

Chapter 34 – Insurance Costs

Authoritative Sources

[48 CFR 9904.416](#) (CAS) 416
Accounting for Insurance
Costs

[DFARS Subpart 228.3](#)
Insurance

[FAR Subpart 28.3](#) Insurance

[FAR 31.205-6](#) Compensation
for Personal Services

[FAR 31.205-19](#) Insurance
and Indemnification

Contractors have insurance to cover its exposure to risk of loss by some unforeseen event. Contractors' generate insurance costs by (1) insurance required to be carried by the terms of Government contracts, (2) insurance maintained in connection with the general conduct of business, (3) insurance maintained because of statutory requirements, and (4) insurance maintained as part of employee benefits.

General Audit Guidelines

When developing an audit program consideration should be given to the (1) materiality of the premium amounts involved for each type of insurance, (2) types and amounts of

coverage included under self-insurance programs, (3) effectiveness of contractor's management of the insurance function, and (4) elimination of potential hazards which will cause loss.

This chapter addresses the following topics:

34-1 Methods of Cost Accounting for Insurance Programs

34-2 Different Types of Insurance Programs

34-1 Methods of Cost Accounting for Insurance Programs

Contractors account for the insurance costs by purchase and/or self-coverage. Refer to CAM Chapter 8 Section 416 for the specifics related to measurement of insurance costs, the assignment of such costs to cost accounting periods, and their allocation to cost objectives in accordance with CAS 416.

CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and the allocation to final cost objectives. Briefly stated, the standard requires that allocation of insurance costs to cost objectives shall be based on the beneficial or causal relationship between insurance costs and the cost objectives. It also specifies that the amount of insurance cost to be assigned to a cost accounting period is the projected average loss for that period plus insurance administration expenses incurred in the same period.

34-1.1 Purchased Insurance

Contractors can usually purchase insurance from commercial carriers for all types of risks. Generally, contractors purchase insurance at fixed premiums or advance premiums, which are subject to retroactive adjustments based on claim experience.

AUDIT GUIDELINES

The auditor's assessment should include reviewing the individual insurance policies for indications of excessive or duplicated coverage or unrealistic premium rates. The auditor should ascertain whether the contractor [periodically](#) solicits competitive quotations. Competitive quotations provide support in determining the reasonableness of the plan coverage and premiums.

The Government's participation in premium costs should be commensurate with the benefits received. Also, contracts should share in dividends and other credits received by the contractor, in proportion to the participation in gross premium costs.

Insurance provided by captive insurers (owned by or under the control of the contractor) is considered self-insurance and must comply with the self-insurance provisions of CAS 416. Premiums paid to fronting insurance companies (companies not related to the contractor which reinsure with a captive insurer) should not exceed (excluding a reasonable service charge) the amount in which the contractor would have been allowed had it contracted with a competitive insurer.

34-1.2 Self-Coverage (Self-Insurance)

Contractors may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The contractor's decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. Self-coverage can take two forms: (1) self-insurance based on payments to a funded reserve or trust, or (2) self-insurance programs that are not accounted for based on payments to a funded reserve or trust.

Generally, the contractor will rely on self-insurance to cover ordinary risks and losses and, at the same time, maintain various forms of purchased insurance to cover major risks and catastrophic losses. For example, under a self-insured employee group health and survivorship plan the contractor usually will limit its self-insurance to providing hospital, surgical, and medical expenses and, at the same time, purchase insurance covering life, accidental death and dismemberment, disability income benefits, and dreaded disease coverage.

Under a [self-insurance program](#), the contractor shall make a charge for each period, which represents the projected average loss for that period. The self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed the cost of comparable purchased insurance plus the associated insurance administration expenses in accordance with FAR 31.205-19(c)(3). The contractor's actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner as would

purchased insurance. The actual loss shall be measured by actual cash value of the property destroyed, amounts paid or accrued to repair damage, amounts paid or accrued to estates and beneficiaries, and amounts paid or accrued to compensate claimants, including subrogation. It is acceptable to use the actual losses as the self-insurance costs (1) when probable losses will not differ significantly from the projected average loss for that period and (2) for [self-insurance programs for retired persons](#).

