract type activity, IR & D efforts and B & P efforts (tr. 2/83-84). While each of these activities had the "AAS" code, each was further differentiated by the use of the sub-task code.

11. Tasks under Unisys subcontract with HAC changed from time to time and the subcontract was amended as a new or revised Statement of Work (SOW) was included. By means of Subcontract Change No. 9, dated 8 May 1986, HAC deleted the requirement for an AAS Acquisition Phase proposal from the Unisys AAS DCP subcontract (R4, tab 21).

12. In subcontract Change No. 23, dated 16 October 1987, HAC divided the Unisys AAS DCP subcontract into two parts. By letter of 21 October 1987 HAC forwarded SOW Revision 14 dated 1 October 1987. SOW Revision 14 showed the division of the work into two parts as follows:

Basic—Consists of tasks to be performed and deliveries to be made prior to 31 December 1987.

Option—Consists of tasks to be performed and deliveries to be made between 1 January 1988 and 20 June 1988.

(R4, tab 21)

13. By letter of 20 October 1987 Unisys advised HAC that the option must be exercised by HAC in writing not later than 16 November 1987. This letter further stated:

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In the event Buyer [HAC] fails to exercise the option, Unisys (Seller) shall take all necessary steps to discontinue technical performance effective 31 December 1987 and shall prepare the summary reports required elsewhere.

(R4, tab 21)

14. Subcontract Change No. 24, dated 23 October 1987, added a separate and independent new task to the Unisys subcontract for the "PARMI" interface subsystem [the acronym PARMi was not further identified in the record] (R4, tab 21). No costs for performing the PARMi tasks were ever transferred to B & P and IR & D (tr. 1/154).

15. The option expired on 16 November 1987 without being exercised (tr. 1/152-53). Accordingly, Unisys had no obligation to perform those tasks that had been identified as the option tasks. These tasks concerned certain developmental work on some of the systems that were to go into the ultimate proposal to HAC and through HAC to FAA.

16. During October/November 1987 Unisys initiated a series of internal reviews to determine how to charge costs for continuation of work on the AAS program after 31 December 1987 which was the scheduled completion date (tr. 1/155).

17. FAA notified HAC and IBM that it would not fund the AAS DCP program after 31 December 1987. On 18 January 1988, HAC sent a letter to FAA which read in part:

1. Hughes Aircraft Company and its AAS program team companies, Unisys and Sanders, are pleased to advise the FAA that its respective corporate officers have decided to invest private resources (voluntary overrun) in order to achieve the successful completion of the AAS Design Competition Phase (DCP) Program.

2. The Hughes team companies agree that any voluntary overrun incurred beyond the total estimated cost of the contract during the period from 1 January 1988 through 20 June 1988, will be at their own risk and the Government shall not be obligated to reimburse the Hughes team companies therefor. Accordingly, Hughes and its team companies waive any rights they might have for recovery from the U.S. Government of any such voluntary overrun.

3. It should be clearly understood that the term “voluntary overrun” does not include any costs which would otherwise be normally allowable under Government procurement regulations such as those resulting from future changes to the DCP contract or from costs attributable to such items as retroactive rate adjustments.

(R4, tab 13 at 35) Appellant’s comptroller, as did appellant’s president of the systems group, testified that Unisys did not authorize, consent to or agree with Hughes’ representation (tr. 1/159–61, 2/34–36, 43–46). The Government did not refute this testimony. Accordingly, we find no persuasive evidence in the record that Unisys had agreed to the conditions of the HAC letter.

18. On 19 January 1988 HAC sent a letter to Unisys referencing a Memorandum of Understanding (MOU) dated 1 December 1987. This MOU, between HAC and Unisys had not at that time been signed nor was it, in fact, ever signed by Unisys. HAC’s 19 January 1988 letter read in pertinent part:

The remaining issue needs to be closed with the FAA. As we expected in our MOU, the FAA has insisted that we waive our rights to recover any such investment from the US Government. In fact, we have been advised by the FAA that the IBM team took a similar investment decision and has already agreed in writing not to pursue recuperation of its DCP investment from the FAA.

Therefore, as a result of the FAA’s request, Hughes has submitted the referenced b) letter to the FAA [the 18 January 1988 letter referenced above]. A copy of this letter is attached hereto for your information and records.

19. Between 22 January 1988 and 17 February 1988, Unisys and HAC exchanged correspondence changing the completion date for the basic portion of the Unisys AAS DCP subcontract from 31 December 1987 to 22 January 1988 (R4, tab 21).

20. On 22 January 1988 all HAC funding for the Unisys subcontract, excluding PARMI, was exhausted (R4, tab 21; tr. 1/159). After that date until 20 June 1988 Unisys used its own financial resources and continued to work on completion of approximately nine DCP related tasks as well as perform substantial other technical and developmental work as part of the process of supporting the team’s pursuit of an AAS acquisition phase contract award. This ongoing work was not the same as that which was performed prior to the expiration of funding. The Unisys program manager testified concerning those tasks:

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They were not per se the same DCP tasks, though by a description or title of the task, one might be led to believe that they were the same tasks, though they were very specifically different tasks.

(Tr. 2/98) This testimony was not rebutted by the Government. These latter tasks included some of the tasks that would have been covered under the unexercised option of the contract (tr. 1/161). Unisys worked on these tasks in order that the HAC “team” might possibly be awarded the acquisition contract.

21. The direct costs incurred from 22 January 1988 to 20 June 1988 for completion of the DCP related tasks and certain other costs associated with the continuation of the AAS effort were originally charged to the Unisys DCP subcontract work order numbers pending a final decision by Unisys on the ultimate allocation of those costs. Nonetheless, these costs were differentiated by the sub-task code and were thus identified.

22. On 21 April 1988 Unisys responded to HAC’s letter of 18 January 1988 to FAA. The Unisys letter stated that it did not expect to recover costs incurred on clearly identified DCP tasks but reserved the right to recover costs associated with legitimate B & P and IR & D work. (R4, tab 13) Unisys’s president of the systems group testified and we find that Unisys did not intend this letter to constitute any agreement on the part of Unisys with HAC’s commitment to a voluntary overrun of the subcontract (tr. 2/35–36, 38–39).

23. HAC temporarily reinstated Unisys DCP subcontract coverage and added funding for a temporary period of performance to 22 July 1988 (R4, tab 21—Subcontract Change Orders “Q,” No. 26 and “R,” dated 24 June 1988, 11 July 1988 and 1 August 1988). This action was the result of FAA’s postponement of the award of the AAS acquisition phase contract and its desire to keep the competing teams intact until an award was made (tr. 1/164–66, 2/100–01). The record does not establish that this extension related to DCP work.

24. Appellant had solicited the accounting firm of Arthur Young for an opinion concerning the allocability of the AAS DCP completion costs to B & P and IR & D. On 28 June 1988 Arthur Young issued an opinion letter in which it concluded that it was proper to allocate the costs in question to B & P. This particular conclusion stated:

UNISYS’ voluntary technical activity post-exhaustion of allotted funds and/or the total estimated cost can and should be charged to a B & P project since the effort is not required by the subcontract and is in furtherance of a B & P activity.

(R4, tab 13 at 9)

25. With respect to IR & D expenses, Arthur Young's letter expressed the following opinion:

Contrary to the existing belief of UNISYS' finance and legal personnel there is a specific technical effort required under the Hughes subcontract with a period of performance planned to run until May 1988. A project called "PARMI" is an independent task and not related to support of the existing AP proposal. Absent a contract requirement, it would be IR & D.

(R4, tab 13 at 10)

26. Appellant's comptroller testified that the Arthur Young opinion was considered authoritative guidance by Unisys (tr. 1/168-69).

27. On 25 July 1988 FAA awarded the AAS acquisition proposal production contract to IBM.

28. By means of Journal Entries Nos. 03750 and 04512 dated 23 September 1988 and 21 October 1988, respectively, Unisys transferred \$2,520,256 of direct costs incurred after 22 January 1988 and before 20 June 1988 for completion of the DCP related tasks and certain other work associated with continuation of the AAS effort from the AAS DCP subcontract accounts to B & P and IR & D accounts (exh. A-2, A-3; tr. 1/172-73).

29. A preliminary audit was performed by Defense Contract Audit Agency (DCAA) on a subsequent contract between the Government (Air Force) and Unisys and on 30 November 1988 it forwarded a draft Statement of Conditions and Recommendations for response by Unisys. This Statement alleged that Unisys was noncompliant with CAS 420 by reason of the Unisys transfer of the costs in question to B & P and IR & D accounts in the HAC subcontract. (R4, tab 13) CAS 420 concerns the recording of B & P and IR & D costs. Unisys responded to the DCAA Statement and disagreed with the report's conclusions (R4, tab 13). Noncompliance with CAS 420 is not included in the DCAA final audit report which was the precursor for this appeal. For purposes of this appeal, we consider that the Government has abandoned or withdrawn its position that there was noncompliance with CAS 420. (R4, tab 6; tr. 2/64).

30. The costs in question would not be recoverable if considered as an overrun, while as B & P and IR & D costs they would be included in the overhead pool allocable to all contracts.

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31. An audit report was issued on 28 February 1989 by DCAA in which that Agency summarized its results as follows:

3.a. In our opinion, the contractor is in noncompliance with CAS 402, CAS 405, and its Disclosure Statement.

(R4, tab 6)

32. The auditor's rationale was stated as follows:

4.a.(1)(c) The funding of a contract is not a criteria [sic] in determining the appropriate accounting classification of costs. Work performed after the funding limitation was met was specifically identifiable to contract requirements and represents cost incurred for the same purpose, in like circumstances, as contract work performed before the funding limitation was met.

33. The auditor had no real knowledge concerning the technical tasks being performed after 22 January 1988, the date that the funding under the contract expired, and did not know the kind of work that would ordinarily be required in support of a proposal effort (tr. 1/92). The auditor was asked during the hearing whether, after reviewing Change Order No. 23 to the Unisys subcontract, there was any doubt that the actual work under the basic portion of the contract was completed under the express terms of the contract on 22 January 1988. She responded that, under the express terms of the contract, it was completed on 22 January 1988. (Tr. 1/89) HAC did receive additional funding to keep the contract in existence and the "team" intact until 22 July 1988 and made part of these funds available to Unisys (R4, tab 21—Subcontract Change Orders "Q," No. 26 and "R," dated 24 June 1988, 11 July 1988 and 1 August 1988; finding 23).

34. On 28 February 1989 DCAA issued its final Audit Report on Noncompliance, No. 7361-89U44200138. This report stated that the Unisys allocation of AAS costs in question to B & P and IR & D was in noncompliance with CAS 402 and CAS 405. (R4, tab 6)

35. By letter of 12 October 1989 the administrative contracting officer (ACO) asserted that the cost impact of Unisys' noncompliance with CAS 402 and CAS 405 was \$663,528 to be applied to forty-three contracts (R4, tab 11).

36. On 16 March 1990 the ACO issued a final decision confirming his finding of noncompliance with CAS 402 and CAS 405 and with Unisys' disclosed practices. The ACO asserted that the cost impact was applicable to

Contract F4701-86-C-0007, et al. This final decision asserts a cost impact of \$663,528 which was later recomputed due to additional information provided by Unisys. (R4, tab 2)

37. On 14 June 1990 Unisys filed its Notice of Appeal in this dispute.

38. On 29 March 1991 DCAA issued supplemental Audit Report No. 7361)-89U44500572-S1 which revised the impact cost of the asserted noncompliance with CAS 402 and CAS 405 from \$663,528 to \$494,822 (tr. 1/94-95).

DECISION

In any appeal that involves alleged noncompliance with cost accounting standards, the burden is on the Government to establish the noncompliance. While there had been an obligation under the Unisys subcontract to provide an acquisition phase proposal, this requirement had been deleted on 8 May 1986 (findings 2, 11). Accordingly, Unisys was under no contractual obligation to provide a proposal. The Government has provided no evidence that there was a specific contract to which to record the costs of this effort after it had been deleted from the subcontract between HAC and Unisys. Since the cost objective could not be a specific contract, it was proper to record the costs of this effort under the B & P cost objective.

With respect to technical work which was ultimately costed out to IR & D, HAC divided the subcontract on 16 October 1987 into two parts, (1) basic tasks to be performed prior to 31 December 1987 and (2) option tasks which were to be performed between 1 January 1988 (which was amended to 22 January 1988) and 20 June 1988. Accordingly, the obligation to perform the basic tasks expired under the terms of the subcontract on 31 December 1987. As the option was not exercised, no obligation ever came into being which required Unisys to perform the tasks enumerated in the option. Further, the PARM tasks were performed and recorded to the contract and these costs were not reallocated to either B & P or IR & D. The Government has failed to show that the work that Unisys did between 22 January 1988 and 20 June 1988 was in furtherance of any contractual obligation. Accordingly, the proper cost objective was IR & D and the costs should have been so recorded.

Further, the Government did not establish any details of the technical work that was performed by appellant after 22 January 1988 and before 20 June 1988. To establish a violation of CAS 402 it is necessary to prove that the costs "are incurred for the same purpose, in like circumstances." In this appeal, the Government has failed to do so.

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We hold that the Government has not proved that the costs in question were improperly allocated to B & P and IR & D; accordingly, no violation of CAS 405 has been shown.

The appeal is sustained.

WILLIAM T. WATKINS

Administrative Judge

Armed Services Board of Contract Appeals

I concur

V. JOHN RIISMANDEL

Administrative Judge

Acting Chairman, Armed Services

Board of Contract Appeals

I concur

WILLIAM J. RUBERRY

Administrative Judge

Vice Chairman, Armed Services

Board of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 41135, Appeal of Unisys Corporation, rendered in conformance with the Board's Charter.

EDWARD S. ADAMKEWICZ

Recorder, Armed Services

Board of Contract Appeals

94-2 BCA P 26894, ASBCA No. 41135, 1994 WL 472066 (A.S.B.C.A.)

United States District Court, C.D. California.

GENERAL DYNAMICS CORPORATION

v.

UNITED STATES of America

No. CV 89-6762 JGD.

Nov. 7, 1990.

DAVIES, District Judge:

*1 On October 22, 1990, the Government's motion to dismiss the complaint came on for hearing before this Court. Having considered the arguments of counsel, and the memoranda points and authorities submitted by the parties, the Court hereby DENIES the motion.

Background

On January 13, 1978, the Department of the Army awarded the plaintiff, General Dynamics, a contract to develop two prototypes for the Divisional Air Defense System ("DIVADS contract"), a computer-operated weapons system. The Defense Contract Audit Agency ("DCAA"), an agency under the direction of the Department of Defense, continually audited the plaintiff and other defense contractors to verify compliance with defense contracts. On February 29, 1984, at the request of the Department of Justice, the DCAA issued Audit Report No. 4501-3A486354 ("Audit Report") which indicated that plaintiff had fraudulently mischarged approximately \$7.5 million of DIVADS contract costs.

On December 2, 1985, a grand jury indicted the plaintiff and four individual executives of General Dynamics on charges of fraudulently mischarging costs related to the DIVADS contract. On March 3, 1986, the government filed a civil action alleging violations of the False Claims Act arising from the mischarges against the plaintiff. Subsequently, the Department of Justice determined that the DCAA had erroneously interpreted the DIVADS contract and related regulations. Based on this finding, the indictment was dismissed on June 22, 1987, and the civil action against plaintiff was voluntarily dismissed on August 10, 1987.

On March 30, 1989, the plaintiff presented an administrative claim under the Federal Tort Claims Act to the Comptroller of the Department of Defense and to the director of the DCAA. In that claim, the plaintiff alleged that the DCAA

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was negligent in preparing the Audit Report which erroneously concluded that the plaintiff had engaged in mischarging. On November 13, 1989, plaintiff filed its one count complaint under the FTCA alleging the defendant, the United States, was negligent in preparing the Audit Report. On July 23, 1990, the plaintiff filed a first amended complaint. The first amended complaint states a claim under the FTCA and alleges that the DCAA negligently audited General Dynamics from 1979 through 1987. As a result of this negligent audit the DCAA concluded that General Dynamics was mischarging costs. This alleged professional malpractice caused the Department of Justice to file and prosecute criminal and civil actions which caused injury to the plaintiff. The plaintiff seeks as damages the cost of the defending the legal actions.

The Government has moved to dismiss the first amended complaint for failure to state a claim upon which relief may be granted and lack of subject matter jurisdiction, pursuant to Fed.R.Civ.P. 12(b)(6) and 12(b)(1). Based on the following analysis, the Court denies the Government's motion.

Discussion

1. The Statute of Limitations

*2 Under 28 U.S.C. Sec. 2401(b) a tort claim against the United States must first be presented to the appropriate federal agency within two years after the claim accrues. Failure to do so is a jurisdictional defect. *Augustine v. United States*, 704 F.2d 1074, 1077 (9th Cir.1983). The date on which a claim accrues is determined by federal law. *Washington v. United States*, 769 F.2d 1436, 1438 (9th Cir.1985). In a professional malpractice case brought under the FTCA, a claim accrues when the plaintiff discovers, or in the exercise of reasonable diligence should have discovered, the injury and its cause. *United States v. Kubrick*, 444 U.S. 111, 100 S.Ct. 352 (1979) ("Kubrick"). In *Kubrick*, the Supreme Court held that "accrual" of a cause of action under FTCA, Sec. 2401(b), does not await plaintiff's awareness that injury was negligently inflicted. Rather, accrual occurs when the plaintiff possesses the critical facts: both that he had an injury and the potential cause of the injury.

All allegations of material fact in a complaint must be taken as true and must be construed in the light most favorable to the non-moving party. *Hall v. City of Santa Barbara*, 813 F.2d 198, 201 n. 9 (9th Cir.1986). Thus, on the record before the Court, the Court finds that General Dynamics has adequately pleaded that it could only have learned the critical facts relating to its injury at the dismissal of the indictment. Since dismissal was less than two years prior to the filing of the General Dynamics claim, that claim was timely.

2. Discretionary Function Exception under the FTCA

The discretionary function exception excludes any tort claim “based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.” 28 U.S.C. 2680(a). The Supreme Court has set out the appropriate two step analysis to determine whether the discretionary function exception applies in a particular case. *Berkovitz v. United States*, 486 U.S. 351, 108 S.Ct. 1954 (1988). A court must determine whether the allegedly negligent act involves a policy judgment or choice, and if it does, whether that judgment or choice involves the kind of economic, political, or social judgment or choice protected by the discretionary function exception. *Id.*, 108 S.Ct. at 1958–59. The Court held that the “discretionary function exception will not apply when a federal statute, regulation or policy specifically prescribes a course of action for an employee to follow.” 108 S.Ct. at 1958.

The Government argues that the discretionary function exception should apply to the current action. The Government asserts that its decision to investigate, prosecute, and bring a civil fraud suit involves a permissible exercise of a policy judgment, and, that the actions of the DCAA are so intertwined with this prosecutorial function as to be themselves discretionary. The Government contends further that, because the plaintiff alleges no harm separate and distinct from the harm caused by the defendant’s discretionary actions, the discretionary exception extends to the actions taken by the DCAA throughout the investigation and prosecution of General Dynamics.

