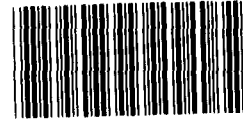


National Security and  
International Affairs Division

B-224782



148196

December 23, 1992

The Honorable Sam Nunn  
Chairman, Committee on  
Armed Services  
United States Senate

The Honorable John Glenn  
Chairman, Committee on  
Governmental Affairs  
United States Senate

The Honorable Les Aspin  
Chairman, Committee on  
Armed Services  
House of Representatives

The Honorable John Conyers, Jr.  
Chairman, Committee on  
Government Operations  
House of Representatives

Section 2324 of title 10 U.S.C. requires us to evaluate and report on substantive changes to the Department of Defense's (DOD) regulations concerning allowable costs on covered defense contracts. The purpose of this letter is to report on recent regulatory changes.

The regulatory changes are published in the Federal Register as revisions to the Federal Acquisition Regulation (FAR) and the Department of Defense Federal Acquisition Regulation Supplement (DFARS). On September 24, 1992, a FAR cost principle revision on independent research and development/bid and proposal (IR&D/B&P) costs, making these costs allowable as indirect costs on contracts to the extent that the costs are

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allocable and reasonable, was published in the Federal Register. A DFARS revision supplementing the FARS revision was published on November 12, 1992. These regulatory changes implement provisions in the National Defense Authorization Acts for Fiscal Year 1991 and for Fiscal Years 1992 and 1993.

#### RESULTS IN BRIEF

The revisions to the IR&D/B&P cost principles appear to be consistent with the intent of the recent legislation. Much of the language of the legislation is contained in the regulations. The increases to the maximum allowable IR&D/B&P costs should reduce the problem of contractors misclassifying these costs.

In view of the potential for a large increase in allowable IR&D/B&P costs charged to government contracts, there is a need to closely monitor the implementation of these regulatory changes and assess their impact.

DOD has agreed to have the Defense Contract Audit Agency continue its annual report on contractor IR&D/B&P expenditures and reimbursements, as recommended in our September 1992 report.<sup>1</sup> In addition, the Office of Technology Assessment (OTA) will report on whether the IR&D/B&P regulatory revisions are achieving the policy goal of encouraging contractors to invest in research and development activities of potential interest to DOD. The OTA report is required by the National Defense Authorization Act for Fiscal Years 1992 and 1993 to be issued not later than December 1, 1995. This information should help DOD and Congress assess the impact of the regulatory changes.

#### BACKGROUND

DOD, the General Services Administration, and the National Aeronautics and Space Administration, working through the FAR Secretariat, published a final FAR rule governing IR&D/B&P costs (FAR 31.205-18) in the Federal Register on September 24, 1992. On November 12, 1992, DOD published a DFARS cost

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<sup>1</sup>Government Contracting: Proposed Regulation Would Limit DOD's Ability to Review IR&D/B&P Program (GAO/NSIAD-92-265, Sept. 24, 1992).

principle revision on IR&D/B&P costs, which supplements this FAR rule. The FAR and DFARS revisions implement section 824 of the National Defense Authorization Act for Fiscal Year 1991 and section 802 of the National Defense Authorization Act for Fiscal Years 1992 and 1993.

The FAR cost principle gradually makes IR&D/B&P costs allowable as indirect costs on contracts to the extent that the costs are allocable and reasonable. For the contractor's three fiscal years beginning on or after October 1, 1992, allowable IR&D/B&P costs of major contractors (those whose covered segments allocated a total of more than \$10 million in IR&D/B&P costs to covered contracts during the preceding year) may not increase by more than 5 percent each year, adjusted for inflation. However, this restriction may be waived if necessary to ensure that the contractor's allowable costs are at least the same amount that would have been allowed before enactment of the National Defense Authorization Act for Fiscal Years 1992 and 1993, or when it is in the best interest of the government. After the 3-year period, all IR&D/B&P costs will be allowable as overhead costs.

The fiscal year 1991 legislation raised the thresholds for requiring certain large contractors to negotiate annual advance agreements on IR&D/B&P costs. The fiscal years 1992 and 1993 legislation eliminates the requirement for advance agreements, effective with the contractor's first fiscal year beginning on or after October 1, 1992. Even though advance agreements are no longer required, DOD officials believed it necessary to include the revised thresholds in the FAR in order to implement the 1991 legislation.

