The Defense Federal Acquisition Regulation Supplement (DFARS) 231.205-18 identifies Independent Research & Development (IR&D) as an allowable expense provided that the IR&D costs are allocable to a contractor’s cost objectives and that the efforts are of potential interest to the Department of Defense (DoD). However, recent regulatory actions have increased the administrative hurdles contractors must jump over for their IR&D costs to be allowable.

One of these regulatory actions is in the form of a DFARS Final Rule that was issued on November 4, 2016. This Final Rule expands upon the requirements of DFARS 231.205-18 and establishes a prerequisite for the subsequent determination of whether IR&D costs are allowable. According to the prerequisite, for IR&D projects initiated in the contractor’s fiscal year 2017 and later, contractors are required to hold “technical interchanges” with the DoD prior to generating IR&D costs. This interchange is to be conducted with a “technical or operational DoD Government employee” or with the Office of the Assistant Secretary of Defense for Research and Engineering (OASD R&E) if the contractor does not have a point of contact at the DoD. Additionally, the details of this interchange must be documented in the Government’s Defense Technical Information Center (DTIC) database, along with the standard information that is still required to be reported. Per the revised cost principle, the purpose of the technical interchange is so “the contractor plans and goals for IR&D projects benefit from the awareness of and feedback by a DoD Government employee who is informed of related ongoing and future potential interest opportunities.”

As mentioned above, the Final Rule stated the interchange must occur prior to generating the IR&D costs. However, on December 1, 2016, the Director, Defense Procurement and Acquisition Policy issued a class deviation to alleviate this requirement for IR&D projects that are initiated in the contractors’ fiscal year 2017. The class deviation indicated it would allow contractors a phase-in period to develop policies and procedures on how to comply with the Final Rule.

A potential saving grace for certain contractors is that the technical interchange required by the Final Rule is only applicable to “major contractors.” For the purposes of the Final Rule, the DFARS defines a major contractor as a contractor whose covered segments allocated a total of $11 million or more in IR&D and Bid and Proposal during the preceding fiscal year.

The Government has indicated the additional requirements added by this November 2016 Final Rule were driven by the IR&D initiative included in the Better Buying Power (BBP) 3.0, which sought to increase the productivity, efficiency and effectiveness of the DoD’s acquisition, technology and logistics efforts. Additionally, the Government indicated these requirements will result in IR&D performers and their Government customers being aware of each other’s efforts and will provide an opportunity for the Government to give feedback to industry.

While the DoD claims that the rule was not issued to restrict the use of IR&D, it is hard to imagine that placing new prerequisite requirements on the determination for allowability of such costs as doing anything else. Many of the comments on the new rule, when initially proposed, expressed concerns in how the new requirements would limit or de-incentivize contractors from pursuing paradigm shifting technologies and focus more on “pre-approved” department priorities. Such comments are especially concerning at a time when the Under Secretary of Defense, Acquisition, Technology and Logistics has indicated “our technological superiority is at risk and we must respond.”

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1. DFARS 231.205-18 (c)(ix)(A)
2. DFARS 231.205-18 (c)(ix)(C)(4)
In addition to this Final Rule, on November 4, 2016, the DoD also issued a proposed DFARS rule (DFARS Case 2016-D017)\(^4\) which aims to ensure that substantial future independent research and development expenses are evaluated in a uniform way during competitive source selections. This proposed rule is only applicable to solicitations for major defense acquisition programs and major automated information systems, but the potential changes this rule seeks to implement are significant for contractors involved in such programs. The proposed rule intends to add a new clause to DFARS 252.215-70XX titled “Notification of Inclusion of Evaluation Criteria for Reliance Upon Future Government-Reimbursed Independent Research and Development Investments,” which will require contractors to identify in their proposals the amount of future IR&D they plan to use to meet the requirements of the proposal. Additionally, the proposed rule modifies DFARS 215.305 – Proposal Evaluation, to require contracting officers to adjust (i.e., increase) the total evaluated cost or price, for evaluation purposes only, to include the contractor’s planned IR&D investment that is related to the resultant contract.

The third regulatory action impacting IR&D is Section 824 of the 2017 National Defense Authorization Act (NDAA), which outlines requirements that will impact how contractors account for IR&D. Section 824 requires DoD to establish regulations that will require IR&D to be reported separately from other allowable indirect costs. Furthermore, this section requires the Defense Contract Audit Agency (DCAA) to include in its annual report the dollar and percentage amount of IR&D incurred by contractors in the prior fiscal year. Regulatory actions to implement Section 824 of the 2017 NDAA have already commenced with the DoD having established a DFARS Case to address the changes (DFARS Case 2017-D018).

**How EY can help**

It is increasingly becoming more important for defense contractors to support the allowability of their IR&D costs. The November 2016 Final Rule amending DFARS 231.205-18 and pending regulatory changes are sure to generate numerous questions for defense contractors. These include questions related to how technical interchanges will occur, the information that must be shared during the technical interchanges, and who contractors should contact to schedule the interchanges. These questions will undoubtedly become more profound as cognizant contracting offices begin to adapt their determinations of potential interest of contractor IR&D efforts to include the technical interchange. Finally, it is only natural to expect additional audit scrutiny of IR&D costs, particularly during the course of the forward pricing and incurred costs audits for indirect cost years starting in FY 2017.

EY Government Contract Services (GCS) professionals are available to assist clients with addressing these challenges and developing an approach to comply with the additional IR&D requirements. In addition, EY GCS will continue to monitor the open DFARS cases and will keep clients updated of the potential changes and associated impacts as these rules as they become final.

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