*³ However, the plaintiff has not alleged that the DCAA was acting in any discretionary capacity but merely following prescribed regulations set forth in the DCAA Contract Audit Manual. It was DCAA’s negligent auditing pursuant to the regulations which the plaintiff alleges caused the injury. Absent any discretionary judgment or policy choices, the auditing function may be distinguished from the prosecutorial function and, therefore, does not fall under the discretionary exception to the FTCA. Thus, the plaintiff has adequately pleaded that the DCAA’s auditing was not discretionary.

Finally, whether the DCAA’s auditing function is so intertwined with discretionary prosecutorial functions to be exempt itself, is not a question the Court can effectively address at the pleading stage.

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3. *Professional Malpractice*

The FTCA renders the United States liable in tort for the negligent acts of its employees when liability would exist under the law of the state where the wrongful act occurred. 28 U.S.C. Secs. 1346(b) and 2674. Since the allegedly wrongful conduct occurred in California, the plaintiff must plead a prima facie case of professional malpractice under California law.

Under California law, for professional malpractice a plaintiff must allege (1) the duty of the professional to use such skill, prudence, and diligence as other members of his profession commonly possess and exercise; (2) a breach of that duty; (3) a proximate causal connection between the negligent conduct and the resulting injury; and (4) actual loss or damage resulting from the professional's negligence. *Budd v. Nixon*, 98 Cal.Rptr. 849, 852 (1971). Furthermore, under *Bily v. Arthur Young & Company*, 271 Cal. Rptr. 470 (1990), an accountant is liable to third parties who reasonably and foreseeably rely upon the accountant. In the first amended complaint, this plaintiff has adequately alleged the preceding elements which are necessary under state law for a cause of action for professional malpractice.

The Government has raised other substantive objections to dismiss the complaint. Those objections are more aptly addressed at a later stage in the proceedings. Therefore, pursuant to the foregoing analysis, the Court DENIES the motion to dismiss.

C.D.Cal.,1990.
General Dynamics Corp. v. U.S.

Not Reported in F.Supp., 1990 WL 267366 (C.D.Cal.), 36 Cont.Cas.Fed.
(CCH) P 75,978

United States Court of Appeals,
Federal Circuit.

The BOEING COMPANY, Appellant,

v.

The UNITED STATES, Appellee.

Appeal No. 88-1298.

Nov. 30, 1988.

Rehearing Denied Feb. 24, 1989.

Contractor appealed decision of the Armed Services Board of Contract Appeals that all of contractor's bid and proposal costs incurred to enhance its ability to receive Phase 2 contract had to be recorded as direct costs of Phase 1 contract. The Court of Appeals, Bissell, Circuit Judge, held that Board erred in interpreting consistency requirements of General Accounting Office cost accounting standard to require that result.

Reversed.

West Headnotes

Public Contracts 316H 273

316H Public Contracts

316HV Construction and Operation

316Hk271 Compensation

316Hk273 k. Cost-plus contracts. Most Cited Cases

United States 393 70(18)

393 United States

393III Contracts

393k70 Construction and Operation of Contracts

393k70(15) Compensation

393k70(18) k. Cost basis and cost-plus. Most Cited Cases

Consistency requirements of General Accounting Office cost accounting standard did not require that all of contractor's bid and proposal costs incurred to enhance its ability to receive Phase 2 contract be recorded

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as direct cost of Phase 1 contracts; bid and proposal costs were normally allocable to indirect account, in that they benefited all business of contractor rather than specific existing contract.

*290 Richard W. Oehler of Perkins Coie, Seattle, Wash., argued for appellant. With him on the brief was Harold F. Olsen.

Gregory A. Harrison, Dept. of Justice, Washington, D.C., argued for appellee. John R. Bolton, Asst. Atty. Gen., David M. Cohen, Director, M. Susan Burnett, Asst. Director and Paul F. McQuade, Commercial Litigation Branch, Dept. of Justice, Washington, D.C., were on the brief for appellee. Also on the brief were Major Scott Bagley, Office of the Judge Advocate Gen., Dept. of the Air Force and Richard L. Hanson, Dept. of the Air Force, of counsel.

*291 Before MARKEY, Chief Judge, RICH and BISSELL, Circuit Judges.

BISSELL, Circuit Judge.

The Boeing Company (Boeing) appeals the decision of the Armed Services Board of Contract Appeals (Board), *Boeing Co.—Boeing Military Airplane Div.*, ASBCA No. 29793, 88-1 BCA ¶ 20,380 (1987) [available on WESTLAW, 1987 WL 46116], holding that all of Boeing's bid and proposal (B & P) costs incurred to enhance its ability to receive a Phase 2 contract must be recorded as direct costs of the Phase 1 contract, Contract No. F33657-77-C-0175, under the consistency requirements of General Accounting Office Cost Accounting Standard (CAS) 402, 4 C.F.R. §§ 402.10-.80 (1988). Because the Board erred in interpreting CAS 402, we reverse.

BACKGROUND

In April 1976, the Air Force issued a request for proposals (RFP) specifically soliciting two proposals for the competitive design, production and demonstration of a B-52G and a KC-135 weapon systems trainer. The winner of a Phase 1 initial production contract competition would receive the Phase 2 contract for the balance of the equipment.

The RFP, at Line Item 0010 of the proposed contract, required each offeror to prepare a proposal for the Phase 2 contract and to specify a target cost for the proposal preparation. The RFP further provided that (1) the contents of the Phase 2 proposal would be specified at a later date, (2) the proposal

instruction package (PIP) would be issued 23 months after award of the Phase 1 contract, and (3) the proposal would be due 2 months later. In October 1976, Boeing submitted its bid for the Phase 1 contract, including a target cost of \$1,010,380 for the Phase 2 proposal effort.

Shortly thereafter, Boeing described its interpretation of CAS 402's Interpretation No. 1, 4 C.F.R. Part 402, Appendix (1988) (Interpretation No. 1), in an internal memorandum to its contracts directors and finance directors. Consistent with the foregoing memorandum, Boeing issued an internal directive specifying that all Phase 2 proposal preparation costs incurred during the two months between receipt of the PIP and submission of the proposal were to be allocated as direct costs of the Phase 1 contract, and all other costs for proposal activity generated to obtain the Phase 2 contract—those incurred prior to receipt of the PIP or after submission of the proposal—were to be allocated to Boeing's indirect B & P cost account.

In January 1977, Boeing submitted its best and final offer for the Phase 1 contract. The offer set forth a price of \$486,310 for Line Item 0010—the Phase 2 proposal activity—and stated that this price covered only the costs incurred in preparing the Phase 2 proposal. In April 1977, the Air Force awarded one of the Phase 1 contracts to Boeing and the other to Singer Company.

On April 20, 1979, the Air Force issued a PIP for only the B-52 trainer and cancelled the procurement of the KC-135 trainer. Although Boeing made a best and final offer for the Phase 2 production contract, the Air Force awarded the Phase 2 contract to Singer Company in May 1980.

From 1974 through 1979, Boeing had performed several independent research and development (IR & D) and B & P projects to enhance its capability to design and produce the weapon systems trainers and simulators for the B-52, KC-135 and other military aircraft. In accordance with defense contracting regulations, Boeing regularly reported its costs in these endeavors to the Department of Defense Tri-Service Office, the office responsible for negotiating ceilings on indirect cost allowances for IR & D/B & P projects undertaken by defense contractors. Boeing allocated all B & P costs incurred in performing the weapon systems trainer B & P efforts to its indirect IR & D/B & P cost accounts except for those costs incurred between receipt of the Phase 2 PIP and submission of the Phase 2 proposal. These latter costs, amounting to \$444,235, were allocated directly to the Phase 1 contract.

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The contracting officer in his final decision directed Boeing to adjust its accounts ^{*292} to remove all B & P costs recorded as indirect costs for the years 1977 through 1980 and record these costs as direct costs of the Phase 1 contract. The issue of direct or indirect cost allocation for all years except 1979 was resolved during negotiation of final overhead rates.

Before the Board, the parties agreed that Boeing had properly allocated directly to the Phase 1 contract the costs incurred in actually preparing the Phase 2 proposal, *i.e.*, the costs incurred between Phase 2 PIP receipt and Phase 2 proposal submission. Thus, the only remaining dispute was whether CAS 402 allowed Boeing to treat all other 1979 B & P costs related to the weapon systems trainers as indirect costs. The Board resolved the dispute adversely to Boeing.

ISSUE

Whether the Board erred in interpreting CAS 402 to require Boeing to allocate all B & P costs incurred to enhance its ability to receive the Phase 2 contract as direct costs of the Phase 1 contract.

OPINION

CAS 402, promulgated by the Cost Accounting Standards Board (CASB) pursuant to the Defense Production Act Amendments of 1970, Pub.L. 91-379, 84 Stat. 796 (1970), enjoys the “full force and effect of law.” 50 U.S.C.App. § 2168(i)(A) (1982). CAS 402 requires in pertinent part that

[a]ll costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives.

4 C.F.R. § 402.40.

The CASB published an interpretation of Interpretation No. 1 because a number of questions had been raised as to how the standard was to be applied to account for B & P costs and, particularly, as to whether all costs incurred in preparing proposals are incurred for the same purpose, in like circumstances and therefore must all be allocated alike. Preamble C, 4 C.F.R. Part 402 (1988). Interpretation No. 1 “deals with the way Part 402 applies to the treatment of costs incurred in preparing, submitting, and supporting proposals.” Interpretation No. 1.

Under Part 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 proposals costs relate to all work of the contractor.

This interpretation does not preclude the allocation, as indirect costs, of costs incurred in preparing all proposals. The cost accounting practices used by the contractor, however, must be followed consistently and the method used to reallocate such costs, of course, must provide an equitable distribution to all final cost objectives.

Id.

The Board held that the consistency requirement of CAS 402 supported the contracting officer's decision. *Boeing*, 88-1 BCA at 103,052-53. Because all of the 1979 B & P costs were "caused or generated" by or "relate[d]" to the Phase 1 contract and were not "caused or generated" by all work of the contractor, the Board concluded that the costs had to be allocated directly to the Phase 1 contract. *Id.* The Board explained that all 1979 B & P costs were generated in anticipation of the preparation and submission of the Phase 2 proposal as required by the Phase 1 contract and would not have occurred without the Phase 1 contract. *Id.* Because they were costs of competition caused or generated by the Phase 1 contract, the Board held that CAS 402 requires allocating these costs in the same manner as costs of proposals specifically required by the Phase 1 contract. *Id.*

The Board erred as a matter of law in interpreting CAS 402 to require like accounting^{*293} for B & P costs "relate[d] to" or "caused or generated" by a contract and B & P costs "specifically required" by a contract. In interpreting CAS 402, the CASB used the words "specific requirement of an existing contract" to distinguish between proposals in different circumstances. Interpretation No. 1. During the comment period on Interpretation No. 1, the CASB was requested to change the "specifically required" language to "related to," "arising from" or the like. Preamble C, 4 C.F.R. Part 402. The CASB refused, maintaining that the "specific requirement" provision is the distinguishing characteristic for determining if circumstances can be considered different with respect to allocating costs directly or indirectly. *Id.*

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The Board failed to take into consideration the overall thrust of Interpretation No. 1—that B & P costs are normally allocable to an indirect account. Prior case law also supports allocating all B & P costs indirectly. *See, e.g., Singer–General Precision, Inc. v. United States*, 192 Ct.Cl. 435, 427 F.2d 1187, 1190–91 (1970) (recognizing the reasonableness of allocating B & P costs to a general overhead account); *North Am. Rockwell Corp.*, ASBCA No. 13067, 69–2 BCA ¶ 7812, at 36,305 (1969) [1969 WL 544] (stating that “bid and proposal costs are chargeable to current overhead accounts”). Because B & P costs benefit all business of a contractor rather than a specific existing contract, treating all such costs as indirect overhead is logical.

CAS 402, however, does permit a contractor to charge some B & P costs directly if all the B & P costs incurred in like circumstances are allocated alike. 4 C.F.R. § 402.40. In other words, splitting of B & P costs is allowed only if the costs are incurred in different circumstances or for different purposes. *Id.* Costs of proposals specifically required by an existing contract are incurred in circumstances different from proposal costs relative to all work of the contractor. Interpretation No. 1. Therefore, B & P costs arising from a specific requirement in an existing contract may be reallocated from the indirect cost account to the direct cost account. The CASB, however, has mandated that any such reallocation must follow consistently the contractor’s established accounting practices. *Id.*

Under its established accounting practices, Boeing, with two exceptions, allocates all B & P costs indirectly. If the proposal is a follow-on to an existing single source, *i.e.*, noncompetitive, contract or is a proposal specifically required by an existing contract, Boeing allocates the costs directly to the existing contract. Boeing is not splitting like costs between indirect and direct accounts because the single source follow-on and specifically-required costs arise in circumstances different from other B & P costs that Boeing allocates indirectly. Boeing’s accounting practices, if followed consistently, comply with CAS 402.

As a result of the government’s Phase 1 contract acceptance, only the Phase 2 proposal costs delineated in Boeing’s best and final offer—those incurred between Phase 2 PIP receipt and Phase 2 proposal submission—were specifically required by an existing contract. Boeing allocated those B & P costs directly to the contract because they were incurred in different circumstances from Boeing’s overall B & P efforts. Although other Phase 2 B & P costs may have been generated by the Phase 1 contract, no contractual obligation existed which would differentiate these costs from other B & P costs. Thus, these costs were properly allocated as indirect B & P costs.

Because Boeing followed consistently its established accounting practices and those practices comply with CAS 402, the Board's decision is

REVERSED.

C.A.Fed.,1988.

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862 F.2d 290, 35 Cont.Cas.Fed. (CCH) P 75,596

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Subpart 31.2. Contracts with Commercial Organizations
31.205 Selected Costs.

31.205-18 Independent research and development and bid and proposal costs.

(a) Definitions. As used in this subsection--Applied research means that effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) attempts to determine and exploit the potential of scientific discoveries or improvements in technology, materials, processes, methods, devices, or techniques, and (3) attempts to advance the state of the art. Applied research does not include efforts whose principal aim is design, development, or test of specific items or services to be considered for sale; these efforts are within the definition of the term development, defined in this subsection.

Basic research, (See 2.101).

Bid and proposal (B&P) costs means the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement, or required in the performance of a contract.

Company means all divisions, subsidiaries, and affiliates of the contractor under common control.

Development means the systematic use, under whatever name, of scientific and technical knowledge in the design, development, test, or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purpose of meeting specific performance requirements or objectives. Development includes the functions of design engineering, prototyping, and engineering testing. Development excludes: (1) Subcontracted technical effort which is for the sole purpose of developing an additional source for an existing product, or (2) development effort for manufacturing or production materials, systems, processes, methods, equipment, tools, and techniques not intended for sale.

Independent research and development (IR&D) means a contractor's IR&D cost that consists of projects falling within the four following areas: (1) Basis research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. The term does not include the costs of effort sponsored by a grant or required in the performance of a contract. IR&D effort shall not include technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.

Systems and other concept formulation studies means analyses and study efforts either related to specific IR&D efforts or directed toward identifying desirable new systems, equipment or components, or modifications and improvements to existing systems, equipment, or components.

(b) Composition and allocation of costs. The requirements of 48 CFR 9904.420, Accounting for independent research and development costs and bid and proposal costs, are incorporated in their entirety and shall apply as follows--

(1) Fully-CAS-covered contracts. Contracts that are fully-CAS-covered shall be subject to all requirements of 48 CFR 9904.420.

(2) Modified CAS-covered and non-CAS-covered contracts. Contracts that are not CAS-covered or that contain terms or conditions requiring modified CAS coverage shall be subject to all requirements of 48 CFR 9904.420 except 48 CFR 9904.420-50(e)(2) and 48 CFR 9904.420-50(f)(2), which are not then applicable. However, non-CAS-covered or modified CAS-covered contracts awarded at a time the contractor has CAS-covered contracts requiring compliance with 48 CFR 9904.420, shall be subject to all the requirements of 48 CFR 9904.420. When the requirements of 48 CFR 9904.420-50(e)(2) and 48 CFR 9904.420-50(f)(2) are not applicable, the following apply:

(i) IR&D and B&P costs shall be allocated to final cost objectives on the same basis of allocation used for the G&A expense grouping of the profit center (see 31.001) in which the costs are incurred. However, when IR&D and B&P costs clearly benefit other profit centers or benefit the entire company, those costs shall be allocated through the G&A of the other profit centers or through the corporate G&A, as appropriate.

(ii) If allocations of IR&D or B&P through the G&A base do not provide equitable cost allocation, the contracting officer may approve use of a different base.

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(c) Allowability. Except as provided in paragraphs (d) and (e) of this subsection, or as provided in agency regulations, costs for IR&D and B&P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.

(d) Deferred IR&D costs.

(1) IR&D costs that were incurred in previous accounting periods are unallowable, except when a contractor has developed a specific product at its own risk in anticipation of recovering the development costs in the sale price of the product provided that--

(i) The total amount of IR&D costs applicable to the product can be identified;

(ii) The proration of such costs to sales of the product is reasonable;

(iii) The contractor had no Government business during the time that the costs were incurred or did not allocate IR&D costs to Government contracts except to prorate the cost of developing a specific product to the sales of that product; and

(iv) No costs of current IR&D programs are allocated to Government work except to prorate the costs of developing a specific product to the sales of that product.

(2) When deferred costs are recognized, the contract (except firm-fixed-price and fixed-price with economic price adjustment) will include a specific provision setting forth the amount of deferred IR&D costs that are allocable to the contract. The negotiation memorandum will state the circumstances pertaining to the case and the reason for accepting the deferred costs.

(e) Cooperative arrangements.

(1) IR&D costs may be incurred by contractors working jointly with one or more non-Federal entities pursuant to a cooperative arrangement (for example, joint ventures, limited partnerships, teaming arrangements, and collaboration and consortium arrangements). IR&D costs also may include costs contributed by contractors in performing cooperative research and development agreements, or similar arrangements, entered into under--

(i) Section 12 of the Stevenson–Wylder Technology Transfer Act of 1980 (15 U.S.C. 3710(a));

(ii) Sections 203(c)(5) and (6) of the National Aeronautics and Space Act of 1958, as amended (42 U.S.C. 2473(c)(5) and (6));

(iii) 10 U.S.C. 2371 for the Defense Advanced Research Projects Agency; or

(iv) Other equivalent authority.

(2) IR&D costs incurred by a contractor pursuant to these types of cooperative arrangements should be considered as allowable IR&D costs if the work performed would have been allowed as contractor IR&D had there been no cooperative arrangement.

(3) Costs incurred in preparing, submitting, and supporting offers on potential cooperative arrangements are allowable to the extent they are allocable, reasonable, and not otherwise unallowable.