In accordance with FAR 28.308, contractors must submit self-insurance programs to the contracting officer for approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated Government contracts and the self-insurance costs at the segment are expected to be \$200,000 or more annually. The submission shall be by segment or segments of the contractor's business to which the program applies and shall include:

- (1) A complete description of the program, including any resolution of the board of directors authorizing and adopting coverage, including types of risks, limits of coverage, assignments of safety and loss control, and legal service responsibilities;
- (2) If available, the corporate insurance manual and organization chart detailing fiscal responsibilities for insurance;
- (3) The terms regarding insurance coverage for any Government property;
- (4) The contractor's latest financial statements;
- (5) Any self-insurance feasibility studies or insurance market surveys reporting comparative alternatives;
- (6) Loss history, premiums history, and industry ratios;
- (7) A formula for establishing reserves, including percentage variations between losses paid and losses reserved;
- (8) Claims administration policy, practices, and procedures;
- (9) The method of calculating the projected average loss; and
- (10) A disclosure of all captive insurance company and reinsurance agreements, including methods of computing cost.

FAR 28.308 provide that programs of self-insurance covering any kind of risk may be approved when examination of such programs indicates that their application is in the best interest of the Government. FAR 42.302(a)(2) requires the administrative contracting officer (ACO) to review contractors' insurance plans. The ACO must

specifically approve, normally in advance, the form, extent, amount and period of insurance coverage in accordance with FAR 28.308.

The Government's general survey and review of a contractor's insurance program, which may be performed under FAR 42.3, may be limited to verifying that the contractor's insurance program provides appropriate protection in consonance with the types of risks involved. Such a review, by itself, does not constitute a sufficient basis for accepting related premium costs. Once the ACO has approved a program, the contractor must submit to that official for approval any major proposed changes to the program. Any program approval may be withdrawn.

AUDIT GUIDELINES

When reviewing a contractor's self-insurance program, the auditor should consider in its evaluation:

- (1) the types of risks covered and the nature of the contractor's risk assumption,
- (2) comparative costs of the program, including administrative and [corollary costs](#),
- (3) effectiveness of the contractor's claims procedures,
- (4) equity of the accounting treatment of self-insurance costs from the standpoint of the plan of funding and allocation of costs, and
- (5) maintenance of the reserve in accordance with CAS 416.

In reviewing the administrative and corollary costs, the auditor must assure that all appropriate costs have been taken into account and that self-insurance is economical. A contractor may administer its self-insurance program either by employing personnel possessing the necessary technical skills, contracting with one or more insurance firms to provide the necessary services, or both. The auditor should determine whether the system has internal controls that are adequate to assure accurate payment of claims to employees or third parties. Since self-insurance costs should not exceed the cost charged by a commercial carrier, it is important that all costs be readily identifiable in the accounts.

In addition to losses related to claims, the cost of operating a self-insurance program should include the salaries of employees in the company's insurance department, any outside services, and all of the incidental expenses incurred such as use and occupancy, telephone, and supplies. The contractor should make periodic comparisons between the actual cost it has incurred and the cost of premiums it would have paid to an insurance company if the contractor purchased the coverage.

34-2 Different Types of Insurance Coverage

In accordance with FAR 28.3, Insurance, contractors are required to provide insurance and when directed a minimum amount of insurance is required. When developing audit procedures for the different types of insurance coverage consideration should be given to the (1) materiality of the premium amounts involved for each type of insurance, (2) types and amounts of coverage included under self-insurance programs, (3) effectiveness of contractor's management of the insurance function, and (4) elimination of potential hazards which will cause loss.

34-2.1 Aircraft Liability Insurance

When aircraft are used in performance of Government contracts, FAR 28.307-2(d) requires public liability coverage with minimum limits of \$200,000 per person and \$500,000 per accident for bodily injury and a minimum limit of \$200,000 per accident for property damage. Also, passenger liability bodily injury limits of \$200,000 per passenger is required, with an aggregate minimum limit equal to total number of seats or total number of passengers, whichever is greater.

