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What's Next For Independent R&D Costs

On March 2, 2011, the U.S. Department of Defense issued a proposed rule that would condition the allowability of independent research and development (IR&D) costs charged to DOD contracts on reporting IR&D projects when a contractor's annual IR&D costs exceed $50,000.

The rule would require contractors to report IR&D projects to the Defense Technical Information Center. The contractor must update inputs to the reporting system "at least annually" and the information must be made available to the cognizant administrative contracting officer (ACO) and the Defense Contract Auditing Agency (DCAA).

The DOD has stated that the policy for this change is "to increase effectiveness by providing visibility into the technical content of industry IR&D activities to meet DOD needs and promote the technical prowess of the industry."

The DOD further explains that "[w]ithout the collection of this information, DOD will be unable to maximize the value of the IR&D funds that it disburses without infringing on the independence of a contractor to choose which technologies to pursue in its independent research and development." The proposed rule does not identify, however, the details of the content that a contractor will have to report.

The allowability of IR&D costs has had a tortured history. The National Defense Authorization Act for Fiscal Year 1991 imposed a ceiling on the allowability of IR&D costs for companies recovering IR&D and bid and proposal (B&P) costs exceeding $7 million through government contracts. Such contractors were to accomplish the ceiling by negotiating an advance agreement; the failure to initiate negotiation of the required advance agreement before the end of the fiscal year for which the agreement was required would render the costs unallowable.

The National Defense Authorization Act for Fiscal Years 1992 and 1993 applied limitations to the allowability of IR&D costs by "major contractors" to a specified formula. By the late 1990s, IR&D costs were allowable to the extent they were reasonable and allocable.

DOD regulations, however, have continued to condition the allowability of IR&D costs charged to DOD contracts to "projects that are of potential interest to DOD."

After the relaxed FAR rules, the government launched a series of challenges to the allowability of IR&D based on the concept that a cost was "required in the performance of a contract," and thus not allowable IR&D, when the effort was implicitly required to perform a contract, but the U.S. Court of Appeals for the Federal Circuit resolved that matter to mean "specifically required by the provisions of a contract." The current, proposed rule, seeks to tighten the allowability of IR&D costs again.

The DOD states that the reporting requirements are "mandated by 10 U.S.C. 2372," however the reporting requirements are permissive. Moreover, the requirement to disclose the information to the DCAA, which has been gaining more and more authority (actual or presumptive) over the past years, will likely present contractors with greater challenges to the allowability of IR&D costs.

One should question whether a local DCAA auditor should have authority to assess the propriety of an IR&D project when determining the allowability of IR&D costs. The proposed rule portends more allowability questions for defense contractors.

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