[49 FR 12986, March 30, 1984; 55 FR 25530, June 21, 1990; 56 FR 15148, April 15, 1991; 57 FR 39591, Aug. 31, 1992; 57 FR 44265, Sept. 24, 1992; 59 FR 11379, March 10, 1994; 59 FR 67042, Dec. 28, 1994; 62 FR 12705, March 17, 1997; 62 FR 51271, Sept. 30, 1997; 62 FR 64932, Dec. 9, 1997; 66 FR 2131, Jan. 10, 2001; 66 FR 14260, March 9, 2001]

SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205–18, 48 CFR 31.205–18

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31.205 Selected Costs.
31.205-23 Losses on other contracts.

An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts) is unallowable.

SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205-23, 48 CFR 31.205-23

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31.205 Selected Costs.
31.205-25 Manufacturing and production engineering costs.

(a) The costs of manufacturing and production engineering effort as described in (1) through (4) below are all allowable:

- (1) Developing and deploying new or improved materials systems, processes, methods, equipment, tools and techniques that are or are expected to be used in producing products or services;
- (2) Developing and deploying pilot production lines;
- (3) Improving current production functions, such as plant layout, production scheduling and control, methods and job analysis, equipment capabilities and capacities, inspection techniques, and tooling analysis (including tooling design and application improvements); and
- (4) Material and manufacturing producibility analysis for production suitability and to optimize manufacturing processes, methods, and techniques.

(b) This cost principle does not cover:

- (1) Basic and applied research effort (as defined in 31.205-18(a)) related to new technology, materials, systems, processes, methods, equipment, tools and techniques. Such technical effort is governed by 31.205-18, Independent research and development costs and bid and proposal costs; and
- (2) Development effort for manufacturing or production materials, systems, processes, methods, equipment, tools and techniques that are intended for sale is also governed by 31.205-18.

(c) Where manufacturing or production development costs are capitalized or required to be capitalized under the contractor's capitalization policies, allowable cost will be determined in accordance with the requirements of 31.205-11, Depreciation.

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SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205–25, 48 CFR 31.205–25

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31.205 Selected Costs.
31.205–32 Precontract costs.

Precontract costs means costs incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. These costs are allowable to the extent that they would have been allowable if incurred after the date of the contract (see 31.109).

[66 FR 2131, Jan. 10, 2001; 66 FR 14260, March 9, 2001]

SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205–32, 48 CFR 31.205–32

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31.205 Selected Costs.
31.205-38 Selling costs.

(a) "Selling" is a generic term encompassing all efforts to market the contractor's products or services, some of which are covered specifically in other subsections of 31.205. The costs of any selling efforts other than those addressed in this cost principle are unallowable.

(b) Selling activity includes the following broad categories:

(1) Advertising. Advertising is defined at 31.205-1(b), and advertising costs are subject to the allowability provisions of 31.205-1(d) and (f).

(2) Corporate image enhancement. Corporate image enhancement activities, including broadly targeted sales efforts, other than advertising, are included within the definition of public relations at 31.205-1(a), and the costs of such efforts are subject to the allowability provisions at 31.205-1(e) and (f).

(3) Bid and proposal costs. Bid and proposal costs are defined at 31.205-18 and are subject to the allowability provisions of that subsection.

(4) Market planning. Market planning involves market research and analysis and general management planning concerned with development of the contractor's business. Long-range market planning costs are subject to the allowability provisions of 31.205-12. Other market planning costs are allowable.

(5) Direct selling. Direct selling efforts are those acts or actions to induce particular customers to purchase particular products or services of the contractor. Direct selling is characterized by person-to-person contact and includes such efforts as familiarizing a potential customer with the contractor's products or services, conditions of sale, service capabilities, etc. It also includes negotiation, liaison between customer and contractor personnel, technical and consulting efforts, individual demonstrations, and any other efforts having as their purpose the

application or adaptation of the contractor's products or services for a particular customer's use. The cost of direct selling efforts is allowable.

(c) Notwithstanding any other provision of this subsection, sellers' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business.

[51 FR 2665, Jan. 17, 1986; 51 FR 12301, April 9, 1986; 52 FR 19805, May 27, 1987; 55 FR 38517, Sept. 18, 1990; 56 FR 15153, April 15, 1991; 57 FR 39591, Aug. 31, 1992; 59 FR 11387, March 10, 1994; 59 FR 67042, Dec. 28, 1994; 61 FR 39188, July 26, 1996; 62 FR 12704, March 17, 1997; 68 FR 43872, July 24, 2003]

SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205-38, 48 CFR 31.205-38

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31.205 Selected Costs.
31.205-48 Research and development costs.

Research and development, as used in this subsection, means the type of technical effort described in 31.205-18 but sponsored by a grant or required in the performance of a contract. When costs are incurred in excess of either the price of a contract or amount of a grant for research and development effort, the excess is unallowable under any other Government contract.

[65 FR 46072, July 26, 2000; 68 FR 28092, May 22, 2003]

SOURCE: 48 FR 42301, Sept. 19, 1983; 52 FR 35669, Sept. 22, 1987; 54 FR 5054, Jan. 31, 1989; 68 FR 28079, 28091, May 22, 2003; 68 FR 43865, 43872, July 24, 2003; 68 FR 56688, Oct. 1, 2003; 68 FR 69247, 69254, Dec. 11, 2003; 69 FR 17766, April 5, 2004; 69 FR 34242, 34243, June 18, 2004; 70 FR 11763, March 9, 2005; 70 FR 33675, June 8, 2005; 78 FR 6191, Jan. 29, 2013, unless otherwise noted.

AUTHORITY: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 51 U.S.C. 20113.

48 C. F. R. 31.205-48, 48 CFR 31.205-48

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Part 231. Contract Cost Principles and Procedures (Refs & Annos)

Subpart 231.2. Contracts with Commercial Organizations

231.205 Selected Costs.

231.205-18 Independent research and development and bid and proposal costs.

(a) Definitions. As used in this subsection--

(i) Covered contract means a DoD prime contract for an amount exceeding the simplified acquisition threshold, except for a fixed-price contract without cost incentives. The term also includes a subcontract for an amount exceeding the simplified acquisition threshold, except for a fixed-price subcontract without cost incentives under such a prime contract.

(ii) Covered segment means a product division of the contractor that allocated more than \$1,100,000 in independent research and development and bid and proposal (IR & D/B & P) costs to covered contracts during the preceding fiscal year. In the case of a contractor that has no product divisions, the term means that contractor as a whole. A product division of the contractor that allocated less than \$1,100,000 in IR & D/B & P costs to covered contracts during the preceding fiscal year is not subject to the limitations in paragraph (c) of this subsection.

(iii) Major contractor means any contractor whose covered segments allocated a total of more than \$11,000,000 in IR & D/B & P costs to covered contracts during the preceding fiscal year. For purposes of calculating the dollar threshold amounts to determine whether a contractor meets the definition of "major contractor," do not include contractor segments allocating less than \$1,100,000 of IR & D/B & P costs to covered contracts during the preceding fiscal year.

(c) Allowability.

(i) Departments/agencies shall not supplement this regulation in any way that limits IR & D/B & P cost allowability.

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(ii) See 225.7303-2(c) for allowability provisions affecting foreign military sale contracts.

(iii) For major contractors, the following limitations apply:

(A) The amount of IR & D/B & P costs allowable under DoD contracts shall not exceed the lesser of--

(1) Such contracts' allocable share of total incurred IR & D/B & O costs; or

(2) The amount of incurred IR & D/B & P costs for projects having potential interest to DoD.

(B) Allowable IR & D/B & P costs are limited to those for projects that are of potential interest to DoD, including activities intended to accomplish any of the following:

(1) Enable superior performance of future U.S. weapon systems and components.

(2) Reduce acquisition costs and life-cycle costs of military systems.

(3) Strengthen the defense industrial and technology base of the United States.

(4) Enhance the industrial competitiveness of the United States.

(5) Promote the development of technologies identified as critical under 10 U.S.C. 2522.

(6) Increase the development and promotion of efficient and effective applications of dual-use technologies.

(7) Provide efficient and effective technologies for achieving such environmental benefits as: Improved environmental data gathering, environmental cleanup and restoration, pollution reduction in manufacturing, environmental conservation, and environmentally safe management of facilities.

(C) For a contractor's annual IR & D costs to be allowable, the IR & D projects generating the costs must be reported to the Defense Technical Information Center (DTIC) using the DTIC's on-line input form and

instructions at <http://www.dtic.mil/ird/dticdb/index.html>. The inputs must be updated at least annually and when the project is completed. Copies of the input and updates must be made available for review by the cognizant administrative contracting officer (ACO) and the cognizant Defense Contract Audit Agency auditor to support the allowability of the costs. Contractors that do not meet the threshold as a major contractor are encouraged to use the DTIC on-line input form to report IR & D projects to provide DoD with visibility into the technical content of the contractors' IR & D activities.

(iv) For major contractors, the ACO or corporate ACO shall--

(A) Determine whether IR & D/B & P projects are of potential interest to DoD; and

(B) Provide the results of the determination to the contractor.

(v) The cognizant contract administration office shall furnish contractors with guidance on financial information needed to support IR & D/B & P costs and on technical information needed from major contractors to support the potential interest to DoD determination (also see 242.771-3).

[56 FR 67217, Dec. 30, 1991; 57 FR 53600, Nov. 12, 1992; 59 FR 27672, May 27, 1994; 64 FR 8729, Feb. 23, 1999; 77 FR 4636, Jan. 30, 2012]

SOURCE: 56 FR 36284, July 31, 1991; (DAC) 91-4, 57 FR 53598, Nov. 12, 1992; 58 FR 37868, July 14, 1993; 59 FR 26144, May 19, 1994; (DAC) 91-7, 60 FR 29496, June 5, 1995; (DAC) 91-7, 60 FR 29497, June 5, 1995; 60 FR 40106, Aug. 7, 1995, 77 FR 4636, Jan. 30, 2012; 70 FR 75411, Dec. 20, 2005, unless otherwise noted.

AUTHORITY: 41 U.S.C. 1303 and 48 CFR chapter 1.

48 C. F. R. 231.205-18, 48 CFR 231.205-18

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48 C.F.R. 9904.402-10

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Part 9904. Cost Accounting Standards (Refs & Annos)
9904.402 Cost Accounting Standard--Consistency in
Allocating Costs Incurred for the Same Purpose.
9904.402-10 [Reserved]

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-10, 48 CFR 9904.402-10

Current through Oct. 9, 2014; 79 FR 60995.

48 C.F.R. 9904.402-20

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Chapter 99. Cost Accounting Standards Board,

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(Refs & Annos)

Part 9904. Cost Accounting Standards (Refs & Annos)

9904.402 Cost Accounting Standard--Consistency in

Allocating Costs Incurred for the Same Purpose.

9904.402-20 Purpose.

The purpose of this standard is to require that each type of cost is allocated only once and on only one basis to any contract or other cost objective.

The criteria for determining the allocation of costs to a product, contract, or other cost objective should be the same for all similar objectives.

Adherence to these cost accounting concepts is necessary to guard against the overcharging of some cost objectives and to prevent double counting.

Double counting occurs most commonly when cost items are allocated directly to a cost objective without eliminating like cost items from indirect cost pools which are allocated to that cost objective.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-20, 48 CFR 9904.402-20

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48 C.F.R. 9904.402-30

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9904.402 Cost Accounting Standard--Consistency in

Allocating Costs Incurred for the Same Purpose.

9904.402-30 Definitions.

(a) The following are definitions of terms which are prominent in this standard. Other terms defined elsewhere in this part 99 shall have the meanings

ascribed to them in those definitions unless paragraph (b) of this section requires otherwise.

(1) Allocate means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) Cost objective means a function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost to processes, products, jobs, capitalized projects, etc.

(3) Direct cost means any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

(4) Final cost objective means a cost objective which has allocated to it both direct and indirect costs, and in the contractor's accumulation system, is one of the final accumulation points.

(5) Indirect cost means any cost not directly identified with a single final

cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(6) Indirect cost pool means a grouping of incurred costs identified with two or more cost objectives but not specifically identified with any final cost objective.

(b) The following modifications of terms defined elsewhere in this chapter 99 are applicable to this Standard: None.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-30, 48 CFR 9904.402-30

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48 C.F.R. 9904.402-40

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9904.402-40 Fundamental requirement.

All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-40, 48 CFR 9904.402-40

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48 C.F.R. 9904.402-50

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9904.402 Cost Accounting Standard--Consistency in

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9904.402-50 Techniques for application.

(a) The Fundamental Requirement is stated in terms of cost incurred and is equally applicable to estimates of costs to be incurred as used in contract proposals.

(b) The Disclosure Statement to be submitted by the contractor will require that he set forth his cost accounting practices with regard to the distinction between direct and indirect costs. In addition, for those types of cost which are sometimes accounted for as direct and sometimes accounted for as indirect, the contractor will set forth in his Disclosure Statement the specific criteria and circumstances for making such distinctions. In essence, the Disclosure Statement submitted by the contractor, by distinguishing between direct and indirect costs, and by describing the criteria and circumstances for allocating those items which are sometimes direct and sometimes indirect, will be determinative as to whether or not costs are incurred for the same purpose. Disclosure Statement as used herein refers to the statement required to be submitted by contractors as a condition of contracting as set forth in subpart 9903.2.

(c) In the event that a contractor has not submitted a Disclosure Statement, the determination of whether specific costs are directly allocable to contracts shall be based upon the contractor's cost accounting practices used at the time of contract proposal.

(d) Whenever costs which serve the same purpose cannot equitably be indirectly allocated to one or more final cost objectives in accordance with the contractor's disclosed accounting practices, the contractor may either:

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(1) Use a method for reassigning all such costs which would provide an equitable distribution to all final cost objectives, or

(2) Directly assign all such costs to final cost objectives with which they are specifically identified.

In the event the contractor decides to make a change for either purpose, the Disclosure Statement shall be amended to reflect the revised accounting practices involved.

(e) Any direct cost of minor dollar amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives, provided that such treatment produces results which are substantially the same as the results which would have been obtained if such cost had been treated as a direct cost.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-50, 48 CFR 9904.402-50

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48 C.F.R. 9904.402-60

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9904.402 Cost Accounting Standard--Consistency in

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9904.402-60 Illustrations.

(a) Illustrations of costs which are incurred for the same purpose:

1) Contractor normally allocates all travel as an indirect cost and previously disclosed this accounting practice to the Government. For purposes of a new proposal, contractor intends to allocate the travel costs of personnel whose time is accounted for as direct labor directly to the contract. Since travel costs of personnel whose time is accounted for as direct labor working on other contracts are costs which are incurred for the same purpose, these costs may no longer be included within indirect cost pools for purposes of allocation to any covered Government contract. Contractor's Disclosure Statement must be amended for the proposed changes in accounting practices.

(2) Contractor normally allocates planning costs indirectly and allocates this cost to all contracts on the basis of direct labor. A proposal for a new contract requires a disproportionate amount of planning costs. The contractor prefers to continue to allocate planning costs indirectly. In order to equitably allocate the total planning costs, the contractor may use a method for allocating all such costs which would provide an equitable distribution to all final cost objectives. For example, he may use the number of planning documents processed rather than his former allocation base of direct labor. Contractor's Disclosure Statement must be amended for the proposed changes in accounting practices.

(b) Illustrations of costs which are not incurred for the same purpose:

(1) Contractor normally allocates special tooling costs directly to contracts. The costs of general purpose tooling are normally included

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in the indirect cost pool which is allocated to contracts. Both of these accounting practices were previously disclosed to the Government. Since both types of costs involved were not incurred for the same purpose in accordance with the criteria set forth in the Contractor's Disclosure Statement, the allocation of general purpose tooling costs from the indirect cost pool to the contract, in addition to the directly allocated special tooling costs, is not considered a violation of the standard.

(2) Contractor proposes to perform a contract which will require three firemen on 24-hour duty at a fixed-post to provide protection against damage to highly inflammable materials used on the contract. Contractor presently has a firefighting force of 10 employees for general protection of the plant. Contractor's costs for these latter firemen are treated as indirect costs and allocated to all contracts; however, he wants to allocate the three fixed-post firemen directly to the particular contract requiring them and also allocate a portion of the cost of the general firefighting force to the same contract. He may do so but only on condition that his disclosed practices indicate that the costs of the separate classes of firemen serve different purposes and that it is his practice to allocate the general firefighting force indirectly and to allocate fixed-post firemen directly.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-60, 48 CFR 9904.402-60

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48 C.F.R. 9904.402-61

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9904.402 Cost Accounting Standard--Consistency in

Allocating Costs Incurred for the Same Purpose.

9904.402-61 Interpretation.

(a) 9904.402, Cost Accounting Standard--Consistency in Allocating Costs Incurred for the Same Purpose, provides, in 9904.402-40, that “ * * * no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.”

(b) This interpretation deals with the way 9904.402 applies to the treatment of costs incurred in preparing, submitting, and supporting proposals. In essence, it is addressed to whether or not, under the Standard, all such costs are incurred for the same purpose, in like circumstances.

(c) 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.

(d) This interpretation does not preclude the allocation, as indirect costs, of costs incurred in preparing all proposals. The cost accounting practices used by the contractor, however, must be followed consistently and the method used to reallocate such costs, of course, must provide an equitable distribution to all final cost objectives.

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SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-61, 48 CFR 9904.402-61

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48 C.F.R. 9904.402-62

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9904.402-62 Exemption.

None for this Standard.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-62, 48 CFR 9904.402-62

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48 C.F.R. 9904.402-63

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9904.402 Cost Accounting Standard--Consistency in

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9904.402-63 Effective date.

This Standard is effective as of April 17, 1992.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.402-63, 48 CFR 9904.402-63

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48 C. F. R. 9904.418-10

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9904.418 Allocation of Direct and Indirect Costs.
9904.418-10 [Reserved]

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

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48 C. F. R. 9904.418-10, 48 CFR 9904.418-10

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48 C. F. R. 9904.418-20

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9904.418 Allocation of Direct and Indirect Costs.
9904.418-20 Purpose.

The purpose of this Cost Accounting Standard is to provide for consistent determination of direct and indirect costs; to provide criteria for the accumulation of indirect costs, including service center and overhead costs, in indirect cost pools; and, to provide guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives. Consistent application of these criteria and guidance will improve classification of costs as direct and indirect and the allocation of indirect costs.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

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48 C. F. R. 9904.418-30

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9904.418 Allocation of Direct and Indirect Costs.
9904.418-30 Definitions.

(a) The following are definitions of terms which are prominent in this Standard. Other terms defined elsewhere in this chapter 99 shall have the meanings ascribed to them in those definitions unless paragraph (b) of this subsection, requires otherwise.

(1) Allocate means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) Direct cost means any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

(3) Indirect cost means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(4) Indirect cost pool means a grouping of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective.

(b) The following modifications of terms defined elsewhere in this chapter 99 are applicable to this Standard: None.

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SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

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9904.418 Allocation of Direct and Indirect Costs.

9904.418-40 Fundamental requirements.

(a) A business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied.

(b) Indirect costs shall be accumulated in indirect cost pools which are homogeneous.

