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Decisions

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Software Development Costs Lacked Sufficient Nexus To Government Contract

Teknowledge Corp. v. U.S., 2009 WL 57014 (Fed. Cl. Jan. 7, 2009)

Because the contractor did not establish the necessary nexus between a Government contract and indirect costs related to software development, the costs did not meet the Federal Acquisition Regulation test for allocability, the U.S. Court of Federal Claims held.

Teknowledge Corp., an Internet-transaction company, provides services involvingsecure transactions and "processing application knowledge." In 1999, Teknowledge began developing the TekPortal software program, intending that the company's commercial and Government customers would use it.

Teknowledge's commercial segment includes the operating unit that oversaw the TekPortal program, and Teknowledge accumulated the overhead for that operating unit in its commercial overhead pool. The Government segment included four operating units that performed Government contracts, mostly for Navy research and development.

In 2001, as its accounting practices required, Teknowledge amortized $885,000 in costs for TekPortal and charged 31 percent to the Government segment overhead pool. The remaining costs were charged to commercial overhead. According to Teknowledge's counsel, these percentages matched the respective revenue or hours worked in the two segments.

Although Teknowledge proposed TekPortal in response to three Government requests for proposals from 2001 to 2005, the Government never purchased the program, and none of the company's Government contracts used the TekPortal technology. The contracting officer disallowed the costs, and Teknowledge appealed to the COFC.

FAR 31.201-1(b) permits a contractor to charge costs to a Government contract if they are allocable and allowable under FAR pt. 31 and applicable agency supplements. Allocability, an accounting concept, involves relationships between incurred costs and contracts to which these costs are charged. It depends on a sufficient nexus between the costs and a contract. *Boeing N. Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002) (hereinafter "*BNA*").

A cost is allocable to a Government contract if it is "assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship." To be allocable, a cost must meet one of three tests: it (1) is incurred specifically for a contract; (2) benefits contracts and other work, and can be distributed to them in reasonable proportion to the benefit received; or (3) is necessary to the overall operation of the business, although a direct relationship to a particular cost objective cannot be shown. FAR 31.201-4.

Under FAR 2.101, a cost "identified specifically with a particular final cost objective" is a direct cost, and the first prong of the allocability test requires a contractor to charge that cost to a contract. If costs are "specifically identified with other final cost objectives, they are to be treated as direct costs of those other cost objectives and not to be charged to the specific contract in question," the COFC said, citing FAR 31.202(a).

In contrast, 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 with at least one intermediate cost objective." FAR 2.101. To be allocable to the Government, an indirect cost must meet prong two or three of the allocability test.

TekPortal development costs included labor, applied overhead and fringe related to producing the software and "incurred by Teknowledge post technological feasibility." Teknowledge stated that the costs did not relate to a specific purchase order or contract. Instead, they "resulted from work done on speculation in anticipation of acquiring both government and commercial purchase orders and contracts." Teknowledge admitted that the overhead costs are not allocable as direct costs because Teknowledge did not contract with the Government to develop, use or provide TekPortal.

The COFC agreed, noting that overhead and fringe costs ordinarily are indirect costs. *Alliant Techsys. Inc. v. U.S.*, 74 Fed. Cl. 566 (2007); *Thermalon Indus., Ltd. v. U.S.*, 51 Fed. Cl. 464 (2002). In addition, Teknowledge did not incur the costs in developing TekPortal under a Government contract, so the costs were not "identified specifically with a particular final cost objective," as required under FAR 2.101.

Teknowledge contended that the development costs meet the second prong of the allocability test because they benefit contracts and other work, and can be distributed to them in reasonable proportion to the benefit received. According to Teknowledge, on a general level, the TekPortal development costs allow the company to remain viable by both developing software and performing Government contracts. On a specific level, the amortized costs allowed the commercial segment to absorb nearly $3 million in general and administrative (G&A) expense that otherwise would have been allocated to Government cost-reimbursement contracts.

The COFC rejected this argument. "Benefit" as defined in the allocability test "requires some showing that the cost relates to a Government contract, not that it promotes the Government's public policy interests," the COFC held, citing *BNA*.

Although courts broadly construe the requirement, a nexus must exist between the costs and some underlying Government contract, the COFC said. For example, in *KMS Fusion, Inc. v. U.S.*, 24 Cl. Ct. 582 (1991), the cost of governmental affairs consultants was allocable to a contract because the Government benefited generally by gaining information to use for procurement decisions. The contract benefited "in a specific sense" from reduced indirect costs as a result of successful marketing efforts.