34-2.2 Automobile Liability Insurance

For automobile liability, FAR 28.307-2(c) requires coverage with minimum limits of \$200,000 per person and \$500,000 per accident for bodily injury and \$20,000 per accident for property damage. This coverage is required in a comprehensive policy covering the operation of all vehicles used in performance of Government contracts.

34-2.3 Defense Base Act and War Hazard Compensation Act Insurance

In accordance with 42 U.S.C. 1651, all U.S. Government contractors and subcontractors working outside the United States must secure workers' compensation insurance for their employees. Coverage is required for all U.S. citizens, as well as third-country and local nationals. The insurance is commonly referred to as "Defense Base Act" (DBA) insurance, named after the 1941 legislation which extends the mandatory coverage requirements of the Longshore and Harbor Workers Compensation Act at 33 U.S.C. 901 through 950 to contractor employees working outside the United States. The intent of these acts is to extend workers compensation coverage to employees who would not otherwise be covered under state workers compensation programs due to the location in which they are working.

Where the Defense Base Act applies, the War Hazard Compensation Act, as amended (42 U.S.C. 1701 et seq.), also applies. The War Hazard Compensation Act affords protection to employees against the hazards of war (injury, death, capture, detention). In general, war hazard benefits are payable when the claim cannot be reimbursed under DBA coverage because the event which caused the claim was attributable to a "War Risk Hazard" as defined in the Act. The Department of Labor (DoL) administers the War Hazard Compensation program and provides direct reimbursement for the costs of war related claims to the insurance carrier or self-insured

as long as charges for mandatory War Hazard Compensation coverage are not included within the DBA insurance premium charged to the contractor. Since the DoL provides the mandatory coverage at no cost to the contractor, any amounts included as part of a claim or proposal are unallowable. However, contractors may provide additional or supplemental war hazard insurance in order to induce employees to accept work in hazardous areas. The auditor should evaluate this supplemental insurance coverage for reasonableness in accordance with FAR 31.205-6, Compensation for personal services.

Upon recommendation of the officials concerned, the Secretary of Labor may waive the applicability of the Defense Base Act with respect to any contract, subcontract, or classification of employees. DoD officials, when submitting [requests for waiver](#), as prescribed at DFARS 228.305(d), are required to follow the procedures included in the DFARS resource companion guide at PGI 228.305(d).

AUDIT GUIDELINES

Typically, contractors will purchase DBA insurance from commercial carriers at market premiums. Consistent with the evaluation of other types of purchased insurance, auditors should ensure that the contractor solicits adequate competitive quotes to ensure that coverage is obtained at reasonable rates. Contractors may also offer additional insurance benefits in excess of the mandatory DBA coverage requirements. These additional benefits provided to the employees must be evaluated for reasonableness in accordance with FAR 31.205-6, Compensation for personal services. When determining reasonableness the auditor should have the contractor support why the additional insurance benefits in excess of the mandatory DBA coverage is a comparable compensation practice to other companies in the same industry at the respective geographical area or that the additional benefits are offset by lower compensation elements that results in the aggregate of each measurable and allowable element sums to a reasonable total.

34-2.4 Fidelity Bonds

Fidelity bonds provide protection against defalcation and theft by employees, especially those in positions of trust. Even though these are called bonds, these obligations are really insurance policies. Fidelity bonds come in two types:

- First-party fidelity bonds protect businesses against intentionally wrongful acts committed by employees of that business.
- Third-party fidelity bonds protect businesses against intentionally wrongful acts committed by people working on a contract basis (e.g., consultants or subcontractors).

The auditor should become familiar with the circumstances involved in any claim for loss, inasmuch as it indicates a failure of internal control.

34-2.5 Fire and Comprehensive Casualty Insurance

Fire insurance provides for reimbursement to the insured for losses resulting from the causes enumerated within each policy. Most of these policies will include hazards in addition to fire, such as hail, windstorm and earthquake. When such is the case, it is common to refer to the policy as a multiple peril or comprehensive policy. These policies ordinarily cover buildings, capital equipment, inventories, and supplies belonging to the insured. With respect to buildings, rating bureaus established under the various State insurance departments are responsible for setting the rates for each type of building. Self-insurance is most appropriate where a contractor's plants are isolated and scattered over a wide area, thereby dispersing the risk.