(c) Pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives as follows:

(1) If a material amount of the costs included in a cost pool are costs of management or supervision of activities involving direct labor or direct material costs, resource consumption cannot be specifically identified with cost objectives. In that circumstance, a base shall be used which is representative of the activity being managed or supervised.

(2) If the cost pool does not contain a material amount of the costs of management or supervision of activities involving direct labor or direct material costs, resource consumption can be specifically identified with cost objectives. The pooled cost shall be allocated based on the specific identifiability of resource consumption with cost objectives by means of one of the following allocation bases:

(i) A resource consumption measure,

(ii) An output measure, or

(iii) A surrogate that is representative of resources consumed.

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The base shall be selected in accordance with the criteria set out in 9904.418-50(e).

(d) To the extent that any cost allocations are required by the provisions of other Cost Accounting Standards, such allocations are not subject to the provisions of this Standard.

(e) This Standard does not cover accounting for the costs of special facilities where such costs are accounted for in separate indirect cost pools.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.418-40, 48 CFR 9904.418-40

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9904.418 Allocation of Direct and Indirect Costs.

9904.418-50 Techniques for application.

(a) Determination of direct cost and indirect cost.

(1) The business unit's written policy classifying costs as direct or indirect shall be in conformity with the requirements of this Standard.

(2) In accounting for direct costs a business unit shall use actual costs, except that--

(i) Standard costs for material and labor may be used as provided in 9904.407; or

(ii) An average cost or pre-established rate for labor may be used provided that:

(A) The functions performed are not materially disparate and employees involved are interchangeable with respect to the functions performed, or

(B) The functions performed are materially disparate but the employees involved either all work in a single production unit yielding homogeneous outputs, or perform their respective functions as an integral team.

Whenever average cost or pre-established rates for labor are used, the variances, if material, shall be disposed of at least annually by allocation to cost objectives in proportion to the costs previously allocated to these cost objectives.

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(3) Labor or material costs identified specifically with one of the particular cost objectives listed in paragraph (d)(3) of this subsection shall be accounted for as direct labor or direct material costs.

(b) Homogeneous indirect cost pools.

(1) An indirect cost pool is homogeneous if each significant activity whose costs are included therein has the same or a similar beneficial or causal relationship to cost objectives as the other activities whose costs are included in the cost pool. It is also homogeneous if the allocation of the costs of the activities included in the cost pool result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

(2) An indirect cost pool is not homogeneous if the costs of all significant activities in the cost pool do not have the same or a similar beneficial or causal relationship to cost objectives and, if the costs were allocated separately, the resulting allocation would be materially different. The determination of materiality shall be made using the criteria provided in 9903.305.

(3) A homogeneous indirect cost pool shall include all indirect costs identified with the activity to which the pool relates.

(c) Change in allocation base. No change in an existing indirect cost pool allocation base is required if the allocation resulting from the existing base does not differ materially from the allocation that results from the use of the base determined to be most appropriate in accordance with the criteria set forth in paragraphs (d) and (e) of this subsection. The determination of materiality shall be made using the criteria provided in Subpart 9903.305.

(d) Allocation measures for an indirect cost pool which includes a material amount of the costs of management or supervision of activities involving direct labor or direct material costs.

(1) The costs of the management or supervision of activities involving direct labor or direct material costs do not have a direct and definitive relationship to the benefiting cost objectives and cannot be allocated on measures of a specific beneficial or causal relationship. In that circumstance, the base selected to measure the allocation of the pooled costs to cost objectives shall be a base representative of the activity being managed or supervised.

(2) The base used to represent the activity being managed or supervised shall be determined by the application of the criteria below. All significant elements of the selected base shall be included.

(i) A direct labor hour base or direct labor cost base shall be used, whichever in the aggregate is more likely to vary in proportion to the costs included in the cost pool being allocated, except that:

(ii) A machine-hour base is appropriate if the costs in the cost pool are comprised predominantly of facility-related costs, such as depreciation, maintenance, and utilities; or

(iii) A units-of-production base is appropriate if there is common production of comparable units; or

(iv) A material cost base is appropriate if the activity being managed or supervised is a material-related activity.

(3) Indirect cost pools which include material amounts of the costs of management or supervision of activities involving direct labor or direct material costs shall be allocated to:

(i) Final cost objectives;

(ii) Goods produced for stock or product inventory;

(iii) Independent research and development and bid and proposal projects;

(iv) Cost centers used to accumulate costs identified with a process cost system (i.e., process cost centers);

(v) Goods or services produced or acquired for other segments of the contractor and for other cost objectives of a business unit; and

(vi) Self-construction, fabrication, betterment, improvement, or installation of tangible capital assets.

(e) Allocation measures for indirect cost pools that do not include material amounts of the costs of management or supervision of activities involving direct labor or direct material costs. Homogeneous indirect cost pools of this type have a direct and definitive relationship between the activities in the pool and benefiting cost objectives. The pooled costs shall be allocated using an appropriate measure of resource consumption. This determination

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shall be made in accordance with the following criteria taking into consideration the individual circumstances:

- (1) The best representation of the beneficial or causal relationship between an indirect cost pool and the benefiting cost objectives is a measure of resource consumption of the activities of the indirect cost pool.
- (2)(i) If consumption measures are unavailable or impractical to ascertain, the next best representation of the beneficial or causal relationship for allocation is a measure of the output of the activities of the indirect cost pool. Thus, the output is substituted for a direct measure of the consumption of resources.
 - (ii) The use of the basic unit of output will not reflect the proportional consumption of resources in circumstances in which the level of resource consumption varies among the units of output produced. Where a material difference will result, either the output measure shall be modified or more than one output measure shall be used to reflect the resources consumed to perform the activity.
- (3) If neither resources consumed nor output of the activities can be measured practically, a surrogate that varies in proportion to the services received shall be used to measure the resources consumed. Generally, such surrogates measure the activity of the cost objectives receiving the service.
- (4) Allocation of indirect cost pools which benefit one another may be accomplished by use of:
 - (i) The cross-allocation (reciprocal) method,
 - (ii) The sequential method, or
 - (iii) Another method the results of which approximate those achieved by either of the methods in subdivisions (e)(4)(i) or (e)(4)(ii) of this subsection.
- (5) Where the activities represented by an indirect cost pool provide services to two or more cost objectives simultaneously, the cost of such services shall be prorated between or among the cost objectives in reasonable proportion to the beneficial or causal relationship between the services and the cost objectives.

(f) Special allocation. Where a particular cost objective in relation to other cost objectives receives significantly more or less benefit from an indirect cost pool than would be reflected by the allocation of such costs using a base determined pursuant to paragraphs (d) and (e) of this subsection, the Government and contractor may agree to a special allocation from that indirect cost pool to the particular cost objective commensurate with the benefits received. The amount of a special allocation to any such cost objective made pursuant to such an agreement shall be excluded from the indirect cost pool and the particular cost objective's allocation base data shall be excluded from the base used to allocate the pool.

(g) Use of preestablished rates for indirect costs.

(1) Preestablished rates, based on either forecasted actual or standard cost, may be used in allocating an indirect cost pool.

(2) Preestablished rates shall reflect the costs and activities anticipated for the cost accounting period except as provided in paragraph (g)(3) of this subsection. Such preestablished rates shall be reviewed at least annually, and revised as necessary to reflect the anticipated conditions.

(3) The contracting parties may agree on preestablished rates which are not based on costs and activities anticipated for a cost accounting period. The contractor shall have and consistently apply written policies for the establishment of these rates.

(4) Under paragraphs (g) (2) and (3) of this subsection where variances of a cost accounting period are material, these variances shall be disposed of by allocating them to cost objectives in proportion to the costs previously allocated to these cost objectives by use of the preestablished rates.

(5) If preestablished rates are revised during a cost accounting period and if the variances accumulated to the time of the revision are significant, the costs allocated to that time shall be adjusted to the amounts which would have been allocated using the revised preestablished rates.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

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9904.418-60 Illustrations.

(a) Business Unit A has various classifications of engineers whose time is spent in working directly on the production of the goods or services called for by contracts and other final cost objectives. In keeping with its written policy, detailed time records are kept of the hours worked by these engineers, showing the job/account numbers representing various cost objectives. On the basis of these detailed time records, Unit A allocates the labor costs of these engineers as direct labor costs of final cost objectives. This practice is in accordance with the requirements of 9904.418-50(a)(1).

(b) Business Unit B has a fabrication department, employees of which perform various functions on units of the work-in-process of multiple final cost objectives. These employees are grouped by labor skills and are interchangeable within the skill grouping. The average wage rate for each group is multiplied by the hours worked on each cost objective by employees in that group. The contractor classifies these costs as direct labor costs of each final cost objective. This cost accounting treatment is in accordance with the provisions of 9904.418-50(a)(2)(ii)(B).

(c) Business Unit C accumulates the costs relating to building ownership, maintenance, and utility into one indirect cost pool designated "Occupancy Costs" for allocation to cost objectives. Each of these activities has the same or a similar beneficial or causal relationship to the cost objectives occupying a space. Unit C's practice is in conformance with the provisions of 9904.418-50(b)(1).

(d) Business Unit D includes the indirect costs of machining and assembling activities in a single manufacturing overhead pool. The machining activity does not have the same or similar beneficial or causal relationship to cost objectives as the assembling activity. Also, the allocation of the cost of the machining activity to cost objectives would be significantly different if allocated separately from the cost of the assembling activity. Unit D's single

manufacturing overhead pool is not homogeneous in accordance with the provisions of 9904.418-50(b), and separate pools must be established in accordance with 9904.418-40(b).

(e) In accordance with 9904.418-50(b)(3), Business Unit E includes all the cost of occupancy in an indirect cost pool. In selecting an allocation measure for this indirect cost pool, the contractor establishes that it is impractical to ascertain a measurement of the consumption of resources in relation to the use of facilities by individual cost objectives. An output base, the number of square feet of space provided to users, can be measured practically; however, the cost to provide facilities is significantly different for various types of facilities such as warehouse, factory, and office and each type of facility requires a different level of resource consumption to provide the same number of square feet of usable space. Allocation on a basic unit measure of square feet of space occupied will not adequately reflect the proportional consumption of resources. Unit E establishes a weighted square foot measure for allocating occupancy costs, which reflects the different levels of resource consumption required to provide the different types of facilities. This practice is in conformance with provisions of 9904.418-50(e)(2)(ii).

(f) Business Unit F has an indirect cost pool containing a significant amount of material-related costs. The contractor allocates these costs between his machining overhead cost pool and his assembly overhead cost pool. The business unit finds it impractical to use an allocation measure based on either consumption or output. The business unit selects a dollars of material-issued base which varies in proportion to the services rendered. The dollars of material-issued base is a surrogate base which conforms to the provisions of 9904.418-50(e)(3).

(g) Business Unit G has a machining activity for which it develops a separate overhead rate, using direct labor cost as the allocation base. The machining activity occasionally does significant amounts of work for other activities of the business unit. The labor used in doing the work for other activities is of the same nature as that used for contract work. However, the machining labor for other activities is not included in the base used to allocate the overhead costs of the machining activity. This practice is not in conformance with 9904.418-50(d)(2). Unit G must include the cost of labor doing work for the other activities in the allocation base for the machining activity indirect cost pool.

(h) Business Unit H accounts for the costs of company aircraft in a separate homogeneous indirect cost pool and allocates the cost to benefiting cost objectives using flight hours. Unit H prorates the cost of a single flight between benefiting cost objectives whenever simultaneous services have

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been rendered. Manager of Contract 2 learns of the trip and goes along with Manager of Contract 1. Unit H prorates the cost of the trip between Contract 1 and Contract 2. This practice is in conformance with the provision of 9904.418-50(e)(5).

(i) During a cost accounting period, Business Unit I allocates the cost of its flight services indirect cost pool to other indirect cost pools and final cost objectives using a preestablished rate. The preestablished rate is based on an estimate of the actual costs and activity for the cost accounting period. For the cost accounting period, Unit I establishes a rate of \$200 per hour for use of the flight services activity. In March, the contractor's operating environment changes significantly; the contractor now expects a significant increase in the cost of this activity during the remainder of the year. Unit I estimates the rate for the entire cost accounting period to be \$240 an hour. Pursuant to the provisions of 9904.418-50(g)(4), the Business Unit may revise its rate to the expected \$240 an hour. If the accumulated variances are significant, the business unit must also adjust the costs previously allocated to reflect the revised rates.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.418-60, 48 CFR 9904.418-60

Current through Oct. 9, 2014; 79 FR 60995.

48 C. F. R. 9904.418-61

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9904.418 Allocation of Direct and Indirect Costs.
9904.418-61 Interpretation. [Reserved]

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.418-61, 48 CFR 9904.418-61

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48 C. F. R. 9904.418-62

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9904.418 Allocation of Direct and Indirect Costs.
9904.418-62 Exemptions.

This Standard shall not apply to contracts and grants with state, local, and Federally recognized Indian tribal governments.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.418-62, 48 CFR 9904.418-62

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48 C. F. R. 9904.418-63

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Part 9904. Cost Accounting Standards (Refs & Annos)
9904.418 Allocation of Direct and Indirect Costs.
9904.418-63 Effective date.

This Standard is effective as of April 17, 1992. Contractors with prior CAS-covered contracts with full coverage shall continue this Standard's applicability upon receipt of a contract to which this Standard is applicable. For contractors with no previous contracts subject to this Standard, this Standard shall be applied beginning with the contractor's second full fiscal year beginning after the receipt of a contract to which this Standard is applicable.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.418-63, 48 CFR 9904.418-63

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48 C.F.R. 9904.420-10

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9904.420 Accounting for Independent Research and
Development Costs and Bid and Proposal Costs.

9904.420-10 [Reserved]

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-10, 48 CFR 9904.420-10

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48 C.F.R. 9904.420-20

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9904.420 Accounting for Independent Research and
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9904.420-20 Purpose.

The purpose of this Cost Accounting Standard is to provide criteria for the accumulation of independent research and development costs and bid and proposal costs and for the allocation of such costs to cost objectives based on the beneficial or causal relationship between such costs and cost objectives. Consistent application of these criteria will improve cost allocation.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-20, 48 CFR 9904.420-20

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48 C.F.R. 9904.420-30

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9904.420-30 Definitions.

(a) The following are definitions of terms which are prominent in this Standard. Other terms defined elsewhere in this Chapter 99 shall have the meanings ascribed to them in those definitions unless paragraph (b) of this subsection, requires otherwise.

(1) Allocate means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

(2) Bid and proposal (B&P) cost means the cost incurred in preparing, submitting, or supporting any bid or proposal which effort is neither sponsored by a grant, nor required in the performance of a contract.

(3) Business unit means any segment of an organization, or an entire business organization which is not divided into segments.

(4) General and administrative (G&A) expense means any management, financial, and other expenses which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole. G&A expense does not include those management expenses whose beneficial or causal relationship to cost objectives can be more directly measured by a base other than a cost input base representing the total activity of a business unit during a cost accounting period.

(5) Home office means an office responsible for directing or managing two or more, but not necessarily all, segments of an organization. It typically establishes policy for, and provides guidance to the segments

in their operations. It usually performs management, supervisory, or administrative functions, and may also perform service functions in support of the operations of the various segments. An organization which has intermediate levels, such as groups, may have several home offices which report to a common home office. An intermediate organization may be both a segment and a home office.

(6) Independent research and development means the cost of effort which is neither sponsored by a grant, nor required in the performance of a contract, and which falls within any of the following three areas:

- (i) Basic and applied research,
- (ii) Development, and
- (iii) Systems and other concept formulation studies.

(7) Indirect cost means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

(8) Segment means one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service. The term includes Government-owned contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership. The term also includes those joint ventures and subsidiaries (domestic and foreign) in which the organizations has less than a majority of ownership, but over which it exercises control.

(b) The following modifications of terms defined elsewhere in this chapter 99 are applicable to this Standard: None.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-30, 48 CFR 9904.420-30

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48 C.F.R. 9904.420-40

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Development Costs and Bid and Proposal Costs.

9904.420-40 Fundamental requirement.

(a) The basic unit for the identification and accumulation of Independent Research and Development (IR&D) and Bid and Proposal (B&P) costs shall be the individual IR&D or B&P project.

(b) The IR&D and B&P project costs shall consist of all allocable costs, except business unit general and administrative expenses.

(c) The IR&D and B&P cost pools consist of all IR&D and B&P project costs and other allocable costs, except business unit general and administrative expenses.

(d) The IR&D and B&P cost pools of a home office shall be allocated to segments on the basis of the beneficial or causal relationship between the IR&D and B&P costs and the segments reporting to that home office.

(e) The IR&D and B&P cost pools of a business unit shall be allocated to the final cost objectives of that business unit on the basis of the beneficial or causal relationship between the IR&D and B&P costs and the final cost objectives.

(f)(1) The B&P costs incurred in a cost accounting period shall not be assigned to any other cost accounting period.

(2) The IR&D costs incurred in a cost accounting period shall not be assigned to any other cost accounting period, except as may be permitted pursuant to provisions of existing laws, regulations, and other controlling factors.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-40, 48 CFR 9904.420-40

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48 C.F.R. 9904.420-50

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9904.420-50 Techniques for application.

- (a) The IR&D and B&P project costs shall include (1) costs, which if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective, and (2) the overhead costs of productive activities and other indirect costs related to the project based on the contractor's cost accounting practice or applicable Cost Accounting Standards for allocation of indirect costs.
- (b) The IR&D and B&P cost pools for a segment consist of the project costs plus allocable home office IR&D and B&P costs.
- (c) When the costs of individual IR&D or B&P efforts are not material in amount, these costs may be accumulated in one or more project(s) within each of these two types of effort.
- (d) The costs of any work performed by one segment for another segment shall not be treated as IR&D costs or B&P costs of the performing segment unless the work is a part of an IR&D or B&P project of the performing segment. If such work is part of a performing segment's IR&D or B&P project, the project will be transferred to the home office to be allocated in accordance with paragraph (e) of this subsection.
- (e) The costs of IR&D and B&P projects accumulated at a home office shall be allocated to its segments as follows:
- (1) Projects which can be identified with a specific segment(s) shall have their costs allocated to such segment(s).

(2) The costs of all other IR&D and B&P projects shall be allocated among all segments by means of the same base used by the company to allocate its residual expenses in accordance with 9904.403; provided, however, where a particular segment receives significantly more or less benefit from the IR&D or B&P costs than would be reflected by the allocation of such costs to the segment by the base, the Government and the contractor may agree to a special allocation of the IR&D or B&P costs to such segment commensurate with the benefits received. The amount of a special allocation to any segment made pursuant to such an agreement shall be excluded from the IR&D and B&P cost pools to be allocated to other segments and the base data of any such segment shall be excluded from the base used to allocate these pools.

(f) The costs of IR&D and B&P projects accumulated at a business unit shall be allocated to cost objectives as follows:

(1) Where costs of any IR&D or B&P project benefit more than one segment of the organization, the amounts to be allocated to each segment shall be determined in accordance with paragraph (e) of this subsection.