Similarly, in *Lockheed Aircraft Corp. v. U.S.*, 375 F.2d 786 (Ct. Cl. 1967), property taxes assessed on the facilities plaintiff used to perform the contract were allocable "because the Government benefited on a general level from Lockheed's fulfillment of its responsibilities as a corporate citizen to the local community and, on a specific level, from the services Lockheed provided to the community." See also *Gen. Dynamics Corp.*, ASBCA 18503, 75-2 BCA ¶ 11,521 (bid and proposal expenses related to a tanker program were allocable to the underlying contract because they were "basic to appellant's viability as a commercial enterprise").

The benefits Teknowledge cited—the viability of the company and reduced indirect cost to the Government segment—did not connect the TekPortal program and a current Government contract. They are "too remote and insubstantial" to deem the costs allocable, the COFC held.

The COFC also concluded that the TekPortal development costs did not meet the third prong of the allocability test, which requires a benefit to Government work from a cost that is necessary to the overall operation of the contractor's business. Even under the third prong, a contractor must show a nexus to a Government contract. Teknowledge admitted that no such nexus exists and offered no evidence "explaining how TekPortal keeps Teknowledge afloat or will bring in new business in the future," the COFC held.

Finally, the COFC held that because the costs are not allocable, they are also not allowable.

✦ **Practitioner's Comment**—The *Teknowledge* case is puzzling. The COFC states that the contractor incurred the cost to "develop" a new software product in a commercial business unit of the company. There is a regulatory provision, FAR 31.205-18, concerning independent research and development (IR&D) costs, that seems to be directly relevant to the allowability of those development costs. FAR 31.205-18(a) defines "development" as "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." FAR 31.205-18 also incorporates by reference the provisions of Cost Accounting Standard 420, 48 CFR § 9904.420, concerning the assignment and allocation of IR&D costs to contracts. IR&D costs are allowable if they are not required in the performance of a contract or grant, provided that they are measured, assigned to accounting periods and allocated to contracts in accordance with CAS 420. CAS 420 thus applies to all contractors, even those not otherwise covered by CAS requirements.

The costs at issue in *Teknowledge* as described in the decision sound like IR&D costs, but apparently neither party characterized them as IR&D, and there is no suggestion in the decision that the COFC was made aware by the parties that the FAR and CAS provisions concerning IR&D might be relevant to its decision.

Under the provisions of CAS 420, IR&D costs must be collected by project. 48 CFR § 9904.420-40(a). In addition to labor and material costs incurred specifically for the IR&D project, all allocable costs other than G&A expenses must be included in the project costs. 48 CFR § 9904.420-40(b). If the IR&D costs incurred by a single business unit benefit multiple business units, the IR&D costs may be allocated to the benefiting business units on the same basis that the contractor uses to allocate residual home office costs to its business units. 48 CFR § 9904.420-50(e)(2) and (f)(1). Within each business unit, IR&D costs must be allocated to cost objectives on the same basis that the business unit uses to allocate G&A expenses. 48 CFR § 9904.420-50(f)(2). Except in unusual circumstances, IR&D costs must be assigned to the year in which they are incurred; they may not be capitalized and deferred to future periods. FAR 31.205-18(d); 48 CFR § 9904.420-40(f)(2).

In simple terms, CAS 420 requires that material and labor costs incurred for a specific IR&D project must be charged to that project. Those "direct"-type costs must also be included in the allocation base for the appropriate indirect costs. All indirect costs other than G&A that would be allocated to the IR&D project if it were a contract must be included in the IR&D project costs. For example, if the contractor allocates overhead costs on the basis of direct labor, the labor incurred on an IR&D project must be included in the allocation base for overhead, and an appropriate share of overhead expense must be allocated to the IR&D project. If the project benefits multiple business units, all costs included in the IR&D cost pool must be allocated to other business units in accordance with CAS 420. The IR&D costs allocated to each business unit must be allocated to contracts either as G&A expenses—the most common practice—or in a separate pool that is allocated on the same basis as G&A.

As the facts are described in the *Teknowledge* decision, it appears that the contractor charged all of the costs at issue as "overhead expenses" in one commercial business unit. If true, that appears to violate the CAS 420 requirement that IR&D costs be collected by project and burdened with the appropriate overhead costs, rather than treated as overhead. If the contractor charged the costs as overhead, the "direct" labor and material costs associated with the IR&D project would presumably not have been included in the allocation base for overhead and would presumably not have been burdened with overhead. If so, the contractor would have understated the amount claimed as development costs because it probably would have claimed the IR&D project's "direct" labor and material costs without their allocable shares of overhead. Although the decision refers to costs "amortized" by the contractor, which suggests that the costs were deferred from prior accounting periods, "amortized" may be inaccurate; to say that the contractor allocated the costs might be more accurate. If the costs were amortized, other issues under CAS 420 and the FAR would arise because deferral of IR&D costs typically is not permitted. There is no indication in the decision that the development costs were charged on the same basis as G&A, as required by the regulations.

