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## DCAA Audit Guidance on Insurance Industry Settlement Agreements and Potential Credits Due on Government Contracts

On August 31, 2007, DCAA's Memorandum for Regional Directors (MRD) was issued as an audit alert pertaining to settlement agreements involving the Attorney General for New York and several insurance brokerage firms. DCAA's interest in these settlements is not within the headlining restitution amounts (as much as \$850 million), but within the fact that settlements specify that the brokers and insurers will also provide restitution to the policy holders (which will likely include some government contractors).

As properly noted in DCAA's MRD, this after-the-fact restitution will trigger FAR 31.201-5, "Credits". However, DCAA's MRD is carefully and specifically worded as "restitution available" to the contractors (as opposed to actual



refunds of previous insurance premiums). The implications for any contractor are a series of audit questions beginning with your history of insurance providers and for those whose history includes any of the specifically named brokers, more extensive audit inquiry in terms of refund applicability, actual refunds or efforts to proactively obtain any "restitution available".

If restitution may be available, an auditor can only expect reasonable actions to obtain the refund; however, the auditor cannot project and impute amounts not yet recovered. Once a refund is recovered or determined to be recoverable within a known timeframe, the other likely issue will be the amount of the credit allocable to government contracts.

Insignificant credits are typically a credit to current year overhead or G&A; however, large credits will almost

always involve the government's interest in a more precise determination of insurance costs actually absorbed by government contracts which will typically stimulate the debate over insurance costs as an element of price within firm-fixed price contracts. Considering all that goes with it for a government contractor, a large unexpected credit (after-the-fact) is analogous to a phone call that your distant cousin passed away and left you as the sole beneficiary to several million dollars; financially great news for both you and the government.

## Directly Associated Unallowable Costs

Cost Accounting Standard (CAS) 405 is the relevant contract criteria in terms of accounting for unallowable costs, including directly associated unallowable costs. In defining directly associated unallowable costs, the

basic rule has been the “but for” rule (i.e. the directly associated cost would not have been incurred but for the incurrence of the unallowable cost).

This seemingly straightforward rule was misapplied from day-1; hence, the well-known (at the time) memorandum issued in January 1977 by Arthur Schoenhaut, Executive Secretary of the CAS Board. Mr. Schoenhaut restated and re-emphasized the “but for” rule in responding to an inquiry from Dale R. Babione, Assistant Secretary of Defense wherein Mr. Babione expressed concerns over DCAA’s application of a common percentage of costs (e.g. fringe rate applied to unallowable salaries or use and occupancy costs prorated to unallowable “fractional” headcount). Mr. Schoenhaut specifically stated that directly associated costs were intended to cover only costs which were incremental with respect to identified unallowable costs. Travel and subsistence for an unallowable business entertainment trip served as the example of directly associated unallowable costs. In contrast, use and occupancy costs, except in the most unusual circumstances, would not pass the “but for” test.

What’s the significance of a 1977 memorandum in 2007? In August 2007, DCAA issued an MRD which re-emphasized audit planning to insure audit coverage of Washington Area Offices which “historically incurred expressly unallowable costs”. Although the MRD is silent with respect to directly associated costs, a January 2007 DCAA MRD emphasized the need for auditors to identify directly associated costs noting that unallowable lobbying costs may by association result in directly associated unallowable costs which “may include travel expenses, support staff labor and facilities costs”. Something of a déjà vu in as much as the activity which triggered the January 1977 CAS Board memorandum was DCAA’s application of fringe benefits rates and



use and occupancy rates to unallowable costs.

This simply reinforces that auditor judgment including that supported by an internal DCAA interpretation, is not always the correct interpretation of the procurement regulation.

## Training Opportunities

### Government Contract Accounting Systems Compliance

#### **Brief Synopsis:**

This course is designed to detail the components of a government contract accounting system and explain how an accounting system helps to ensure your compliance with government contracting rules and regulations.

#### **Presented by:**

Federal Publications Seminars

#### **Dates:**

December 11-12, 2007, Las Vegas, NV

#### **Instructors:**

Scott Butler and Mike Steen

Go to [www.fedpubseminars.com](http://www.fedpubseminars.com) and click on the Government Contracts tab

or call Beason & Nalley at 256.533.1720.

## Specialized Training

Beason & Nalley will develop and provide specialized Government contracts compliance training for client/contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Sandra Baker at [sbaker@beasonnalley.com](mailto:sbaker@beasonnalley.com), or at 256.533.1720.

## Future Newsletters

Beason & Nalley welcomes any feedback from the readers of this newsletter. We appreciate any suggestions that you may have as to future content, presentation and format, or interesting developments in the procurement community that would be of interest to our readers. Please provide any feedback or suggestions via our email address at [dwalker@beasonnalley.com](mailto:dwalker@beasonnalley.com).

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