(2) The IR&D and B&P cost pools which are not allocated under subparagraph (f)(1) of this subsection, shall be allocated to all final cost objectives of the business unit by means of the same base used by the business unit to allocate its general and administrative expenses in accordance with 9904.410–50; provided, however, where a particular final cost objective receives significantly more or less benefit from IR&D or B&P cost than would be reflected by the allocation of such costs the Government and the contractor may agree to a special allocation of the IR&D or B&P costs to such final cost objective commensurate with the benefits received. The amount of special allocation to any such final cost objective made pursuant to such an agreement shall be excluded from the IR&D and B&P cost pools to be allocated to other final cost objectives and the particular final cost objective's base data shall be excluded from the base used to allocate these pools.

(g) Notwithstanding the provisions of paragraph (d), (e) or (f) of this subsection, the costs of IR&D and B&P projects allocable to a home office pursuant to 9904.420–50(d) may be allocated directly to the receiving segments, provided that such allocation not be substantially different from the allocation that would be made if they were first passed through home office accounts.

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SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-50, 48 CFR 9904.420-50

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48 C.F.R. 9904.420-60

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9904.420-60 Illustrations.

(a) Business Unit A's engineering department in accordance with its established accounting practice, charges administrative effort including typing its overhead cost pool. In submitting a proposal, the engineering department assigns several typists to the proposal project on a full time basis and charges the typists' time directly to the proposal project, rather than to its overhead pool. Because the engineering department under its established accounting practice does not charge the cost of typing directly to final cost objectives, the direct charge does not meet with the requirements of 9904.420-50(a).

(b) Company B has five segments. The company undertakes an IR&D project which is part of IR&D plans of segments X, Y, and Z, and will be of general benefit to all five segments. The company designates Segment Z as the project leader in performing the project. In accumulating the costs, each segment allocates overhead to its part of the project but does not allocate segment G&A. The IR&D costs are then allocated to the home office by each segment. The costs are combined with other IR&D costs that benefit the company as a whole. The costs are allocated to all five segments by means of the same base by which the company allocates its residual home office expense costs of all segments. This practice meets the requirements of 9904.420-40(b), 9904.420-50(e)(2), and 9904.420-50(f)(1).

(c) Business Unit C normally accounts for its B&P effort by individual project. It accumulates directly allocated costs and departmental overhead costs by project. The business unit also submits large numbers of bids and proposals whose individual costs of preparation are not material in amount. The business unit collects the cost of these efforts under a single project. Since the cost of preparing each individual bid and proposal is not material, the practice of accumulating these costs in a single project meets the

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requirements of 9904.420–50(c).

(d) Segment D requests that Segment Y provide support for a Segment D IR&D project. The work being performed by Segment Y is similar in nature to Segment Y's normal product and is not part of its annual IR&D plan. Segment Y allocates to the project all costs it allocates to other final cost objectives, including G&A expense. Segment Y then directly transfers the cost of the project to Segment D in accordance with its normal intersegment transfer procedure. The accounting treatment meets the requirements of 9904.420–50(d) and 9904.410.

(e)(1) Contractor E has six operating segments and a research segment. The research segment performs work under:

(i) Research and development contracts,

(ii) Projects which are not part of its own IR&D plan but are specifically in support of other segments' IR&D projects, and

(iii) IR&D projects for the benefit of the company as a whole.

(2) The research segment directly allocates the cost of the projects in support of another segment's IR&D projects, including an allocation of its general and administrative expenses, to the receiving segment. This practice meets the requirements of 9904.420–50(d).

(3) The costs of the IR&D projects which benefit the company as a whole exclude any allocation of the research segment's general and administrative expenses and are transferred to the home office. The home office allocates these costs on the same base it uses to allocate its residual expenses to all seven segments. This practice meets the requirements of 9904.420–50 (e)(2) and (f)(1).

(f) Company F accumulates at the home office the costs of IR&D and B&P projects which generally benefit all segments of the company except Segment X. The company and the contracting officer agree that the nature of the business activity of Segment X is such that the home office IR&D and B&P effort is neither caused by nor provides any benefit to that segment. For the purpose of allocating its home office residual expenses, the company uses a base as provided in 9904.403. For the purpose of allocating the home office IR&D and B&P costs, the company removes the data of Segment X from the base used for the allocation of its residual expenses. This practice meets the requirements of 9904.420–50(e)(2).

(g) Company G has 10 segments. Segment X performs IR&D projects, the results of which benefit it and two other segments but none of the other seven segments. The cost of those projects performed by Segment X are transferred to the home office and allocated to the three segments on the basis of the benefits received by the three segments. This practice meets the requirements of 9904.420-50(e)(1) and 9904.420-50(f)(1).

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-60, 48 CFR 9904.420-60

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9904.420-61 Interpretation. [Reserved]

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-61, 48 CFR 9904.420-61

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9904.420-62 Exemptions.

This Standard shall not apply to contracts and grants with State, local, and federally recognized Indian tribal governments.

SOURCE: 57 FR 14153, April 17, 1992, unless otherwise noted.

AUTHORITY: Pub.L. 100-679, 102 Stat. 4056, 41 U.S.C. 422.

48 C. F. R. 9904.420-62, 48 CFR 9904.420-62

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9904.420–63 Effective date.

This Standard is effective as of April 17, 1992. Contractors with prior CAS-covered contracts with full coverage shall continue this Standard's applicability upon receipt of a contract to which this Standard is applicable. For contractors with no previous contracts subject to this Standard, this Standard shall be applied beginning with the contractor's second full fiscal year beginning after the receipt of a contract to which this Standard is applicable.

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Better buying power 3.0 implementation guide

OVERVIEW

In Better Buying Power (BBP) 3.0, under the overarching theme, Achieving Dominant Capabilities through Technical Excellence and Innovation, we are strengthening our efforts in innovation and technical excellence while also continuing the Department's efforts to improve efficiency and productivity. There is more continuity than change in this set of Better Buying Power initiatives, but there is a new emphasis on our products and their ability to provide military technological superiority.

The theme that ties the content of BBP 3.0 together is an overriding concern that our technological superiority is at risk. Potential adversaries are challenging the U.S lead in conventional military capability in ways not seen since the Cold War. Our technological superiority is based on the effectiveness of our research and development efforts. These efforts span science and technology, component development, early prototyping, full-scale development, and technology insertion into fielded products. The Department's research and development efforts are conducted by government laboratories, non-profit research institutions, and defense companies both large and small. Innovation comes from all of these sources, but increasingly, it also comes from the commercial sector and from overseas. Our ability to utilize all of these sources of innovation and technology effectively rests on the professionalism of our work force. The BBP 3.0 initiatives are designed to improve the Department's performance in all of these dimensions.

As the attached BBP 3.0 slide shows, we are retaining many of the BBP 1.0 and 2.0 initiatives, particularly "core" initiatives to include affordability caps, should cost targets, competition, effective contractual incentives, and professionalism in the acquisition work force. Some earlier initiatives that may not be included here are still in the process of being implemented, while others are either complete or well underway and not specifically emphasized in BBP 3.0.

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The remainder of this document provides the implementing directives for BBP 3.0, with specific actions, for each initiative. In order to have one authoritative reference, significant ongoing and incomplete actions from BBP 1.0 and 2.0 are included. The Business Senior Integration Group (BSIG), which was established to implement BBP 1.0 and which includes all the DoD's relevant acquisition and related leadership, will continue to meet approximately once a month to oversee BBP implementation.

ACHIEVE AFFORDABLE PROGRAMS

Continue to set and enforce affordability caps

A. General guidance

This is a continuing core BBP initiative originally implemented under BBP 1.0. Affordability caps require Office of the Secretary of Defense (OSD) and Service leadership (including leaders of the operational, requirements, programming, and acquisition communities) to ensure that a desired weapon system can be afforded in future budgets before the program is initiated. An affordability analysis is conducted to establish both production and sustainment affordability caps. Policy requiring the establishment of affordability caps has been included in the recent update to the Department of Defense Instruction (DoDI) 5000.02 on Operation of the Defense Acquisition System. Affordability is now being reviewed as part of all milestone decisions.

Under BBP 3.0, we will continue our emphasis on Service affordability analysis, improve our oversight of established affordability caps, and continue to assess program performance against these caps.

B. Specific actions

Acquisition Category (ACAT) 1 programs projected to exceed approved caps will undergo a Defense Acquisition Executive (DAE) review to determine appropriate corrective action.

ACHIEVE DOMINANT CAPABILITIES WHILE CONTROLLING LIFECYCLE COSTS

Strengthen and expand "should cost" based cost management

A. General guidance

This continuing core BBP initiative requires programs to actively manage costs through the careful assessment of the contributing drivers of cost

across a program, identification of goals for cost reduction (should cost goals), and implementation of specific efforts designed to achieve those cost reductions. Should cost goals and actionable plans to achieve these goals are to be established for all activities throughout the program lifecycle. Component Acquisition Executives (CAEs) and Program Executive Officers (PEOs) will review and approve should cost targets, monitor progress, and direct or recommend allocation of realized cost savings as appropriate. Nearly 100 percent of ACAT I programs, approximately 90 percent of ACAT IIs, and 80 percent of ACAT IIIs now have should cost targets and are managing to them, generating significant savings across the Department. We will continue to expand this practice until 100 percent compliance on all ACAT programs is achieved.

B. Specific actions

Should cost implementation and performance will be reviewed by the DAE and the BSIG on a quarterly basis.

By July 2015, the Assistant Secretary of Defense for Acquisition (ASD(A)) will institute an annual Should Cost and Innovation Award program recognizing organizations, groups, and teams who have displayed outstanding should cost commitment, innovation, and results for acquisition programs. Best practices from these programs will be forwarded to the Defense Acquisition University (DAU) for incorporation into acquisition education programs.

Anticipate and plan for responsive and emerging threats by building stronger partnerships of acquisition, intelligence and requirements communities

A. General guidance

The need for early and close cooperation between the requirements and acquisition communities was highlighted in BBP 2.0. BBP 3.0 extends this focused collaboration to include the intelligence community. The acquisition and requirements communities must be aware of and responsive to changes in the threat as the Department acquires future weapons systems. This acquisition, intelligence, and requirements (AIR) integration must be present throughout the lifecycle. Integration of the three areas should inform portfolio planning, technology development, system design, product improvement and technical refresh, and decisions on obsolescence and retirement. To support these efforts, the AIR communities must work together to ensure that needed threat information is identified and provided throughout the product lifecycle.

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A key aspect of linking these three communities is the use of Critical Intelligence Parameters (CIPs). CIP thresholds, if breached, indicate an adversary's potential to substantially reduce the programs performance or even to defeat a programs designed capability. CIPs are one important means of tracking the ability of a program to remain viable against evolving threats. The acquisition chain of command needs to work with the requirements and intelligence communities, early and throughout the lifecycle, to identify appropriate CIPs. Notification that a CIP threshold has been exceeded or changed may lead to a change in requirement and a subsequent design change, or to other actions.

B. Specific actions

ASD(A), in partnership with Assistant Secretary of Defense for Research and Engineering (ASD(R&E)), Under Secretary of Defense for Intelligence (USD(I)), Joint Staff, and Services, will review and, as necessary, recommend changes to Defense Intelligence Agency (DIA) Instruction on the identification, monitoring, and reporting of CIPs no later than June 1, 2015.

As appropriate, CAEs, PEOs, and Program Managers (PMs), with requirements sponsors, will establish initial CIPs for their programs. The CIP will be continuously monitored by the Intelligence Community (IC), and the PM will present the program CIPs at the annual Configuration Steering Boards (CSBs). CSBs will include IC representation. If a CIP is breached, an out-of-cycle CSB should be convened by the CAE to resolve or otherwise mitigate the CIP breach collaboratively with the requirements and intelligence communities. CAEs will provide to the DAE their Service process for review of ongoing system performance against established CIPs and the process to be used to determine appropriate mitigations by August 2015.

Overarching Integrated Product Team (OIPT) leads and PEOs will ensure that all Defense Acquisition Board (DAB) reviews include an evaluation of program plans based on threat projections, operational intelligence mission data requirements, including review of program CIPs, and whether or not the program requirements and assumptions remain valid.

ASD(A), in partnership with Comptroller, Director of Cost Assessment and Program Evaluation Office (CAPE), and USD(I), will review and recommend relevant changes to the financial management policies for funding mission data to ensure they are consistent with DoDI 5000.02 and other intelligence acquisition support initiatives by July 2015.

ASD(A) will work with OUSD(I) to review DoD Directive 5250.01 on Management of Intelligence Mission Data (IMD) in DoD Acquisition to ensure processes are in place to enhance flexibility, integration, risk assessment, and prioritization of mission data supply and demand for acquisition programs. This update will be presented to USD(AT&L) and USD(I) by June 2015.

ASD(A) in partnership with DIA, Services, and USD(I), will develop a plan for reducing latency and improving intelligence data integration through transition to the Validated Online Lifecycle Threat (VOLT) and Threat Library. DIA will complete on-going pilots to a dynamic threat assessment and present findings and a plan for transition to VOLT to the BSIG by August 2015.

ASD(A), in partnership with DIA and the Services, will evaluate options for integrating intelligence and acquisition modeling and simulation capabilities to support requirements trades and life-cycle risk management associate with threat baselines. ASD(A) will present recommendations to the BSIG by August 2015.

DAU will increase AIR focus in revised curriculum specifically in the program management and requirements areas. DIA will work with the National Intelligence University (NIU) and Professional Analyst Career Education (PACE) to revise intelligence professional training that supports the Acquisition Community. The curricula revisions will be briefed to the BSIG by September 2015.

ASD(A), in partnership with the SAEs, Director of Human Capital Initiative (HCI), and DIA, will jointly lead an evaluation of options for establishing Key Leader Positions (KLPs) for Intelligence Support at the PEO level or elsewhere in the acquisition chain. Recommendations will be provided to USD(AT&L) by August 2015.

Institutionalize stronger DoD level Long Range R&D Program Plans

A. General guidance

With reference to the October 29, 2014, USD(AT&L) memorandum, "Long Range Research and Development Program Plan (LRRDPP) Direction and Tasking," this initiative seeks to identify current and emerging technologies and/or projections of technology-enabled concepts that could provide significant military advantage to the United States and its partners and allies in the 2020 to 2030 time frame.

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This initiative focuses on the study and prioritization of various applications of technology, to include novel and unconventional technologies, in ways that would provide significant, enduring advantage to future U.S. warfighting capabilities in conducting operations against a peer or near-peer competitor. We anticipate using this information to aid in the internal analysis and prioritization of DoD research and development investments. An LRRDPP objective is to identify a suite of technologies that would form the nexus of a “third offset strategy” providing a decade and longer major technological advantage to the United States.

As part of the broader Defense Innovation Initiative, the LRRDPP seeks to explore and develop new technologies and approaches to warfighting. Our superiority has never been guaranteed, and today it is being increasingly challenged. Technologies and weapons that were once the exclusive province of the United States and its partner nations have become available to a broad range of militaries and non-state actors. The LRRDPP seeks to draw on the lessons of previous offset strategies and ensure that America’s power-projection capabilities continue to sustain our competitive advantage over the coming decades.

B. Specific actions

The Deputy Assistant Secretary of Defense for Systems Engineering (DASD(SE)) is leading the development of the LRRDPP as per the referenced memorandum. The report will be provided to the Deputy Secretary of Defense (DSD) and USD(AT&L) by July 2015.

[Strengthen cybersecurity throughout the product lifecycle](#)

A. General guidance

A vital aspect of maintaining U.S. technological superiority is ensuring cybersecurity of our networks and systems. Systems today, as well as all of their external interfaces, must be resilient from cyber adversaries. The Department has initiated a series of actions to improve military system cybersecurity from concept development to disposal, but much more needs to be done. This initiative will help to focus and accelerate DoD’s efforts to address planning, designing, developing, testing, manufacturing, and sustaining activities with cyber security constantly in mind. This initiative addresses both classified and unclassified information as well as potential access to DoD products in the field and through the supply chain.

Unclassified controlled technical information (CTI), potentially accessible through commercial interfaces, is particularly vulnerable to traditional and nontraditional foreign intelligence collection. When compromised, this information can significantly degrade U.S. technological superiority by saving an adversary time and effort in developing similar capabilities or countermeasures. In addition to addressing classified system information, this initiative's objective is to improve CTI protection in both the government and the industrial base, including the supply chain. In FY 2014, the Department amended the Defense Federal Acquisition Regulation Supplement (DFARS) to safeguard unclassified CTI; we must now ensure this provision is effectively applied to all new DoD contracts.

We will also identify the acquisition and technology programs most critical to enabling U.S. technological superiority in order to focus our cybersecurity and protection resources. To facilitate this, we will integrate efforts from acquisition, law enforcement, counterintelligence, and intelligence communities toward a common goal of protecting our programs.

This initiative includes efforts to educate our workforce on the value and best practices for system security and efforts to communicate the importance of cybersecurity across the Department and to the Defense Industrial Base. All our efforts to improve technological superiority will be in vain if we do not provide effective cybersecurity throughout the product lifecycle.

B. Specific actions

ASD(A) and ASD(R&E), with the DoD Chief Information Officer (CIO), will lead the development of a new Enclosure for DoDI 5000.02 addressing all aspects of the program manager's and other's responsibilities for cybersecurity throughout the product lifecycle. A draft will be provided to the USD(AT&L) by July 2015.

DASD(SE), with Deputy Assistant Secretary of Defense for Command, Control, Communications and Cyber and Business Systems DASD(C3CB), and the Services, in partnership with CIO, will review current system security engineering design processes and methods and recommend standardization or other approaches to improve cybersecurity of system designs, including all outside interfaces, to the USD(AT&L) and the SAEs by October 2015.

The SAEs, with DASD(SE), will identify critical acquisition and technology programs requiring higher levels of information protection and will propose appropriate methods of implementing higher level protection of unclassified

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technical information on these efforts. The SAEs will complete these efforts and brief USD(AT&L) by September 2015.

ASD(R&E) and the Services, with USD(I), Defense Security Service (DSS), CIO, and DIA, will develop and demonstrate a process to link intelligence, counterintelligence, law enforcement, and acquisition activities by establishing a joint analysis capability to improve enterprise protection of classified and unclassified technical information and report to the USD(AT&L) and the BSIG by September 2015.

ASD(R&E), with CIO and the Director of Defense Procurement and Acquisition Policy (DPAP), will conduct an assessment of the effectiveness of the implementation of DFARS required CTI protection standards and make a recommendation as to any changes or additions to current requirements by December 2015.

DAU, in coordination with education counterparts in the IC and DSS, will work with ASD(R&E), USD(I), and the Services to develop education and training to increase workforce understanding of the value and best practices for system cybersecurity and CTI protection by December 2015.

INCENTIVIZE PRODUCTIVITY IN INDUSTRY AND GOVERNMENT

Align profitability more tightly with Department goals

A. General guidance

DoD data shows that the Department can still improve its performance in aligning profit incentives with contract performance. Profit is a fundamental driver of private enterprise, and industry should expect to earn an appropriate profit for the products and services it provides. Profit should be reasonable, and higher profit levels should be tied to better performance and lower profit to poorer performance. Our analysis shows that industrial performance responds to the incentive structure that the Department designs into our business arrangements.

