

SELLER BEWARE: GOVERNMENT CONTRACTING AND THE TOTAL COST OF RISK

HOW FAR CAN YOU GO IN RECOVERING INSURANCE COSTS ON FEDERAL PROJECTS?

In challenging times, resourceful companies take on new challenges; one of these is federal work. At first blush, this seems a path worth taking since the federal government glows with the proverbial white light of hope for fresh work: dispensing stimulus funds, military procurements, state and local grants, cooperative incentives, and more. Expanding your business into the federal marketplace can be a lucrative endeavor with an indestructibly solvent buyer. Be warned, however, as winning a federal contract also means complying with laws, regulations and accounting systems profoundly unique to the government. The unwary may be ill-prepared for this new level of accountability.

For cost-sensitive or reimbursable contracts, many expenses that are negotiable within the commercial setting are predefined for federally procured work. Therefore, the issue is not one of negotiated compromise, but rather strict adherence to rules governing cost “allowability,” “reasonableness” and “allocation.” And insurance, self-insurance, and risk management allocations take up a decent amount of this rulebook.

A meaningful discussion on the rules, regulations, accounting standards and audit procedures could fill textbooks (and has). So we’re going to cut to the basics, keeping this *Blueprint* very general and almost dangerously abridged – almost.¹

FEDERAL PROCUREMENT

The U.S. government routinely enters into bi-lateral contracts for many things, including construction projects. These contracts come with rules and procedures authorized by an array of federal laws (the granddaddy of them all – The False Claims Act – dates back to the Civil War) broadly referred to by many as the *Federal Acquisition Regulation* (FAR). Though there are a number of FARs (and none to be ignored in practice), FAR’s purpose is to ensure purchasing procedures are standardized, consistent and conducted in a fair and impartial manner. The FAR is issued and



maintained jointly under the statutory authorities granted to the Secretary of Defense, Administrator of General Services and the Administrator, National Aeronautics and Space Administration.

Government contracts are different from commercial contracts in several important ways and contain provisions unique to the U.S. government. These include requirements for:

- Changing the scope of work
- Terminating contracts
- Making payments
- Conducting inspections, testing and acceptance of delivered goods and services
- Cost reimbursement, including costs associated with insurance and risk (most applicable to this discussion)



COST REIMBURSEMENT

The reimbursement of costs is governed by FAR *cost principles* and applies to:

1. Proposal pricing where cost and pricing data are required
2. Cost reimbursement type contracts
3. Pricing of change orders, even if the original contract is price-fixed under sealed bid

FAR does not generally apply to sealed, competitively awarded fixed price contracts as long as no ethical violations in the bidding process exist.

For purposes of cost reimbursement of insurance fixed costs, self-insurance loss costs and risk management costs and allocations, we will confine this discussion to two authoritative areas: 1) the FAR cost principles² and 2) the Cost Accounting Standards (CAS).³ Typically, CAS and FAR requirements are disclosed to contractors in a number of areas, including:

- Contract solicitation or Request for Bid documents
- Contract draft terms and conditions
- Representation and certifications
- Awarded contract references

Even if the original contract did not require application of FAR cost principles, subsequent change orders, cost reimbursement requests, equitable adjustment claims and/or termination clauses may subsequently require application of FAR cost principles.

Based on FAR, a cost must meet three tests to be recoverable. It must be 1) reasonable, 2) allowable and 3) allocable, directly or indirectly, to a specific contract.

INSURANCE COSTS AND “REASONABLENESS”

Under FAR, “a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a *prudent person in the conduct of a competitive business*.” Reasonable is based on various facts and circumstances and embraces themes such as “ordinary and necessary,” “generally accepted,” “sound business practices” and “arms-length.” Suffice to say, if the sum of insurance fixed costs, self-insurance losses and defense costs exceeds the market cost of first-dollar, guaranteed cost insurance for the same risks, then “reasonableness” has been violated.

INSURANCE COSTS AND “ALLOWABILITY”

FAR cost principles contain specific provisions for allowable insurance costs or risk of loss. Risk of loss is defined as required or approved insurance that may be either purchased insurance or self-insurance (including administrative expenses) or some combination of both. Self-insurance arrangements may require prior approval from the Administrative Contracting Officer. Please consider the following:

- Self-insurance means risk retention or risk assumption by the contractor, and includes deductibles or self-insured retentions, assuming reasonableness and allowability (as always).
- Self-insurance charges are costs based on *projected average loss (PAL)* under a self-insured plan and must be based on historical loss performance where loss projections did not vary significantly from actual development. PAL is a long-term measurement of per-period loss costs of comparable exposures. Actuarial measurement is an acceptable, even desirable, form of loss cost substantiation.
- If purchased insurance is available for a specific risk exposure, allowable self-insurance cost recoveries may be no greater than purchased insurance plus associated administrative expenses.
- Insurance provided by captives is considered self-insurance, especially in single-parent arrangements. Costs associated with group arrangements are reimbursable, but any credits or loss-cost savings accreting to the contractor’s experience accounts must be disclosed and adjustments made to the government as warranted. The cost of “fronting arrangements” is recoverable if reasonable.
- Cost of insurance to protect against loss or damage to government property is allowed if the contractor is liable. Costs are disallowed if losses are attributable to willful misconduct or lack of good faith by the contractor. Minor losses such as breakage, spoilage, petty theft, etc., that are incurred “in the ordinary course” of business are typically allowed.
- The cost of insurance, especially project-specific coverages, to protect the contractor against the costs of rework, defective materials or workmanship is not allowed. However, broad-based insurance programs to cover fortuitous or casualty losses resulting from defective materials or workmanship are allowed as long as the coverages are bound as part of the contractor’s normal annual business activities.
- Premiums associated with retroactive or backdated insurance to cover occurred and known losses are disallowed.

INSURANCE COSTS AND “ALLOCABILITY”

To be recoverable against a specific contract, a cost must be, as noted, reasonable and allowable, but also allocable to that contract. “A cost is allocable if it –

1. is incurred specifically for the contract;
2. benefits both the contract and other work (the contractor does during the period), and can be distributed (assigned) to them in reasonable proportion to the benefits received (by each activity); or,
3. is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (i.e., general and administrative overhead).⁷⁴

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In the simplest terms, costs are segregated between direct and indirect. If certain insurance costs relate to or provide benefit to just one contract, then a direct allocation or “charge” is made to that contract. On the other hand, if the cost provides benefits across several contracts or is a general and administrative (G&A) cost of the company, then it is an indirect cost and is subject to ‘logical groupings’ (fringe benefits, overhead, selling, etc.) before further allocation. Indirect costs should be allocated using a rate that is determined by a ‘base denominator,’ such as total project revenues for a given period and segment revenue.

The methodology of the allocation is important, since it must be supported on governmental audit which is typically performed by the Defense Contract Audit Agency (DCAA). Generally, direct costs are fairly straightforward since they are purchased or incurred on a specific project. Workers’ compensation, builders risk, environmental insurance and subcontractor default insurance may all be examples. Controlled Insurance Programs (OCIPs and CCIPs) are usually direct costs since projects are specifically enrolled and administered.

Indirect insurance costs might include home office workers’ compensation, property, general and professional liability, and directors and officers liability. The company’s master workers’ compensation program may very well be subject to indirect allocation and based on payroll/worker classification bases.

An important issue in the allocation process is consistency in the allocation methodology across the contractor’s historical and current project portfolio, particularly if the company uses operating ‘segments’ to perform governmental projects. Many companies will remit Disclosure Statements outlining allocation methodologies, especially if total governmental awards exceed \$25M for recent annual periods. These statements are filed with the Administrative Contracting Officer who typically forwards them to the DCAA. Any subsequent changes to a disclosed accounting practice will be subject to an impact analysis. Our advice? Be prepared.



FINALLY

This has been a general insight into the realm of government contracting. As forbidding as it may seem, contractors have been successfully working with the feds for generations. And with any new activity, the learning curve flattens over time as projects are awarded, completed, audited and accepted. Those that learn quickly will do well; the U.S. government pays its bills and prefers working with companies with a successful track record.

On the other hand, the government contracts playing field is littered with the bodies of well-meaning contractors, whose only fault was either a lack of competent understanding of the FAR regimen or sloppiness in accounting for costs (or both). The penalties for non-compliance can range from financial discomfort to debarment from governmental work to criminal action (though the government rarely executes offenders in this arena anymore). The best defense is always a good offense that includes:

- Competency with FAR and the governmental procurement regimen
- An accurate, thorough understanding of a project's performance risks so that a mispricing coupled with unforeseen FAR issues does not create an adverse financial outcome
- Sound and supportable costing systems and cost tracking procedures
- Cost oversight and operating controls that prohibit fraudulent activity both internally or by subs
- Stated and well understood company policies regarding contracting compliance, corporate ethics and problem resolution protocols that are not easily bypassed
- Clear and timely communication channels that include briefings with the highest levels of the company's management, including the Board of Directors
- Internal audit and work flow trails, documentation and record management
- Sound and generally accepted loss measurement activities, such as regular actuarial engagements, claim-handling and individual case reviews
- Maintaining good and productive communications with governmental Administrative Contracting Officers who liaise only with specifically authorized individuals within your company
- Partnering with vendors and consultants who have specific competencies in construction, governmental contracting and regulatory compliance

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¹ This paper provides a basic framework of the provisions governing compliance with federal procurement. It is intended to be neither a comprehensive discussion nor legal advice regarding the U.S. governmental contracting system.

² FAR Part 31, in general for allowable costs; FAR 31.205-19 (Insurance and Indemnification); FAR 31.201-5 (Credits); and FAR Part 28 (Bonds and Insurance).

³ CAS 416 (Accounting for Insurance Costs) and CAS 403 (Accounting for Home Costs).

⁴ FAR 31.201-4. Items in parentheses added for clarity.