34-2.6 General Comprehensive Liability Insurance

FAR 28.307-2(b) requires general comprehensive insurance with minimum limits of \$500,000 per accident. Third party property damage liability insurance ordinarily is not required under Government contracts. However, where a commingling of operations permits the contractor to obtain property damage coverage at a nominal cost to the Government under insurance carried by the contractor in connection with the general conduct of its business, the participation in such insurance cost may be deemed in the best interest of the Government.

34-2.7 Health, Medical, Dental, Welfare, or Death Benefits

Contractors may provide insurance coverage to current or retired employees as fringe benefits or post-retirement benefits, respectively, such as health, medical, dental, welfare, or death benefits. The contractor may provide this coverage through purchased insurance and/or by self-insuring.

AUDIT GUIDELINES

In evaluating the allowability and allocability of these costs, audit teams should consider the requirements of:

- FAR 31.205-6, Compensation for Personal Services,
- CAS 415, Deferred Compensation, and
- FAR 31.205-19, Insurance and Indemnification.

Payments under these programs can constitute either current or [deferred compensation](#). Deferred compensation is allowable only to the extent it, together with all other compensation paid to the employee, is reasonable in amount, paid pursuant to a good faith agreement between the employee and the contractor, and consistently applied in future periods. Costs which are unallowable under other paragraphs of FAR 31.2, shall not be allowable under FAR 31.205-6 or CAS 415 solely on the basis that they constitute personal compensation.

FAR 31.205-19 provides limitations specific to self-insurance charges at FAR 31.205-19(c), limitations specific to purchased insurance at FAR 31.205-19(d), and

limitations applicable to both self-insurance and purchased insurance cost at FAR 31.205-19(e). If the contractor elects to self-insure, FAR 31.205-19(c) provides the following limitations:

- (1) The contractor shall measure, assign and allocate cost in accordance with CAS 416, Accounting for Insurance Costs, regardless of whether or not they are subject to CAS.
- (2) The contractor shall comply with FAR Part 28, Bonds and Insurance.
- (3) If purchased insurance is available, any charges for self-insurance in excess of the cost of comparable purchased insurance are unallowable. In performing this comparison, audit teams should consider insurance administration expenses for both purchased insurance and self-insurance.
- (4) Self-insurance charges for risks of catastrophic losses are unallowable.

As indicated above, FAR 31.205-19(c)(2) provides that self-insurance charges are allowable provided the contractor complies with the requirements of FAR Part 28. FAR 28.308, Self-Insurance, requires that contractors submit a self-insurance program, with specific mandatory data requirements, to the administrative contracting officer for approval if certain [thresholds](#) are met.

34-2.8 Insurance for Government Owned Property

FAR 31.205-19(e)(2)(iv) provides that the costs of insurance for the risk of loss, damage, destruction, or theft to Government property are allowable only to the extent that:

- (a) the contractor is liable for such loss, damage, destruction or theft;
- (b) the contracting officer has not revoked the Government's assumption of risk in accordance with FAR 45.104(b)); and
- (c) such insurance does not cover loss, damage or destruction which results from willful misconduct or lack of good faith on the part of any of the contractor's management personnel (as described in FAR 52.245-1(a)).

DFARS 231.205-19(e)(7) identifies additional unallowable costs if the contracting officer terminates the Government's assumption of risk. Accordingly, where the risk of loss is not the responsibility of the contractor, or the contracting officer has revoked the Government's assumption of risk, or the insurance covers loss, damage or destruction resulting from willful misconduct, etc., the cost of purchased insurance coverage or self-insurance (including the contractor's deductible) should be questioned.

34-2.9 Insurance on Lives of Officers and Owners

Costs of insurance on lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation (FAR 31.205-19(e)(2)(v)).

34-2.10 Product Liability

In the normal course of doing business, a contractor will insure itself against bodily injury to others, and damage to, or loss of, property of others arising from the failure of its products.