The Department will continue to refine its guidance on the use of incentives in contracting to align profit with performance that ensures a defense industry that is competitive and innovative.

B. Specific actions

The Acquisition Policy Analysis Center (APAC) will continue to track and analyze the use of various contract types and incentives to determine if additional measures can be taken to further improve cost and schedule performance. APAC will report the results of its analysis annually to the USD(AT&L).

[Employ appropriate contract types, but increase the use of incentive type contracts](#)

A. General guidance

In BBP 3.0, we modify earlier guidance based on our subsequent analysis (as documented in the 2014 Annual Report on the Performance of the Defense Acquisition System.) This analysis demonstrated that the use of Cost Plus Incentive Fee (CPIF) and Fixed Price Incentive Fee (FPIF) contracts was highly correlated with better cost and schedule performance. In these “formulaic incentives” contracts, the impact of overruns and underruns are shared between the industry and government based on a formula (established in the contract) that explicitly ties the contractor’s cost or benefit to performance. We are not directing a wholesale conversion to these types of contracts. We also do not want to set incentive structures that substantially eliminate contractor incentives to reduce cost. We do want to reinforce our preference for these types of contracts when they are appropriate.

B. Specific actions

Director DPAP will propose updated guidance for employing CPIF and FPIF contracts for USD(AT&L) and BSIG review by August 2015.

[Expand the superior supplier incentive program](#)

A. General guidance

The Superior Supplier Incentive Program (SSIP) is designed to recognize higher-performing industry partners based on past performance evaluations, with the intent of incentivizing superior performers and creating healthy competition among industry. We do not intend to implement a DoD-level SSIP, but rather will implement Service-specific SSIPs. The focus of these efforts will continue to be on the performance of major business units. In addition, we will continue to use a weighting function (3,2,1 multipliers over the past three years) that significantly weights the most recent year of performance.

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In BBP 2.0, we announced the results of the Navy's pilot SSIP in June 2014 and announced the initial results of the Army and Air Force programs for 2011 through 2013 in February 2015.

B. Specific actions

The Services will continue to manage their SSIP programs and jointly announce the results for 2012 through 2014 by June 2015, and annually thereafter.

Ensure effective use of Performance-Based Logistics

A. General guidance

This initiative was started in BBP 2.0 and continues under BBP 3.0. When properly established and executed, Performance-Based Logistics (PBL) is an effective way to balance cost and performance regardless of whether industry or the Government is providing the logistics service. PBL also provides explicit productivity incentives and ensures the best value for the DoD, particularly for service contracts such as maintenance and support contracts.

As part of BBP 2.0, the Assistant Secretary of Defense for Logistics and Materiel Readiness (ASD(L&MR)) issued comprehensive guidance on PBL arrangements and published a Guidebook that includes a use case to illustrate the building block approach to an effective PBL business arrangement.

Other accomplishments under BBP 2.0 include the incorporation by DAU of PBL learning assets in two classroom courses and 10 distance learning and online courses within the Lifecycle Logistician curricula and the establishment of a dedicated team of skilled PBL experts to assist and train the Components' program offices and sustainment organizations in developing and managing PBL arrangements.

Under BBP 3.0, we will be placing additional management emphasis and attention on PBL to ensure the effective use of this business approach.

B. Specific actions

ASD(L&MR) will continue to work with the Services and other DoD Components to develop common ways to measure PBL effectiveness, including benefits and savings, and to use those measures to track results. Results of this effort will be reported to USD(AT&L) and the BSIG on a quarterly basis.

As under BBP 2.0, and using these effectiveness measures as they are developed and implemented, the CAEs will provide updates by July 2015 to the BSIG on the implementation of PBL arrangements, including determining the accessible market by Component, the ongoing use of PBL arrangements, plans for additional PBL arrangements, and progress toward those plans. Additional updates will be provided on a quarterly basis thereafter.

ASD(L&MR) will assess the business case analyses for selected current and ongoing PBL arrangements and will provide the results of those assessments to USD(AT&L) as they become available. In addition, ASD(L&MR) will update the PBL Guidebook by October 2015, incorporating lessons learned and best practices from industry and across DoD. As part of that update, ASD(L&MR), with DPAP and the DoD Components, will assess improvements for developing, reviewing, approving, and contracting for PBL arrangements.

DAU will update PBL learning assets to reflect the above assessments and lessons learned, including case studies, by February 2016, following the update of the Guidebook.

Remove barriers to commercial technology utilization

A. General guidance

BBP 3.0 has a primary goal to incentivize greater and more timely innovation in the products DoD uses. DoD's military products are developed and fielded on time scales that are much longer than some commercial development timelines, particularly those associated with electronics, information technology, and related technologies. These commercial technologies have a technology refresh cycle that is a small fraction of a major weapon system's development or recapitalization cycles. The complexity and uniqueness of advanced weapons systems designs is a major factor driving this. Nevertheless, the Department can do a much more effective job of accessing and employing commercial technologies. Our potential adversaries are already doing so. Achieving this objective will require identification and elimination of specific barriers to the use of commercial technology and products. This initiative will assess the need for both policy and regulatory changes, as well as train the workforce on how to access commercial technology and products with existing authorities. This initiative is also closely tied into the small business research and development initiative and those associated with modular open systems and reducing cycle time.

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B. Specific actions

The Deputy Assistant Secretary of Defense for Manufacturing and Industrial Base Policy (DASD(MIBP)), with Director DPAP and ASD(R&E), will develop a handbook of methods and best practices by July 2015 that inform DoD managers on how to engage more effectively with commercial technology companies using existing authorities. The handbook will emphasize Other Transaction Authority (OTA), Cooperative Research and Development Agreements (CRADAs), Federal Acquisition Regulation (FAR) Part 12, public-private partnership, use of 10 USC 2373, and applicable FAR clauses to enable DoD to more quickly access companies that provide commercial technologies of interest and incentivize them to do business with DoD.

ASD(R&E) will evaluate the potential benefits of greater participation in innovation focused consortium arrangements by September 2015. This will include one or more independent organizations that have direct access to companies that are able to provide emerging commercial innovative solutions to address DoD technology needs.

DAU will establish a Community of Practice for rapidly acquiring Commercial Off-the-Shelf products and Commercial Services by October 2015.

DASD(MIBP), with DPAP, will evaluate the potential for legislative or policy changes that would provide greater opportunity for access to commercial technology and report results by October 2015. This action will include an assessment of intellectual property, liability implications, and other commercial industry concerns.

Improve the return on investment in DoD laboratories

A. General guidance

A recent Defense Science Board study gave the DoD laboratories high marks for technical excellence. The laboratories represent a major DoD research and development investment, however, and their productivity is as subject to the need for continuous improvement as any other acquisition enterprise. This initiative to improve the investment in DoD laboratories will examine the mission, organization, cost structure, and productivity of the DoD laboratories with the goal of increasing the return on this investment for both science labs as well as engineering laboratories. The fact that each Service has a fundamentally different operating model for their laboratories complicates the assessment. As a result, the assessment will start by understanding the way each Service operates their lab structure and accounts for cost

categories, such as overhead and support personnel, and for productivity metrics. The review will encompass organizational and funding constructs, customer perceptions, previous study results, and benchmarking against other government and non-profit entities. The goal will be to produce a viable set of metrics to track performance trends and other recommendations to improve the return on investment in DoD laboratories.

B. Specific actions

ASD(R&E), with the SAEs, will develop a Service-agnostic customer assessment survey to understand the strengths and weaknesses of all major DoD laboratories; the surveys will be sent to PEOs/PMs and other users of the DoD laboratories. ASD(R&E) will work with the SAEs to analyze the surveys, synthesize results, and develop recommendations to present to USD(AT&L) by October 2015.

ASD(R&E), with Service S&T Executives will ensure that each laboratory director develops "should cost" targets to reduce indirect and overhead expenses. Any realized savings (like program should cost savings) will be retained by the Service S&T enterprise and reallocated to research or needed mission related capital investments. Individual laboratory should cost targets for 2016 will be developed and presented to the SAEs and USD(AT&L) by November 2015.

ASD(R&E) will work with the S&T Executives to develop transition metrics to track trends in the productivity of the laboratories for producing technologies or products that make it into the hands of the Warfighter (directly or through commercial products) and will brief the BSIG by November 2015.

Services' S&T Executives will work with the Technology Communities of Interest (Cols) to reduce duplication between the laboratories and measure investment changes from year to year, and report changes to the actual funding profile, by technical area, annually. The first assessment will be completed and presented to USD(AT&L) by January 2016 for FY 2015.

ASD(R&E) will conduct a benchmarking analysis of DoD laboratories comparing their business models and performance against those of other government, commercial, and academic laboratories. This analysis will be conducted by independent consultants and completed and briefed to the BSIG by January 2016.

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Increase the productivity of corporate Independent Research and Development

A. General guidance

Independent Research and Development (IRAD) conducted by defense companies as an allowable overhead expense is an important source of innovation for both defense corporations and DoD. It represents over \$4 billion in annual Research and Development (R&D) spending. Changes in legislative guidance and authorities in the early 1990s removed almost all DoD supervision of corporate IRAD. Until that time, IRAD had been tightly regulated and heavily supervised by DoD. This initiative will improve communication between DoD and industry and restore a higher degree of government oversight of this technology investment, while avoiding the burdensome regulatory environment that existed prior to the early 1990s.

Reviews of IRAD spending indicate that a high fraction of IRAD is being spent on near-term competitive opportunities and on de minimis investments primarily intended to create intellectual property. A problematic form of this use of IRAD is in cases where promised future IRAD expenditures are used to substantially reduce the bid price on competitive procurements. In these cases, development price proposals are reduced by using a separate source of government funding (allowable IRAD overhead expenses spread across the total business) to gain a price advantage in a specific competitive bid. This is not the intended purpose of making IRAD an allowable cost.

The intent of the actions below is to ensure that IRAD meets the complementary goals of providing defense companies an opportunity to exercise independent judgement on investments in promising technologies that will provide a competitive advantage, including the creation of intellectual property, while at the same time pursuing technologies that may improve the military capability of the United States. The *laissez faire* approach of the last few decades has allowed defense companies to emphasize the former much more than the later. The goal of this initiative is to restore the balance between these goals. The actions below approach this problem in an incremental way and their effectiveness will be evaluated once they are in place.

B. Specific actions

ASD(R&E), beginning in 2015, will organize and initiate the execution of a continuing series of annual joint Technology Interchange Meetings (TIMs) with industry, organized by the existing S&T Col. Through virtual exchange

of data and in person reviews, the S&T Cols will provide industry with more detailed information about future program plans and gain enhanced DoD understanding and visibility into relevant IRAD.

Director DPAP, with ASD(R&E), will recommend to USD(AT&L) new guidelines for allowable of IRAD expenses by May 2015. The new guidelines will include: identification and endorsement of an appropriate technical DoD sponsor from the DoD acquisition and technology community prior to project initiation; and provision of a written report of results obtained following the completion of the project, or annually if the project spans multiple years. Following USD(AT&L)'s approval, the new guidelines will be implemented through a standard rule making notice and comment process.

Director DPAP, with ASD(A), will develop a proposed regulatory or statutory change that would preclude use of substantial future IRAD expenses as a means to reduce evaluated bid prices in competitive source selections and provide it to USD(AT&L) by July 2015.

INCENTIVIZE INNOVATION IN INDUSTRY AND GOVERNMENT

Increase the use of prototyping and experimentation

A. General guidance

The intent of this initiative is to reinvigorate the use of prototyping and experimentation for the purposes of rapid fielding of technologically advanced weapons systems, providing Warfighters with the opportunity to explore novel operational concepts, supporting key elements of the industrial base, and hedging against threat developments or surprises by advancing technology and reducing the lead time to develop and field new capabilities.

Prototypes are preliminary versions of a system or major sub-system assembled to resolve some area of risk and/or to explore operational potential. In this context, prototyping occurs prior to making a substantial commitment of resources for engineering and manufacturing and development or production and does not require programming or budgeting for follow-on activities. Importantly, during tight budgets these projects are low cost compared to full scale development and production.

Experimentation puts prototypes into the Warfighter's hands for assessment in an operational context. Experimentation capabilities span use in the

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field by military personnel, wargaming, simulation, Service/Combatant Command exercises, and government/industry live, virtual, and constructive environments. Prototyping and experimentation activities contribute to the requirements definition process; aid reducing technical, schedule and cost risk; help refine the manufacturing processes; introduce new tactics, techniques, and procedures; help reveal unanticipated vulnerabilities; and aid retention of critical defense-related skills in the industrial base.

B. Specific actions

Effective in 2015, USD(AT&L) with the Vice Chairman of the Joint Chiefs of Staff (VCJCS) will conduct an annual review with each Service Chief or Vice and SAE of their major 6.3/6.4 prototyping and experimentation efforts (to include late S&T demonstrations) for the current and following year. These reviews will be conducted annually and will begin no later than 30 days after the Services POM Submissions.

Effective in 2015, ASD(R&E) will work with the Services and Agencies to develop, maintain, and publish a database of existing government/industry experimentation capabilities and events and make recommendations to the Services and USD(AT&L) for additional prototyping no later than July 30th of each year.

Emphasize technology insertion and refresh in program planning

A. General guidance

Because of the pace of technology maturation in some sectors, the Department is challenged to maintain its technical edge using traditional acquisition approaches. This initiative focuses on designing acquisition programs to support technology insertion and establishing the practices to use technology refresh or replacement cycles on a more frequent time scale. This will be achieved by enhancing “developmental planning,” which includes understanding the appropriate refresh/replacement cycle timelines for systems (i.e., IT refresh occurs every 18 months; sensor technology every 2-4 years), understanding life-cycle opportunities for technology insertion, and establishing closer collaboration and communication between the S&T and acquisition programs. This initiative will consider fiscal constraints to technology insertion and will be closely aligned with related BBP initiatives to reduce barriers to use of commercial technologies and adopt modular systems open architecture design approaches to enable opportunities for technology insertion.

B. Specific actions

Each SAE will brief USD(AT&L) on their processes for Development Planning associated with technology insertion and refresh, highlighting any remaining challenges and impediments, by June 2015.

ASD(A) will work with Comptroller, Services, and others, as appropriate, to review fiscal rules and identify potential changes that would allow funding to be used more effectively for technology refresh or technology insertion and submit findings and recommended actions, including any policy changes or legislative proposals, to USD(AT&L) by June 2015.

Effective immediately, all program Acquisition Strategies will include a discussion of planned technology insertion or refresh opportunities.

Effective immediately, ASD(A), ASD(R&E), OIPT leaders, and DASD(SE) will include consideration of technology refresh plans in milestone and decision point reviews.

Use Modular Open Systems Architecture to stimulate innovation

A. General guidance

The objective of this initiative is to continue DoD efforts to ensure that our designs are modular and that the government is in a position to control all the relevant interfaces so that competitors with superior technology have the opportunity to win their way onto our programs. Often, this design feature has been either traded away because of competing requirements or lost because the government has failed to secure technical control and ownership of all the needed interfaces, including those required for software integration.

In BBP 2.0, the Department re-published the DoD Open Systems Architecture Contract Guidebook for Program Managers v.1.1, which defines a Modular Open Systems Architecture (MOSA) in terms of adherence to the following five principles:

- Establish an Enabling Environment
- Employ Modular Design
- Designate Key Interfaces
- Use Open Standards
- Certify Conformance

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DoD also re-published a Data Rights brochure to reflect changes to the DFARs, updated DoD 5010.12M on Procedures for the Acquisition and Management of Technical Data, and developed an Intellectual Property Strategy Guidance brochure to support data rights planning.

BBP 3.0 continues the emphasis on open systems architectures and modularity, focusing on providing technical enablers and tools that can be employed by the acquisition workforce and industry to enhance technology insertion, particularly in the most rapidly advancing areas of commercial technology (e.g. microelectronics, sensors, and software). Implementing MOSA architectures will accelerate and simplify the delivery of advanced capability into systems without replacing entire systems. Incorporating modularity principles should result in systems with highly cohesive, loosely coupled, and severable modules that can be openly competed. This approach would enable both pre-planned and opportunistic technology based upgrades in the areas of technology that are most subject to change. It enables the independent acquisition of systems, subsystems, and components, to include software.

In accordance with DoDI 5000.02, PMs are responsible for applying open systems approaches in product designs wherever feasible and cost-effective. Such approaches should be considered for enabling competition for upgrades, facilitating reuse across the joint force, easing technology insertion, and aiding adoption of incrementally upgraded software.

B. Specific actions

The MOSA initiative team led by Executive Director, Army System of Systems Engineering and Integration, will submit to the DAE and SAEs by June 2015 the results of their ongoing efforts to gain insights from acquisition professionals (PEOs/PMs) across all Services and industry on the effectiveness of the DoD's efforts to implement MOSA. Specifically, the results will highlight the level of understanding of MOSA, the ongoing efforts to apply Open Systems approaches to programs, barriers to implementation, and identification of any needed assistance (guidance, tools, training) the PEOs and PMs need in improving the implementation of MOSA. The MOSA initiative team will develop a set of additional modularity technical enablers and recommend items for inclusion in MOSA guidance.

The MOSA initiative team will identify relevant standards and gaps in those standards, identify modularity features (e.g. well defined interfaces, reference architectures) and enabling tools for life-cycle implementation

(e.g. third party development kit, MOSA conformance tool suite, product reuse inventory), and will suggest draft metrics for measuring modularity and openness to the USD(AT&L) and the BSIG by October 2015.

The MOSA initiative team will review and assess DoD's practices in Intellectual Property (IP) acquisition over the last several years. The team will report on trends and the impact of steps taken for source selection and management of IP in both industry and Government. The MOSA initiative team will brief the assessment results and recommendations to the BSIG by October 2015.

ASD(R&E) will collaborate with DPAP, ASD(A), and the SAEs to finalize, coordinate, and disseminate the approved final MOSA guidance, with service-specific amplification and implementation details, to their program managers by December 2015.

Increase the return on and access to small business research and development

A. General guidance

Several actions will be taken to enhance access to and utilization of small business R&D by DoD. The Small Business Innovation Research (SBIR) program has been very successful in helping small creative businesses make progress in early stage technology development. It has been moderately successful in helping businesses transition from development to production. Other programs, such as the Rapid Innovation Fund (RIF) and DARPA's small business outreach programs, have also been successful. The focus of this initiative will be to ensure DoD makes it as easy as possible for small businesses with creative and innovative technologies to work with DoD and have their technologies included in the products that DoD acquires.

DoD will create stronger incentives for industry primes and DoD program managers to 'pull' technology solutions from DoD's SBIR and Small Business Technology Transfer (STTR) investments, non-traditional suppliers, and entrepreneurs, and for inventors to 'push' innovative ideas to program offices and other acquisition organizations.

DoD will also leverage commercial developments in market research related information systems technology to create robust and dynamic information sharing systems to improve the transition of DoD small business technology

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development into Department programs and also to scan the commercial sector to identify and capture emerging disruptive technologies for DoD.