The issue addressed by the COFC in *Teknowledge* was not whether the costs were properly measured, although there are several potential issues about cost measurement. Instead, the issue was whether the contractor could charge the development costs incurred in its commercial business unit to its Government contracts. CAS 420 permits contractors to allocate IR&D costs among multiple business units that benefit from the IR&D costs on the same basis contractors use to allocate residual home office costs to those business units. Because this contractor has multiple business units, it likely has a home office and an established practice concerning the allocation of home office costs to its business units. Under CAS 420, the contractor should have used such a practice to allocate IR&D costs among the benefiting businesses. It is impossible from the factual description in the case to determine whether the basis on which the contractor allocated the costs at issue was the same as the basis it used to allocate residual home office costs.

The key issue in the case, however, is whether the costs were allocable to Government contracts. Apparently neither party cited CAS 420 or the FAR provisions concerning IR&D costs, but CAS 420 requires that IR&D costs be allocated to business units that "benefit" from the IR&D costs. The question is what "benefit" means for an IR&D cost. The COFC, relying on the provisions in FAR 31.201-4 concerning allocability, considered three tests for identifying costs that "benefit" Government contracts and found that the costs at issue are not allocable under those provisions. Would the COFC have reached a different conclusion if it had applied the IR&D regulations?

By definition, IR&D may not be "sponsored by" or "required" in the performance of any existing contract or grant, so, by definition, IR&D is never incurred specifically for a contract, the first test identified by the COFC under the FAR. It is also improbable that IR&D would be allocable because it benefits existing contracts in some measurable way, which is the second test. IR&D is directed to the development of new products and typically has no immediate benefit on existing contracts. If IR&D is allocable, it is allocable under the third FAR test cited by the COFC: it is allocable because it is "necessary." Businesses that do not develop new products or improvements to existing products do not survive for long. IR&D is allocable because it is "necessary" to the survival of any business, as Teknowledge argued. If the costs at issue had been incurred by the contractor's Government contracts business unit, they probably would have been "necessary" and allowable. The real issue is whether a sufficient nexus exists between the development expenses and the contractor's Government contracts business to justify charging a portion of the costs to its Government contracts.

Teknowledge relies on the analysis of "benefit" in *BNA*, the leading decision in a long line of cases about the meaning of "benefit" for Government contracts. *Teknowledge* seems to impose a more restrictive reading of benefit than the *BNA* decision would justify if the costs at issue were IR&D. In *BNA*, the contractor incurred legal expenses to defend a shareholder's derivative action. The Armed Services Board of Contract Appeals upheld the Government's disallowance of the costs because the legal fees at issue could not possibly have "benefited" the Government because they related to a series of situations involving what might broadly be described as wrongdoing by the contractor's predecessor. The U.S. Court of Appeals for the Federal Circuit reversed the ASBCA, with the following explanation of "benefit":

> Thus, we agree with Boeing that allocability is an accounting concept and that CAS does not require that a cost directly benefit the government's interests for the cost to be allocable. The word "benefit" is used in the allocability provisions to describe the nexus required for accounting purposes between the cost and the contract to which it is allocated. The requirement of a "benefit" to a government contract is not designed to permit contracting officers, the Board, or this court to embark on an amorphous inquiry into whether a particular cost sufficiently "benefits" the government so that the cost should be recoverable from the government. The question whether a cost should be recoverable as a matter of policy is to be undertaken by applying the specific allowability regulations, which embody the government's view, as a matter of "policy," as to whether the contractor may permissibly charge particular costs to the government (if they are otherwise allocable).

BNA, 298 F.3d at 1284. *Teknowledge* relies on the principle that "the allocability test requires some showing that the cost relates to a government contract." That test imposes a virtually insurmountable burden on contractors for IR&D costs, and it seems inconsistent with both *BNA* and relevant regulations. Under the costs allowability rules applicable to Defense Department contracts like the ones apparently at issue in *Teknowledge*, the Government has made the kind of "policy" decision about allowability that the Federal Circuit had in mind in *BNA*. That regulation provides that IR&D is allowable if it is of "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.

Defense FAR Supplement 231.205-18(c)(B).

The development costs at issue in *Teknowledge* at least arguably meet the requirements for potential interest under several standards listed, particularly (6), concerning dual-use technologies. The software at issue was proposed on at least three occasions for use on Government contracts, which supports the argument that the costs were of potential interest to the Government and therefore allocable in part to Government contracts. Because the parties did not identify the costs at issue as IR&D costs, however, the COFC presumably was unaware of the existence of the DFARS provisions about IR&D activity that has a sufficient nexus to Government contracts to justify allocation of some portion of the costs to the Government. It is impossible to determine from the facts reported whether the ultimate decision about allowability is correct, but it is unfortunate that the COFC was not directed by the parties to the relevant regulatory standard.

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This Practitioner's Comment was written for The Government Contractor by* Terry Albertson, *a partner at Crowell & Moring LLP in Washington, D.C.