AUDIT GUIDELINES

In general, major defense contractors have negotiated separate rates with insurance companies for its military and commercial products. A common basis used to allocate the premium is sales. However, contractors could use an average composite liability rate for both military and commercial products. The use of a composite rate may be [inequitable](#) if the risk is different against products, resulting in a different premium for both military and commercial.

Auditors should ascertain that the contractor has conscientiously attempted to negotiate with its insurance carrier a separate military product(s) rate commensurate with the loss experience of such product(s). Whenever premium rates are not commensurate with loss experience, obtain the views of the Government contract management official relative to rating the coverage. Further, ensure there is no absorption by Government contracts of premiums solely applicable to a contractor's commercial products.

Audit evaluations of product liability insurance premium allocations should, as a minimum, include an analysis of the Government and commercial loss experience for a representative period. Government premium breakout allocations in excess of the average Government loss experience may be unreasonable. If an excess exists, consider the following:

- (1) requesting detailed explanations from the insurance carriers on the basis of the premium split between commercial and Government and a breakdown of risk exposure;
- (2) if possible, comparisons of premiums and allocation bases with comparable companies; and
- (3) if possible, obtaining independent quotes from insurance carriers on Government exposure only.

34-2.11 Professional Liability Insurance

Professional liability insurance (also referred to as errors and omissions insurance) protects professional advice- and service-providing individuals against damages to clients or third parties resulting from professional errors or judgments.

AUDIT GUIDELINES

The cost of professional liability insurance is allowable, subject to tests of reasonableness and allocability. In performing these tests, if the cost of insurance is material, the auditor should review the policy coverage and claims and loss experience.

Reviewing policy coverage is the first and most important step in determining allocability and reasonableness. If a contractor's liability insurance policy provides coverage for its general practice, allocation of premiums to all contracts through overhead or general and administrative expense is usually acceptable. However, if the policy is written to provide unique liability coverage for a particular business segment or product, costs should be directly allocated to the benefiting cost objective. Where a plain reading of the policy does not clearly establish the general nature of the coverage or the auditor has reason to believe that unique liability coverage is involved, an examination should be made of the types of services being rendered to both the Government and commercial customers. If the services (service primarily refers to discipline, such as architectural, mechanical, civil engineering work, etc.) are essentially similar, a broad-based allocation is acceptable. On the other hand, where the services are dissimilar, examination should be made of the claims and loss experience as explained below.

If the costs are material, and the contractor does not provide the same service to the Government as to the commercial customers, then the auditor should review claims and loss experience. The policy will define what a claim is. This could give the auditor some added insight into the applicability of policy coverage as well as allocability of costs. Items reviewed should include a number of settled and pending claims, whether they apply to Government or commercial contracts, and the dollar amounts. The auditor must exercise judgment in selecting a time frame to review claims history relevant to the costs under audit.

The existence of claims on either Government or commercial contracts alone is not conclusive as to how premiums should be allocated. However, a significant number of claims arising because of one particular product, segment, customer, etc., may indicate the need for a more thorough review of the nature of the service or projects causing the claims disparity and consideration of a more appropriate allocation base.

The review of claims and loss experience should only be used to challenge the broad-based allocation of costs where the auditor can determine that the insurance is primarily purchased to protect against liability unique to particular types of services, components, or projects.

In determining premiums for a contractor, the insurance carrier usually considers such factors as location of the business, size of the firm (billing/revenue), professional discipline(s) being practiced, and loss experience. The proper allocation of premium costs should be determined primarily by the terms of the coverage where services provided are essentially the same for all final cost objectives. While claims and loss experience may vary considerably from year to year, and between classes of

businesses (i.e., Government vs. commercial), such experience should not be used to challenge the broad based allocation of premium cost unless it can be determined that the services provided are essentially dissimilar and hence the risk of claims is proportionally greater for certain services than others.

34-2.12 Split-Dollar Life Insurance

[Split-dollar life insurance plans](#) provide for a sharing between the employer and the employee of the premium payments, ownership, cash values, and the death benefits. Typically, the employer pays the insurance premiums on the life insurance policy on the employee's life and takes a collateral assignment (i.e., interest in the policy) equal to the premiums it pays. The employee owns the policy and designates the beneficiary. If the employment ends or the insurance policy is terminated, the employee is required to reimburse the employer for the aggregate premiums paid by the employer.