The Department will make it easier for small businesses to work with DoD. The "Direct to Phase II" SBIR pilot will explore how DoD can accelerate technology maturation and adoption. Direct to Phase II will allow for DoD to go directly to a Phase II contract in certain cases. The Department will take advantage of investments made by industry in areas DoD has identified as urgent, critical, and disruptive. This will reduce cycle times and accelerate the contracting process.

B. Specific actions

The Director, Office of Small Business Programs (OSBP) will work with the SAEs, ASD(A), and Director DPAP to develop goals and incentives applicable to Government and industry for transition of SBIR programs to fielded systems and/or programs of record, in accordance with applicable policy, and provide recommendations to USD(AT&L) by July 2015. Examples of potential industry incentives that could be increased include: Small Business (SB) participation as a factor during source selection, credit in the Contractor Performance Assessment Reports System for SB subcontracting performance, credit on Cost Plus Award Fee (CPAF)/CPIF contracts that have subcontracting as factor, and SB consideration in weighted guidelines.

Director OSBP, in collaboration with DASD(MIBP), ASD(A), ASD(R&E), and Director DARPA, will develop recommendations to increase access to innovation within the national security environment through engaging non-traditional suppliers, entrepreneurs, and inventors. Recommendations will be provided to USD(AT&L) on increased use of avenues such as Other Transaction Authorities (OTA) and open Broad Agency Announcements (BAA) as a tool by June 2015. This effort will be coordinated closely with the tasks associated with improving access to commercial technologies.

Director OSBP will develop a reporting system for documenting successful transition of small business R&D technologies into fielded systems and programs of record. This system will be in place by October 2015 and will be based on the existing Market Research Center of Excellent (MARCO) tool.

ASD(R&E) will complete his assessment of the RIF program and make a recommendation to USD(AT&L) as to whether to include funding for a RIF in the FY 2017 budget submission by June 2015.

OSBP will work with DAU to identify additional or modified training necessary on the SBIR program and other small business R&D programs for the use by the acquisition workforce and provide recommendations to USD(AT&L) by July 2015.

OSBP will complete the “Direct to Phase II” pilot and make a recommendation to USD(AT&L) on extending and expanding this initiative by October 2015.

Provide draft technical requirements to industry early and involve industry in funded concept definition

A. General guidance

In general, DoD needs to communicate with industry as much as possible up until the time a final Request for Proposals is released, after which communications have to follow the formal contracting process. Everyone benefits from as open an exchange of information and ideas with industry as possible.

In order to exploit industry creativity and innovation, the Department will work more closely with industry in the earliest stages of the product lifecycle, before requirements are firm and before design concepts are determined. The sooner industry learns of DoD’s interest in a new capability need, the sooner industry can begin to explore or invest in applicable technologies and formulate ideas for DoD consideration. Industry will be asked to provide feedback and recommendations on early stage draft requirements. In addition, DoD will routinely fund competitive concept definition studies (e.g. early design trade studies and operations research) to inform decisions about requirements and as inputs to the formal Analyses of Alternatives (AoAs) conducted after the Material Development Decision. This initiative will spur innovation by industry, better inform requirements, and lead to better products.

B. Specific actions

SAEs will make competitive industry concept definition studies a standard part of program plans whenever feasible. Concept definition results should be timed so they can be used to inform requirements trades and AoAs.

SAEs will work with Service requirements counterparts to ensure that draft requirements documents are provided to industry as early as possible and

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will make provisions for industry feedback to be accepted and provided to the requirements community.

ASD(A) will review DoDI 5000.02 to determine what changes, if any, may be required to implement this initiative and recommend these changes to USD(AT&L) by May 2015.

Provide clear “best value” definitions to industry

A. General guidance

This BBP 3.0 initiative builds on the work started in BBP 2.0 to provide industry with information on the value, in monetary terms, of higher levels of performance than minimally acceptable or threshold levels. Without this information, the default position will be to bid to the lowest acceptable level of performance. With this information, industry will know what the competitive effect of offering higher performance will be and can bid accordingly. Equally importantly, this practice creates appropriate incentives to encourage industry to innovate.

In 2.0, we developed a Best Value process manual that we are adding to the Source Selection Guide. In 3.0, we will focus on how to more effectively monetize best value and publicize relevant case studies.

B. Specific actions

DPAP will publish the updated Source Selection Guide containing the Best Value process manual by May 2015.

MDAs will ensure that “best value” definitions for above threshold performance levels are transparent and objective and stated in monetary terms as much as possible.

ELIMINATE UNPRODUCTIVE PROCESSES AND BUREAUCRACY

This BBP 3.0 initiative builds on the BBP 2.0 efforts to reduce the frequency of reviews and unproductive processes and bureaucracy for both industry and government, and to emphasize the role of the acquisition chain of command. This work is far from completed.

Emphasize acquisition chain of command responsibility, authority and accountability

A. General guidance

This initiative is a continuing effort from BBP 2.0. The chain of command for acquisition programs runs upward from the PM through the PEO to the CAE and, for ACAT I, ACAT IA, and other programs so designated, to the DAE. The responsibility and authority for program management, to include program planning and execution, is vested only in these individuals. Staff and other organizations provide support to this chain of command.

Acquisition Executives (AEs), PEOs, and PMs have to exercise full responsibility and authority commensurate with their position and will be accountable for the results of the execution of the program. We need to continue to emphasize and support the central criticality of the acquisition chain of command and align responsibility, authority, and accountability within this chain. We need to emphasize the important but supporting role of staff oversight.

As part of the BBP 3.0 effort, we will continue to review and adjust policy, practices, and organizational relationships to ensure AEs, PEOs, and PMs exercise full responsibility and authority commensurate with their position and are accountable for the results of the execution of the programs.

B. Specific actions

SAEs will conduct a review of the accountability and responsibility of all individuals throughout their Service who review acquisition documents prepared for MDA or OSD approval. The results of this review will be provided to the Service leadership and to USD(AT&L) by July 2015. The Service leadership will be requested to consider the accountability of the reviewers and the contribution these reviews elicit for the purpose of identifying potential streamlining to the current process and emphasizing PM, PEO, and CAE authority.

PDUSD(AT&L) will conduct a similar review of the accountability and responsibility of individuals within OSD. The review will identify all the touch points an acquisition document experiences enroute to the MDA for approval. PDUSD(AT&L) will provide the results of the review to USD(AT&L) by July 2015. The review will consider the accountability of the reviewers and the contribution these reviews elicit for the purpose of identifying potential streamlining to the current review process and emphasizing PM/PEO/CAE authority.

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USD(AT&L) recently requested that each ACAT I PM provide a personal assessment of the status of his or her program to the PEO, CAE, and DAE. This pilot was highly successful, and it will be continued on an annual basis.

Reduce cycle times while ensuring sound investments

A. General guidance

Under BBP 2.0, we introduced the concept of a “Skunk Works” approach to be implemented on a pilot basis. To date, this has not been implemented for any ACAT ID programs, but as concerns about loss of technological superiority grow, DoD will continue the effort to identify programs suitable for this and other forms of accelerated or rapid acquisition. In addition, some of the successful rapid acquisition initiatives that were introduced to support the wars in Iraq and Afghanistan will be sustained and integrated into our standard practices.

The Defense Acquisition System has the flexibility to improve the “speed to market” of our weapons systems development and fielding. The Accelerated Acquisition Program, or Model 4, found in the latest DoDI 5000.02 provides the basis for a high degree of program tailoring with the explicit goal of accepting risk and reducing “time to market.” As DoD begins to implement the Defense Innovation Initiative, the LRRDPP- and Advanced Capability and Deterrence Panel (ACDP)-identified projects, this will be the preferred approach.

B. Specific actions

USD(AT&L) will request VCJCS and the Joint Requirements Oversight Council to review early stage development programs and new starts and to make a recommendation as to whether the urgency of the need would justify a higher risk program approach based on DoDI 5000.02’s accelerated acquisition model.

SAEs and OIPT leads will review all Major Defense Acquisition Programs (MDAPs) and Major Automated Information Systems (MAIS) programs under their control or oversight by July 2015 and recommend whether use of some form of accelerated acquisition as outlined in the recently approved final DoDI 5000.02 should be considered.

By June 2015, each SAE will recommend at least one candidate ACAT 1 program for a pilot skunk works approach that would eliminate the current

document based approach to program milestone review and substitute a hands-on onsite review process in the 2-3 week period preceding a milestone decision by the MDA. These programs should be cost plus development programs that have not already passed the Development Request for Proposal Release decision point. SAEs are encouraged to conduct pilot “skunk works” programs for lower ACAT and delegated programs.

ASD(A), with DAU and APAC support, will analyze case studies of previous accelerated acquisition programs, especially those conducted in support of operations in Iraq and Afghanistan, to glean lessons learned that can be applied to future efforts. The analysis will study the trends and risks associated with program factors (e.g., complexity, software content, concurrency, prior technology maturation, delegation), functions (e.g., testing, quality assurance) and review/oversight approaches (e.g., rapid acquisition, skunk works). Initial results will be briefed to the BSIG by September 2015.

Streamline documentation requirements and staff reviews

A. General guidance

In BBP 2.0, we tracked how much time is logged to prepare for staffed document reviews and decision review briefings. The Government Accountability Office has also recently released a study on document lead times and value. Our data indicates that excessive program management time is spent supporting staff reviews and preparing documents primarily for review, instead of focusing on program execution. The Department will continue and increase the effort to reduce documentation and reviews. Program managers are expected to suggest tailoring throughout the program lifecycle. Options to condense the staffing process, reduce document content, or completely eliminate a document are available. The PM, the acquisition chain of command, the OIPT lead, and staff principals all have a responsibility to make recommendations to the MDA and to take actions that will facilitate an effective but less burdensome review process.

B. Specific actions

Effective immediately for all MDAP and MAIS programs in the acquisition process, Services will make recommendations for streamlined documentation and present these recommendations to the OIPT lead and DAE in time for consideration at the next scheduled DAB planning meeting.

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For lower level ACAT programs and delegated programs, the MDA will consider appropriate tailoring and streamlining early in program planning.

CAEs will establish and enforce standardized Component-level review timelines by May 2015.

CAEs will conduct a review of Component-issued acquisition regulations and policies to determine value-added and brief USD(AT&L) on the results by September 2015.

In lieu of separate Service or Component implementing regulations, CAEs will publish Component-specific addendums to DoDI 5000.02 by January 2016.

ASD(A) will draft a policy memo for USD(AT&L) approval by July 2015 that streamlines the procedures that will be employed by staff for the review of documents required by the defense acquisition system.

ASD(A), with assistance from the SAEs, will conduct a review of the Defense Acquisition Guidebook (DAG) with a goal of simplifying the guidance, eliminating duplication and unnecessary content, and clarifying the substantive program specific information that is needed to support MDA decisions. A brief on preliminary findings and recommendations will be provided to USD(AT&L) and the BSIG by August 2015. Revised DAG guidance will be finalized by January 2016.

Remove unproductive requirements imposed on industry

A. General guidance

In BBP 3.0, we will continue to work with industry to identify unproductive or non-value added regulatory activities. Examples include updating statutes, regulations, and policies and removing inappropriate or inconsistent DoD practices and applications of statutes and regulations. The goal is to increase value by reducing costs and cycle times and eliminating industry uncertainty over regulatory compliance.

Industry has had longstanding concerns about statutory requirements to submit and resubmit cost and pricing data. The Department has identified some pilot approaches that we will test to reduce the need for unnecessary cost and pricing data submissions.

Another key area that we will focus on is Commercial Item Determination. Industry has indicated uncertainty in their transactions with the Department on commercial item acquisitions.

The Office of Defense Pricing has initiated several actions to streamline and accelerate the Commercial Item Determination process, including issuing policy guidance, increasing training, and implementing analytical support tools. We will continue to recommend additional actions under BBP 3.0.

Similarly, in the area of Earned Value Management (EVM), industry has raised concerns that Earned Value (EV) is sometimes applied to inappropriate contract types. They also ask to increase the dollar threshold for compliance reviews. Within this area, we will establish a single threshold for both EVMS compliance reviews and ongoing system surveillance at \$100 million. In doing so, we anticipate a savings of up to \$5 million annually from industry and a number of full time equivalents from the Defense Contract Management Agency (DCMA), which could be repurposed to support other essential priorities and missions.

B. Specific actions

DPAP will initiate pilot programs to demonstrate and quantify impacts of reducing repeated submissions of cost or pricing data by October 2015.

DPAP will submit a revision to FAR 15.407-1(c) that eliminates the requirement that a contracting officer shall request an audit if a contractor voluntarily discloses defective pricing post-award by May 2015.

DPAP will develop a draft legislative proposal to revise the definition of the term “commercial item” to eliminate items and services merely offered for sale, lease, or license by September 2015.

DCMA, in coordination with DPAP, will provide an actionable plan to establish Cost and Pricing Centers of Expertise to facilitate Commercial Item Determinations, and DPAP will prepare updated guidance on Commercial Item Determinations by September 2015.

PARCA will submit revisions to the DoD FAR Supplement that (1) adds work scope as a criteria to whether a contract should have EVM reporting, and (2) establishes a single threshold of \$100 million for DCMA compliance and surveillance reviews of EVM systems by May 2015.

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DCMA will expand “Data-Driven EVM Systems Streamlining Pilot” to conduct streamlined compliance reviews and system surveillance at three additional contractor facilities by October 2015.

DCMA will provide an actionable plan to assess the benefits of streamlining its EVMS operations and centralizing its EVMS competency to improve consistency of EVMS implementation by September 2015.

PROMOTE EFFECTIVE COMPETITION

Create and maintain competitive environments

A. General guidance

Competition is the most effective tool we have to control cost. In the absence of direct competition, anything that creates a “competitive environment” (where the incumbent is concerned about maintaining his or her position relative to an alternative product or service provider) has value to the Department. When direct competition at the product level is not economically viable, then alternative means of introducing competitive pressure or direct competition at lower levels should be pursued.

In BBP 2.0, we published guidelines for creating and maintaining a competitive environment. Going forward, we are going to continue the emphasis on competition and continually assess our performance and progress. This will include understanding any differences between the Services and Agencies in terms of the degree of competition for both products and services of various types.

B. Specific actions

The SAEs will continue to provide quarterly competition reports to include targets and projections and their proposed plans to meet competition targets at the BSIG.

Improve DoD outreach for technology and products from global markets

A. General guidance

The sources of a great deal of today’s technical innovation are not located in the United States. We have global allies, friends, and trading partners who share our values and can assist us in pursuing innovation and technological superiority. Increased investments in cooperative research, co-development,

and co-production may also provide better products for our warfighters at reduced cost.

DoD – across OSD, the Military Departments, Combatant Commands, and Defense Agencies – is extensively engaged in international cooperative engagement activities. These activities range from the cooperative development of the F-35 program to the Coalition Warfare Program to the Engineer and Scientist Exchange Program. This broad engagement, however, presents challenges in optimizing opportunities and managing the flow of information relating to foreign technologies. The current process through which the Department manages acquisition programs does not draw out the full potential for international solutions.

This initiative will establish a centralized process that integrates and provides awareness of global technology for potential application in Acquisition and S&T programs, engagements, and expand opportunities across the Services, Defense Agencies, and OSD for co-development of leading edge technology. The creation of this connective tissue for the Department’s expansive international activities will increase the utility of information resident within disparate DoD programs and organizations and increase opportunities for international cooperation.

BBP 3.0 seeks to improve the knowledge base of acquisition professionals, enabling greater awareness of foreign solutions and the processes by which the Department can maximize its investments. In addition to promoting effective competition, the actions taken below will complement the “Remove barriers to commercial technology utilization” initiative, which is accomplishing related actions.

B. Specific actions

The Defense Technical Information Center (DTIC) will expand the existing web-based International Agreements Database, initially rolled out in 2014 to make available a catalogue of applicable technologies identified by the acquisition and S&T personnel in our embassies and overseas locations. DTIC will work with AT&L and Service International Cooperation Offices to develop a format and process for input and search. This database will be available to all DoD acquisition and technology and requirements personnel. DTIC will release a spiral of the data base on September 30th each year.

Based on the current functionality of the international programs data base, DTIC will work with the International Cooperation program office to prepare

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a Directive-Type Memorandum (DTM) for USD(AT&L) issuance outlining data input procedures, roles, and responsibilities and policy guidance by September 2015.

ASD(R&E), with assistance from ASD(LM&R), will assess the opportunities for a pilot program to identify opportunities for foreign technology solutions to solve sustainment and obsolescence management needs. The assessment will be completed by September 30, 2015.

DAU, with the Services/SAEs and Director, International Cooperation, will lead an assessment of the current career field training curriculum to identify opportunities to include international acquisition and exportability training for personnel not in international acquisition coded positions by February 2016. Target communities for enhanced training include acquisition PMs and U.S. Embassy personnel assigned to Security Cooperation Organizations.

Following the curriculum review, DAU will suggest appropriate training modules for inclusion in the Defense Institute of Security Assistance Management course offerings for personnel assigned to U.S. Embassy Security Cooperation Organizations worldwide.

Increase small business participation, including more effective use of market research

A. General guidance

Market research is the cornerstone of determining supplier capabilities in DoD acquisitions. BBP 1.0 emphasized the need to increase small business participation in services acquisition, including Multiple Award Contracts, Indefinite Delivery Indefinite Quantity, and Government Wide Acquisition Contracts. BBP 2.0 focused on the use of effective market research to identify sweet spots for small business utilization, including the development of procurement forecasts captured in the Maximum Practicable (MaxPrac) Opportunity Analysis Model, and underscored the implementation of Simplified Acquisition Threshold (SAT) guidance. Still, acquisition personnel lack easy access to the decision making information required at each instance where market research is required.

In BBP 3.0, we will build on BBP 2.0 outcomes to broaden the use of effective market research, develop the necessary tools for all stakeholders, and ultimately establish the processes necessary to reinforce effective

market research as part of the culture of producing innovative solutions for the Department.

B. Specific actions

Director OSBP will establish and deploy an improved suite of market research tools that will empower the workforce in market research execution, analysis, goal management, future needs forecasting, and industry engagement by October 2015.

Using the Air Force customer support model as a best practice, Director OSBP will work with DASD(MIBP) and ASD(R&E) to perform an assessment of the feasibility of a regionalized or matrix approach to providing market research capability. The results of the assessment will be presented to the BSIG by December 2015.

Director OSBP, with Director DPAP and DASD(MIBP), will complete a study on the feasibility of establishing a superior supplier program for small business using best practices gained from the existing program targeted to other than small businesses. This study will review services as well as products and equipment. The deliverables of the study will also include the metrics to determine success, requirements to be included in the program, as well as the policies for when companies are removed from such a program. The study will be complete by September 2015.

USD(AT&L) and the SAEs will each complete at least two small business outreach events by January 2016. Other CAEs will complete at least one SB-focused outreach event each fiscal year. The focus of the events will be to inform the SB industrial base on policy updates within the Department, provide training on how to better market the DoD and the Component, and provide an opportunity for matchmaking with various Department organizations.

