Accounting for Independent Research & Development (IR&D or IRAD) expenses is hard to do. There's a cost principle (31.205-18) that discusses the allowability of such costs, but that cost principle also discusses the allowability of Bids & Proposals (B&P) costs. IR&D and B&P expenses are treated similarly, but they are not the same. So the first thing to do is to parse out what parts of 31.205-18 apply to which expenses.

When you do that, you get a definition of the kinds of activities that qualify as IRAD expenses. But that's not the end of the story, not by a long shot. At that point, the cost principle points you to CAS 420 and tells you that you need to comply with that Standard in order for your IRAD costs to be allowable. (This is a news flash to many small businesses that think they are exempt from CAS. If they have a cost-type contract that belief is (unfortunately) not true.)

IRAD expenses are "period" expenses, which means that in almost every circumstance they will be accounted for as "below the line" costs in the fiscal year in which they are incurred.

At its most fundamental level, proper IRAD accounting requires compliance with the requirements of both 31.205-18 and CAS 420. But that's not the end of the story, not by a long shot. Because what about concurrent IRAD and contract work, where the end product of a successful IRAD project will be a technology that will be inserted into an active contract? You need to separate the two cost streams (direct contract work and IRAD work) for both financial reporting and government contract accounting purposes. That can get messy, to say the least.

You need to keep the costs separate because (as noted) IRAD expenses are period expenses, but direct contract costs are "costs of goods sold" or "costs of sales" which is something entirely different. Moreover, for government cost accounting purposes IRAD costs are recovered through the General & Administrative (G&A) expense rate whereas direct contract costs are recovered by charging them to the contract as incurred, dollar for dollar. It makes a difference; it makes a big difference.

And then you have manufacturing and production engineering costs, which are similar to IRAD costs but not IRAD. Take a look at the 31.205-25 cost principle (which almost nobody does because that's one of those cost principles that you don't need to know, until you *really* need to know it). That cost principle defines manufacturing and production engineering costs as (among other things) "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." The development of new stuff sounds a lot like IRAD (that would be the "development" part of independent research and development), but in this case it's not, because it's manufacturing and production engineering costs. Generally speaking, such costs are charged to overhead, but there is also the possibility that they could be capitalized and amortized ratably over future years in accordance with the depreciation cost principle at 31.205-11. The key thing is that they are not subject to CAS 420 and they are not recovered through the G&A expense rate, so you need to keep them separate from IRAD expenses.

So now we have direct contract costs and we have overhead costs and we have G&A costs—and we could maybe have capital assets on the balance sheet—and the poor contractor is expected to keep all that straight and separate, even though the activities all kinda sorta look alike and may well be performed by the same people. It's hard, *surprisingly hard*, to get this right. It's easy to mistake one thing for another, especially if you are an engineer working on a complex development project that involves new tooling and new technology and some contract required stuff, and you have three or four charge numbers but you don't have solid direction about which part of the complex development activity goes where. That situation can create inadvertent mischarging, which could be a problem if the mischarging is systemic and you have a large number of engineers putting the wrong hours to the wrong charge number, and the streams of costs, which are supposed to be kept separate, get crossed and you have direct costs in the IRAD costs or overhead costs in the IRAD costs. That's a bad situation because, if that happens, from a financial reporting perspective you have screwed up your cost of sales and your period expenses.

But even worse than that is that, from a government contract cost accounting perspective, you have too many costs in your G&A expense pool and not enough costs in your G&A expense allocation base, which is a double-whammy that really jacks up the G&A expense rate higher than it should have been. (Mathematically you have increased the numerator while at the same time decreasing the denominator, which is really going to increase the resulting rate.)

Jacking-up your G&A expense rate is *really* bad news if you have been billing that jacked-up G&A expense rate to your government customers on cost-type contracts, and also using that jacked-up G&A expense rate in your cost proposals for firm, fixed-price contracts. In the former case you have billed more than you should have billed, and in the latter case you have bid more than you should have bid.

If the Government believes that you have jacked-up your G&A expense rate by failing to keep the separate activities separate and crossing the streams, and that your failure was large enough and systemic enough to warrant an allegation of “reckless disregard” or “deliberate ignorance” then you may well face charges that you violated the False Claims Act.

Which is very bad news indeed.

Which brings us to a recent Department of Justice **press release** , in which we learned that Sierra Nevada Corporation (SNC) recently paid $14.9 million to settle allegations that it violated the False Claims Act by “misclassifying certain direct contract costs and Manufacturing and Production Engineering costs as Independent Research and Development (IR&D) costs, and charging certain IR&D costs in the wrong cost accounting period.” According to the DOJ, "this improper characterization of costs artificially inflated General & Administrative overhead (*sic*) rates paid to SNC across its federal contracts and resulted in overcharging federal agencies.”

Okay, $14.9 million is a decent amount of money. But before you judge SNC, consider just how hard it is to get all this stuff correct. Consider how hard it is for that engineer in the lab to figure out which charge number goes with which part of their complex activities.

It is hard to do. Accounting for IRAD is a surprisingly difficult job.

But it (obviously) pays to take the necessary pains to get it right.