Some plans include a separate but interrelated deferred compensation agreement that provides the employee with deferred compensation in the same amount as the aggregate premiums the employee (or his/her beneficiaries) must reimburse the employer. The deferred compensation is generally payable to the employee at the same time that the employee or his/her beneficiaries are required to reimburse the employer.

AUDIT GUIDELINES

Financial Accounting Standards Board (FASB), Accounting Standards Codification (ASC) 325-30-35 (formerly FASB Technical Bulletin No. 85-4, Accounting for Purchases of Insurance) addresses the proper accounting treatment of premium payments for split-dollar life insurance. ASC 325-30-35-1 states in part, "An asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position." Under a typical split-dollar life insurance plan where the employee owns the policy and has an unavoidable obligation to reimburse the contractor for the amount of the insurance premiums, the employer would receive from the employee an amount equal to the aggregate premiums paid to the insurance company. Therefore, the employer should recognize the annual premium paid to the insurance company as an asset, not an expense. The annual premiums are essentially an interest free loan from the contractor to the employee, not an element of the total cost of a contract as defined in FAR 31.201-1, Composition of Total Cost, and should be questioned if claimed.

Deferred compensation costs incurred under the employer/employee agreement which provides the employee with deferred compensation equal to the aggregate premiums the employee must reimburse the employer under the terms of a split-dollar life insurance plan should be evaluated in accordance with FAR 31.205-6(k). Under that provision, deferred compensation is allowable if it is based on current or future services and assigned and measured in accordance with CAS 415, Accounting for the

Costs of Deferred Compensation. Deferred compensation payments made in conjunction with a split-dollar life insurance plan are also subject to the reasonableness criteria of FAR 31.205-6(b).

The terms of the interrelated deferred compensation agreements may not explicitly state if it is based on current or futures services. These agreements provide essentially a series of annual awards (each equal to the annual premium) to be paid at some future date, for services provided in the period in which the annual life insurance premium is paid. That is, each year, the employee is awarded deferred compensation equal to the annual insurance premium paid by the employer for that period, to be paid upon retirement, death, or other circumstances as stipulated in the agreement. Therefore, the deferred compensation to be paid under the terms of a typical plan is based on current or future services and meets the allowability criteria at FAR 31.205-6(k)(1).

34-2.13 Vessel Liability Insurance

When contract performance involved use of vessels, FAR 28.307-2(e) states that the contracting officer shall require, as determined by the agency, vessel collision liability and protection and indemnity liability insurance.

34-2.14 Workers' Compensation and Employer Liability Insurance

Workers' compensation insurance protects an employer against the liability imposed by workers' compensation laws to pay benefits and furnish medical care to employees for injuries and occupational diseases attributable to their employment. Employer's liability insurance covers claims for damages relating to special types of work and injuries or occupational diseases not covered under the State laws. These types of liability coverage are not a form of personal compensation to the employee, and their allowability should be considered under FAR 31.205-19.

FAR 28.307-2 requires contractors performing under Government contracts to carry employer's liability coverage in the minimum amount of \$100,000, except in States with exclusive or monopolistic workers' compensation funds which do not permit the writing of such coverage by private carriers, or except in those States where the Workmen's Compensation Act constitutes the exclusive remedy of employees against employers for all injuries or diseases relating to their work.

Usually, an estimated premium is charged when the workers' compensation policy is written. After the policy expires, a payroll audit is made. The actual premium is then determined and adjustments made. However, specific policy clauses will dictate how the premium is calculated. For example, some policies call for interim adjustments, such as adjustments to the estimated premium for the actual amount of labor dollars incurred on a monthly basis.