Director OSBP, in coordination with Director DPAP and DCMA, will establish specific guidance outlining the enforcement of subcontracting/ subcontracting surveillance by September 2015.

Director OSBP, on behalf of the Department, will work with the Small Business Administration (SBA) and the General Services Administration (GSA) to improve Electronic Subcontracting Reporting System functionality focusing on implementation in FY 2015 and FY 2016. The goal is to improve reportable statistics, add ability to automate reconciliation, validation of

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contractor input data, and add comprehensive Subcontracting Test Program Tracking and validation capabilities. This will be tracked and reported through the USD(AT&L) SB monthly progress meetings.

IMPROVE TRADECRAFT IN ACQUISITION OF SERVICES

This area builds on efforts in BBP 1.0 and 2.0 to improve the management of contracted services, which now accounts for over 50 percent of our contracted dollars. Earlier BBP initiatives included the new appointment of Senior Services Managers (SSMs) and Functional Domain Executives for the acquisition of services; the adoption of a uniform taxonomy; the issuance of policy regarding (a) treatment of one-bid contracts, (b) time-and-materials and award fee contracts, and (c) cost efficiency language in services contracts; expanding the use of review boards and tripwires; and increased market research. Despite these actions, there is opportunity for significant continued improvement, reflected in the BBP 3.0 initiatives below that continue, build on, and expand the efforts to date.

Strengthen contract management outside the normal acquisition chain – installations, etc.

A. General guidance

As noted in BBP 2.0, the preponderance of the Department's contracted services support missions that are executed outside the normal acquisition chain. Installation commanders, for example, are ultimately accountable for the success or failure of the mission requirements under their purview, including the contributions of service contractors to those missions. The reliance on contractors to support operational deployments will continue. BBP 1.0 and 2.0 efforts on improving services acquisition identified an ongoing need to ensure that personnel who are not part of the traditional defense acquisition workforce are properly executing services acquisition tradecraft. PDUSD(AT&L), with the Components, has developed proposed policy and oversight structure for contracted services acquisition in the new draft Instruction on Defense Acquisition of Services (DoDI 5000.ac). Areas of improvement include standard processes, appropriate training, and appropriate oversight.

B. Specific actions

PDUSD(AT&L) will finalize staffing of the new draft Instruction on Defense Acquisition of Services for USD(AT&L) signature and issuance by June 2015.

PDUSD(AT&L) and the Component SSMs shall develop and fully execute a communications and implementation plan for DoDI 5000.ac for completion within 12 months of the Instruction's issuance.

PDUSD(AT&L), through the Services Acquisition Functional Leads, DAU, and other training providers, as appropriate, will provide guidance by September 2015 to the Components regarding Contracted Services management training requirements and opportunities and begin executing training as soon as is practicable for non-acquisition personnel.

Each Services Acquisition Functional Lead, will ensure the Services Acquisition Functional Integrated Process Team (SA FIPT) and Component leads execute implementation of appropriate training supporting use of DoDI 5000.ac. Results will be reported to the PDUSD(AT&L) and the BSIG by January 2016.

The Components, supported by the Services Acquisition Functional Leads and with relevant management chains outside of the defense acquisition workforce, will identify additional non-acquisition workforce Contracted Services training requirements by October 2015 and update annually thereafter.

PDUSD(AT&L), with DPAP's Deputy Director for Services Acquisition and the SSMs, will monitor implementation of DoDI 5000.ac to assess and address any shortcomings. Presentation of the assessment(s) will include a corrective action plan for any significant shortcomings or issues and be presented to the BSIG within one year of the DoDI 5000.ac issuance.

Contracted services Functional Domain Experts will, by August 2015, develop and publish appropriate portfolio metrics and goals for use during FY 2016 to monitor and improve portfolio productivity and performance. It is expected that these metrics and goals will be updated annually.

Improve requirements definition for services

A. General guidance

Improving services contracting requirements definition is a continuing BBP initiative. Defining requirements well is a challenging but essential prerequisite in achieving desired services acquisition outcomes. As most services are integrated into the performance of a mission, it is critical to get the mission owner (often an operational commander) involved in the

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requirement definition, as well as the acquisition and execution phases. Continuous involvement through the services acquisition phases will lead to improving requirements definition for future acquisitions.

New BBP 3.0 efforts will focus on identifying successful requirements definition processes employed across the Department and communicating those processes effectively as best practices.

B. Specific actions

SSMs will identify within each existing functional domain area processes for defining requirements, including the organization structure and conditions that make those processes effective. Best practices will also be identified from each organization and results will be briefed to the PDUSD(AT&L) by July 2015.

DPAP's Deputy Director for Services Acquisition, in conjunction with the SA FIPT, will prepare to the PDUSD(AT&L) and the BSIG an integrated assessment describing existing processes and identifying best practices by September 2015.

SSMs, SA FIPT, and DAU will examine and identify gaps in the associated services acquisition training by June 2015 and identify and publish currently available training capabilities (i.e. PWS Handbook, Services Acquisition Workshop, Acquisition Requirements Roadmap Tool, etc.) using appropriate communication channels, including but not limited to online channels, by July 2015.

DPAP's Deputy Director for Services Acquisition, in conjunction with the Components and SA FIPT, will develop and execute a Services Contracting Best Practices Communications Plan beginning in August 2015.

Improve the effectiveness and productivity of contracted engineering and technical services

A. General guidance

DoD relies extensively on contracted services for technical management, systems engineering, and engineering services, including program associated Systems Engineering and Technical Assistance contracts. Enterprise approaches for acquiring these engineering and technical (ETS) services should be used to increase effectiveness of engineering-related

outcomes, improve technical information management, identify cost efficiencies for engineering-related studies, and promote innovation and maintaining technical superiority.

B. Specific actions

DASD(SE), in partnership with the Component ETS leads and in coordination with DPAP and the Single Manager for Services for each Component, will lead an effort to characterize the ETS portfolio and identify recommended practices for allocating work and responsibility between in-house government workforce and ETS, and metrics or techniques for assessing the effectiveness of ETS. DASD(SE) will deliver a portfolio assessment to the USD(AT&L) and the BSIG by August 2015 and deliver recommended practices by October 2015.

USAF PEO (Services), in partnership with DASD(SE) and Component leads, will lead an effort to assess applicability and effectiveness of known service acquisition and source selection practices on the ETS portfolio. This effort will include engagement with external organizations. The review will include consideration of practices for requirements definition, contract type selection, incentive structures, appropriate and inappropriate use of Lowest Priced Technically Acceptable source selection criteria, and make/buy decisions. PEO (Services) will deliver an assessment to the BSIG by August 2015.

Deputy Director DPAP for Services Acquisition, in partnership with DASD(SE) and Component leads, will identify data input and management mechanisms and guidance to improve the Department's ability to monitor and track engineering and technical services and brief the BSIG by August 2015.

IMPROVE THE PROFESSIONALISM OF THE TOTAL ACQUISITION WORKFORCE

Establish higher standards for key leadership positions

A. General guidance

This initiative builds on BBP 2.0 efforts to pilot key leadership position qualification referenced in USD(AT&L's) Key Leadership Position and Qualifications Criteria memorandum dated November 8, 2013. The memorandum established mandatory KLPs associated with MDAP and MAIS Programs, as well as increased the qualification standards for each position resulting in better defined and more experience-based standards.

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Additionally, the memorandum directed the establishment of Joint KLP Qualification Boards to prescreen Acquisition Workforce personnel to qualify a pool of candidates to fill these positions. The Test and Evaluation (T&E) functional community successfully piloted the first joint qualification board pilot in December 2014. The acquisition functional community leaders are assessing the pilot results to inform potential expansion of qualification boards to other Defense Acquisition Workforce Improvement Act (DAWIA) functional areas.

B. Specific actions

Director HCl, the Services, and Agencies will monitor implementation of KLPs on a continual basis.

By May 2015, the Functional leads will identify which career field leads plan to hold KLP Qualification Boards (or determine alternatives), leveraging the success of the T&E KLP Board, and deploy the Boards by the end of December 2015.

Establish stronger professional qualification requirements for all acquisition specialties

A. General guidance

This continues the BBP 2.0 effort in this area. The DAWIA experience requirements must be supplemented to establish a stronger basis for levels of professionalism across all acquisition career fields. The Department started the Acquisition Workforce Qualification Initiative (AWQI) in BBP 2.0 to better define qualification standards. The Department is close to completing the development of experiential/proficiency standards and tasks for each of the Acquisition Career Fields by competency and competency element. This career development tool focuses on the quality versus the quantity of the experience attribute of certification and provides a higher level of measureable demonstration of experience specific to a position. AWQI demonstrated experience standards will be distributed to the Acquisition Workforce (via the Components) as a guide to assist in Talent Management with an emphasis on career development and succession planning. It will aid in developing fully qualified acquisition professionals. The Components will be responsible for their implementation methodologies.

B. Specific actions

DAU/AWQI will incrementally roll out completed standards sets in e-workbook format to each of the Services between April to August 2015, and complete remaining standards development (PM and SB) by June 2015.

Services will define their implementation methodology and brief USD(AT&L) on their plans by August 2015.

Director HCI will assess results of Service implementations and recommend a process for sustainment and update of standards to USD(AT&L) by June 2016.

Strengthen organic engineering capabilities

A. General guidance

DoD cannot effectively support the Warfighter nor retain its technological superiority without a competent and innovative organic engineering workforce, both military and civilian. The goal of this initiative is to strengthen our organic engineering capabilities by equipping our technical workforce with essential education, training, and job experiences, along with the right physics-based tools, models, data and engineering facilities to efficiently and effectively manage the technical content of our complex products throughout their lifecycle. The Department also needs to take active steps to strengthen organic engineering capabilities to better understand the technical risks associated with program execution for its development programs, and this requires a strong engineering workforce.

Development programs for cutting edge weapons systems always carry technical risks. Because of these risks, most development programs are contracted for using cost plus vehicles that require technical supervision by the Government. DoD cannot execute this responsibility without technically qualified program management and a strong supporting workforce. This initiative will focus on identifying and managing the specific technical areas where the Department requires enhanced engineering skill/expertise in order to effectively manage its portfolio. Any uncovered technical area gaps or shortfalls will be prioritized, and mitigation strategies will be developed to meaningfully improve the DoD's organic engineering capability. Potential strategies may include: ensuring that technical qualifications are a primary consideration in assigning individuals to key leadership positions in programs; removing organizational inhibitors to the development of technical expertise; providing added training, experience, and education to retain and grow competency/technical expertise; obtaining required

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analytic capability including necessary physics-based tools, models, data, and engineering facilities; and identifying/developing and implementing innovative methods to retain qualified technical experts, including outside expertise that has not “grown up” within the military or civil service structure.

B. Specific actions

The Services will proactively manage their organic engineering workforce. SAEs will develop metrics to monitor the health of their engineering capabilities and resources (competencies, tools, infrastructure, and data) by July 2015. Engineering workforce health metrics will be reported on an annual basis to USD(AT&L) and the BSIG beginning in August 2015.

The Services will conduct a self-assessment by October 2015 of their in-house engineering capabilities and resources (competencies, tools, infrastructure) and develop data to identify specific organic engineering technical gaps that are creating risk in managing their portfolio of products and services.

The Services will assess their organic technical gaps to determine the cause and impact, prioritize the gaps, and develop mitigation strategies to close the gaps by January 2016.

Ensure development program leadership is technically qualified to manage R&D activities

A. General guidance

Development is an engineering activity which is usually conducted in a cost plus contracting environment. In that environment, government managers must have a thorough understanding of the relevant technical fields and be able to provide effective direction to the Department’s contractors. The Department must ensure that technically qualified leaders are available and assigned to managing our development programs.

B. Specific actions

PDASD(A) will collect and evaluate data on current ACAT I/IA Program manager and PEO training, education, and experience to determine their technical qualifications to manage R&D activities, and will provide this information to USD(AT&L), Service leadership, and the CAEs by May 2015.

Based on the data received, USD(AT&L) will work with Service leadership and CAEs to develop and execute implementation plans designed to improve the technical qualifications of developmental program leadership.

Improve our leaders' ability to understand and mitigate technical risk

A. General guidance

Successful product development requires understanding and actively managing program risks. Risk management is an endeavor that begins with requirements formulation and assessment, includes the planning and conducting of a technical risk reduction phase if needed, and strongly influences the structure of the development and test activities. Active risk management requires investment based on identification of where to best deploy scarce resources for the greatest impact on the program's risk profile. PMs and staff should shape and control risk, not just observe progress and react to risks that are realized. Anticipating possible adverse events, evaluating probabilities of occurrence, understanding cost and schedule impacts, and deciding to take cost effective steps ahead of time to limit their impact if they occur is the essence of effective risk management. Risk management should occur throughout the lifecycle of the program and strategies should be adjusted as the risk profile changes. Among activities to implement this initiative are the development of pilot programs, hands-on training, and briefings to educate acquisition leaders about proactive risk management. The Department will also expand the available repository of risk-related case studies and lessons learned.

In 3.0, we will continue to refine BBP implementation plans through designated supporting organizations, make recommendations to evaluate a set of acquisition programs to assess/evaluate active risk planning, and coordinate updates to program review guidance to incorporate refinements in the technical risk information needed to support major decisions.

B. Specific actions

DASD(SE) will work with the CAEs and DAU to collect risk management case studies and lessons learned and report results to the USD(AT&L) and the BSIG by October 2015.

DASD(SE) will re-issue the DoD Risk Management Guide by June 2015 to ensure understanding, implementation, and reporting of risk identification, management, and mitigation across the Department.

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SAEs will commission a review of current risk management curricula and recommend updates by November 2015.

DASD(SE) will work with the Components to pilot technical risk peer reviews and provide independent feedback to programs prior to major milestones or decision points.

Program Managers will emphasize remaining risks and ongoing or planned mitigation actions in annual program assessments for the DAE, CAE, and PEO.

Increase DoD support for STEM education

A. General guidance

This initiative addresses both direct and indirect DoD support to Science, Technology, Engineering and Mathematics (STEM) education and outreach efforts focused on developing the next generation of STEM professionals, including improving diversity through outreach to underrepresented communities. It will encourage and promote DoD and component outreach to foster STEM education and interest in careers in STEM areas.

This initiative also supports the U.S. Government STEM education from Kindergarten (K)-12 and college to increase the pool of U.S.-eligible STEM personnel available for and participating in national security work. Additionally, it will strengthen the relationship between DoD labs and the civilian technical community, especially within the university system. In order to recruit the best candidates for the RDT&E community, DoD needs to make its labs and engineering centers more highly desirable workplaces that are competitive for technical talent.

B. Specific actions

ASD(R&E) will formulate and publish an annual “campaign plan” for voluntary STEM support activities by the DoD acquisition community during the following year. The first campaign plan will be complete and begin execution in October 2015.

ASD(R&E) will expand the scope of the STEM Board of Directors (BoD) to include more emphasis on engineers by May 2015.

The STEM BoD will provide a strategic STEM education and outreach communication plan for DoD senior leaders by June 2015.

STEM BoD will establish a quarterly STEM support award program and criteria for local STEM support recognition by May 2015.

ASD(R&E), in concert with the STEM BoD, will develop and conduct a STEM activity survey and analyze the results to understand the scope of all DoD K-12 STEM efforts (both direct and indirect funded activity) by December 2015.

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Enhancing the effectiveness of independent research and development

White Paper

Office of the Under Secretary of Defense

Acquisition, Technology and Logistics

Honorable Frank Kendall

26 August 2015

The Independent Research and Development (IR&D) initiative outlined in Better Buying Power 3.0 is intended to improve the effectiveness of IR&D investments by the defense industrial base that are reimbursed as allowable costs. To achieve this goal, both the Department and the Industrial Base need to work together to ensure the department has visibility into the opportunity created by government-reimbursed IR&D efforts performed by defense contractors.

By law and DoD policy, contractor IR&D investments are not-directed by the government – they are identified by individual companies and are intended to advance a particular company’s ability to develop and deliver superior and more competitive products to the warfighter. These efforts can have the best payoff, both for the DoD and for individual performing companies, when the government is well informed of the investments that companies are making, and when companies are well informed about related investments being made elsewhere in the government’s Research and Development portfolios and about government plans for potential future acquisitions where this IR&D may be relevant.

To ensure that a two way dialogue occurs between the Department and IR&D performing organizations and to provide for some minimum oversight of IR&D, the department believes that proposed new IR&D efforts should be communicated to appropriate DoD personnel prior to the initiation of these investments and that results from these investments should also be shared with appropriate DoD personnel. The intent of such engagement is not to reduce the independence of IR&D investment selection, nor to establish a bureaucratic requirement for government approval prior to initiating an

IR&D project. Instead, the objective of this engagement is to ensure that both IR&D performers and their potential DoD customers have sufficient awareness of each other's efforts and to provide industry with some feedback on the relevance of proposed and completed IR&D work.

Dialogue about proposed IR&D projects may take place at focused opportunities for DoD/Industry engagement such as the Technology Interchange Meetings (TIMs) currently hosted by the Air Force Research Laboratory; or it may take place through the current practice of industry personnel meeting with DoD technical or operational personnel on an individual basis to exchange information about proposed IR&D efforts. These interchanges provide all parties with the opportunity to discuss military technological needs, opportunities, and gaps, including mid-and long-term needs or opportunities, and to discuss proposed IR&D projects being pursued to address these needs. These interchanges on industry IR&D investments are an opportunity to inform and align DOD and Industry direction. These interchanges should always be structured to ensure that DOD protects the proprietary information and competitive sensitivities of the parties to these discussions.

The intent is that by FY 2017, every new IR&D project will be preceded by an engagement with appropriate DOD technical or operational staff to ensure that the department is aware of the goals and plans for the effort and that Industry is informed of related ongoing efforts and future potential opportunities from the Department. To document that this interchange is occurring, beginning in FY 2017, DoD will require contractors to record the name of the government party with whom, and date when, a technical interchange took place prior to IR&D project initiation and to provide this information as part of the required IR&D submissions made to the Defense Technology Information Center IR&D electronic portal (which is accessed through the Defense Innovation Marketplace (www.defenseinnovationmarketplace.mil)). Defense Contracts Management Agency and Defense Contracting Auditing Agency will use these DTIC inputs when making allowability determinations for IR&D costs. In order to effect this procedural change, I intend to direct the Defense Acquisition Regulations Council to draft an amendment to the Defense Federal Acquisition Regulation Supplement and begin the public rulemaking process.

To ensure adequate interchange opportunities are provided by the Services, I intend to direct each Military Department to provide me with a plan for supporting robust opportunities for regular IR&D engagements between Service technical, program, and operational communities and industry,

Appendices

beginning no later than 1 July 2016. I also will encourage the Military Departments to continue to make full use of current interchanges with industry, including fully utilizing the services provided by the Defense Innovation Marketplace, in highlighting opportunities for discussions between the Department's workforce and industry. IR&D has been an effective tool in building technological superiority for our warfighters. This renewed emphasis on engagement between government and industry will strengthen this capability even more.

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