

Allocability Bites Contractor's GAAP-Compliant Accounting Practices

Written by Administrator
Thursday, 12 November 2009 00:00

The concept of "allocability" is a tough and counter-intuitive government contract cost accounting concept. The FAR discusses the concept of allocability at § 31.201-4.

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

(a) Is incurred specifically for the contract;

(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

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(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

Government accountants talk about “full absorption cost accounting,” where both fixed and variable costs are allocated to contracts to arrive at total contract costs. However, case law is clear that certain costs are not allocable to government contracts. As the Court of Appeals, Federal Circuit, has noted, “The test for allocability is whether a sufficient ‘nexus’ exists between the cost and a government contract.” (Boeing N. Am., Inc. v. Roche, 298 F.3d 1274, 1280 (Fed. Cir. 2002), citing Lock
heed Aircraft Corp. v. United States
, 375 F.2d 786, 794 (Ct. Cl. 1967)).

Teknowledge Corporation ran into this conundrum in the development of its TekPortal software program. Even though it adhered to [SFAS No. 86](#) (“Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed”), the costs it attempted to allocate to its government contracts via its indirect costs were disallowed by the DCMA Contracting Officer. The U.S. Court of Federal Claims (COFC) and the Court of Appeals upheld that disallowance because the software development costs were deemed “not allocable” to Teknowledge’s government contracts.

According to the [COFC decision](#), Teknowledge had two segments: one for its government contracts (consisting primarily of R&D contracts for the U.S. Navy) and one for its commercial work. The commercial segment oversaw development of the TekPortal software; however, the company intended that the government would use the software and, indeed, proposed that software on three proposals to the government over a four-year period. In 2001, the company amortized \$885,430 in development costs and prorated that amount between the two segments, with 31 percent (\$285,656) of that amount being recorded in the overhead pool of its government segment. Teknowledge was unclear on how it arrived at that percentage, telling the

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court that the company “arrived at these percentages based on either the historical division of revenue generated by the Commercial and Government segments or by headcount hours worked by employees in the two segments.” Regardless of the methodology used, the DCMA Contracting Officer disallowed the costs because there was no discernable benefit to Teknowledge’s existing government contracts.

Teknowledge argued before the COFC that the costs were allocable because they: (1) benefited the government and could be distributed to the government in reasonable proportion to the benefit received; or (2) were necessary to the overall operation of its business. Citing prior cases (e.g., *KMS Fusion, Inc. v. United States*, 24 Cl. Ct. 582, 589, 591 (1991)), Teknowledge argued that a potential increase in business or the reduction of indirect costs to a contractor qualify as benefits to the government. The Court was not impressed, stating that “[t]he word ‘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 Court cited *FMC Corp. v. United States* (853 F.2d 882, 886 (Fed. Cir. 1988) for the proposition that remote and insubstantial benefits to the government do not meet the requirement of a benefit. The Court found that any benefit to the government resulting from the TekPortal development costs would be too remote and insubstantial to deem them allocable. Because the costs were not allocable, the Court found that they were not allowable.

On appeal, the Appellate Court (Federal Circuit) [agreed](#) with the Court of Federal Claims. According to the case—

Teknowledge argues it has satisfied the allocation requirement by its distribution of the developmental costs to various government contracts based upon potential future sales. According to Teknowledge, the fact that such sales never came to fruition is not relevant to the allocation. Similarly, Teknowledge argues that potential benefits to the government from the

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TekPortal software are sufficient to satisfy FAR § 31.201-4(c). The potential benefits that Teknowledge points to include its ability to execute its business plan and remain viable by performing government contracts and developing software.

Although (as the Appellate Court noted) "CAS does not require that a cost directly benefit the government's interests for the cost to be allocable," it found that "Teknowledge has failed to demonstrate a nexus between its software development costs and any government work that it has contracted to do."

As the Court found—

Given that Teknowledge's costs resulted from work done in anticipation of acquiring government purchase orders and contracts, the Claims Court properly found that any benefit from the development of the TekPortal software to any government work would be remote and insubstantial. ... We also reject Teknowledge's argument that a sufficient nexus exists between the costs and its government work because its software development costs are indirect, not pertaining to a specific contract, but are allocable under various CAS provisions to the different contracts that it has with the government. As the government points out, there are no underlying government contracts that are in any way related to the TekPortal software that would allow Teknowledge to properly allocate these indirect costs under any accounting standard. Moreover, the Claims Court found that Teknowledge has proffered no evidence to show how TekPortal keeps Teknowledge afloat or will bring in new business in the future. The Claims Court therefore did not err in concluding that Teknowledge had failed to show any nexus between the TekPortal development costs and any government contract. Our decision in Boeing does not mandate a different result.

Commenters have expressed [concern](#) with this result. As one knowledgeable law partner wrote—

The court's analysis under FAR 31.201-4(b) does not bode well for Government contractors. IR&D ought not need to succeed in the actual delivery of a Government contract in order for it to benefit the Government or any individual Government contract. If that is the rule, IR&D becomes a literal game of chance in which downstream, after-the-fact success becomes determinative of allocability. This can most assuredly have a chilling effect on the willingness of companies to invest in 'dual use' technologies for which success in the Government marketplace is less than assured.

We are not as worried. As the Appellate Court noted, Teknowledge failed to show how its TekPortal software "would bring in new business in the future"—leaving the door open for another contractor to make that demonstration. Moreover, Teknowledge didn't accumulate the costs in its government segment, nor did it offer a compelling rationale for its allocation of 31 percent of the amortization to the government segment. It didn't demonstrate compliance with Cost Accounting Standard (CAS) 420 (48 C.F.R. § 9904.420). Finally, it didn't demonstrate any relationship between performance of its current Navy contracts and the TekPortal software, nor did it demonstrate how the TekPortal software reasonably related to the Navy's current or future mission requirements. In sum, although the Court's continued insistence on a "bright line" allocability "test" should concern all government contract cost accountants, another contractor with a stronger fact pattern might well prevail.

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