For non-major contractors, the IR&D/B&P costs are allowable as indirect expense on contracts to the extent that they are allocable and reasonable. The FAR rule also authorizes the use of certain cooperative arrangements to conduct IR&D activities.

The DFARS cost principle revision prohibits departments or agencies from supplementing the regulation in any way that limits IR&D/B&P cost allowability. The rule adds some additional limitations on reimbursable costs for major contractors, including the requirement that the contractor's IR&D/B&P activities must be of potential interest to DOD, with the regulation listing the seven types of activity specified

in the legislation. However, the total maximum allowable amount limitation may be waived at a level above the contracting officer. The regulation states that this may be appropriate for contractors whose significant growth in sales or IR&D/B&P spending justify higher levels of reimbursement. The cognizant contract administration office is responsible for providing contractors guidance on the type of financial and technical information needed to support IR&D/B&P costs and the determination of potential interest to DOD.

IR&D/B&P COST PRINCIPLES REVISIONS CONSISTENT WITH  
INTENT OF THE DEFENSE AUTHORIZATION ACTS

The revisions to the IR&D/B&P cost principles appear consistent with the intent of the defense authorization acts, with much of the language of the acts contained in the regulations. Our review indicates that the increases to the maximum allowable IR&D/B&P costs should help reduce the problem of contractors misclassifying these costs. For example, some contractors had improperly classified IR&D/B&P costs as manufacturing and production engineering costs.

MONITORING IMPLEMENTATION OF THE CHANGES

The cost principle revisions are intended to foster increased research and development by contractors at a time when the overall defense budget is expected to decline. In view of the potential for large increases in allowable IR&D/B&P costs resulting from the revisions, it is important that controls be in place to monitor the implementation of these regulatory changes and assess their impact.

Need for Information From  
Contractors on IR&D/B&P Programs

The revisions to implement section 802 of the National Defense Authorization Act for Fiscal Years 1992 and 1993 contain a general requirement for annual reporting on the IR&D/B&P program. However, the revisions are vague as to the specific types of statistical information that should be reported. Thus, in September 1992, we recommended that the Defense Contract Audit Agency, which had discontinued its annual financial report on IR&D/B&P, continue to prepare the report. DOD agreed with our recommendation. The Defense Contract Audit Agency expects to report fiscal 1992 data in March 1993.

Under DFARS, the cognizant contract administration office is to provide contractors with guidance on the technical information needed from them to support the potential interest to DOD as well as the financial information needed to support the IR&D/B&P costs. A DOD official told us that DOD has provided draft guidance to the field contract administration offices on the required information and is currently finalizing this guidance.

In addition, the Director, Defense Research and Engineering (DDR&E), is responsible for establishing a regular method for communication (1) from DOD to the contractors, of timely and comprehensive information regarding planned or expected DOD future needs, and (2) from contractors to DOD, of brief technical descriptions of contractor IR&D projects. DDR&E issued Guidelines for Contractor Communication of IR&D Technical Information in July 1992. This information is key, in our opinion, to assuring that there is an effective match between DOD needs and contractor IR&D/B&P projects.

#### Evaluating Results of FAR Changes

The National Defense Authorization Act for Fiscal Years 1992 and 1993 requires the Director of OTA to conduct a study to determine whether the IR&D/B&P regulatory revisions are achieving the policy goal of encouraging contractors to invest in research and development activities of potential interest to DOD. The report, to be issued not later than December 1, 1995, should provide Congress with information needed to help assess the impact of the legislation and the continuing need for full reimbursement of contractor IR&D/B&P costs.

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We are sending copies of this letter to the Secretary of Defense, Director of OTA, and the Director of the Defense Contract Audit Agency.

This letter was prepared under the direction of Paul F. Math, Director, Research, Development, Acquisition, and Procurement Issues, who may be reached on (202) 275-4587 if you or your staff have any questions. Other major contributors to this letter were Charles W. Thompson and Carol S. Markson.



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GAO/NSIAD-93-99R IR&D/B&P Cost Principle Revisions