It is common to have a retrospectively rated workers' compensation insurance plan. The initial premium is adjusted (up or down) at a later date, depending on incurred losses. Although there are many variations of retrospectively rated plans, an

insurance company will normally go through the following steps when billing a customer under a retrospectively rated policy:

- (1) The policy is written using the State bureau rates. The retrospective endorsement and provisions are attached to the policy.
- (2) The premium is billed based on payrolls reported to insurance company.
- (3) After the policy expires, the insurance company audits the actual payroll data. The insurance company's audited payroll amount is used to develop the standard premium used in the retrospective adjustment.
- (4) Actual claims are valued by the claim department six months after the policy expires. The time lag permits accurate valuation of open cases and allows time for settlement of outstanding claims.
- (5) The loss and payroll figures are then used by the insurance company to calculate the first retrospective rating adjustment.
- (6) Subsequent retrospective adjustments may be made at one year intervals to reflect the developments on open cases.

The retrospective rating billing procedures should give the auditor an indication of some of the documentation available to evaluate the allowability and allocability of insurance costs. Where retrospectively rated plans are used, insurance companies may hold reserves. Reserves provide for anticipated payouts after the close of the policy year. The auditor should review the written purpose of the reserve to determine that the reserve is not an unallowable deposit. The auditor should evaluate the support for the reserve and the fluctuations within the reserve. Usually, pending lawsuits, known claims, and legal representations from attorneys are included as part of the supporting reserve package. The same documentation should be available for reserves under both a purchase plan and a self-insurance plan.

Ordinarily, a retrospective rating plan will result in the lowest net cost for workers' compensation insurance. However, the National Defense Projects Rating Plan described in DFARS 228.304 is intended to provide this insurance to an eligible contractor at even lower costs. The savings result partly from covering not only the employees of the prime contractor, but also those of all of its subcontractors performing work at the same location. The rating plan may be applied to cost-reimbursement type contracts and, in appropriate cases, to fixed-price contracts with price redetermination provisions. A defense project is eligible for application of the plan when:

- (1) eligible Government contracts represent, at inception of the plan, at least 90 percent of the payroll for total operations at the specific locations of the project; and
- (2) the annual premium for insurance is estimated to be at least \$10,000.

AUDIT GUIDELINES

Each State has its own workers' compensation laws. Accordingly, auditors should determine that contract charges for workers' compensation are in accordance with laws of the contractor's applicable state of business. Premium rate guidelines are published by the National Council on Compensation Insurance based on accident experience throughout the Nation's businesses and industries. Workers' compensation rates are based on employee occupational classifications and on covered payroll. When evaluating such rates, the auditor should determine that all applicable labor categories are used to estimate the insurance premium. The failure to include all labor categories can result in overstated premiums. As well, the cost of workers' compensation is affected by geographical location and the hazards of the particular work task. Therefore, the contractor's method of allocating the expense to burden centers should recognize this relationship in order to allocate the premium cost equitably.

Callout

Periodically - During periods of high competition within the insurance industry, premium costs diminish. Downward price trends should be reflected in the premiums paid by the company. ([Return](#))

Self-insurance program - Procurement regulations governing self-insurance require a contractor to record a self-insurance liability on the books, while the FASB, in ASC 450-20-55-5, specifies that companies cannot record a liability for self-insurance. ([Return](#))

Self-insurance programs for retired persons - For unfunded self-insurance of retirees, the projected average loss should represent the pay-as-you-go (PAYGO) amount (i.e., actual losses). ([Return](#))

Corollary Costs – Additional costs that are an outcome of administering an insurance program. ([Return](#))

Determine – Did the contractor provide loss history to the insurance broker and did the broker consider the history data in determining the quote. ([Return](#))

Requests for waiver - Waivers of the Defense Base Act should be considered where foreign employees are subject to compensation laws or comparable provisions of their country. ([Return](#))

Deferred Compensation – Not all post-retirement benefits are subject to the deferred compensation provisions. The specific nature and characteristics of each post-retirement benefit will dictate the applicability of the FAR and CAS provisions. ([Return](#))

Thresholds - If it is anticipated that 50 percent or more of the self-insurance costs to be incurred at a segment will be allocable to negotiated Government contracts, and the self-insurance costs at the segment for the contractor's FY are expected to be \$200k or more. ([Return](#))

Inequitable – In this situation, the auditor should discuss with Government contract management personnel and the contractor for the purposes of obtaining separate rates for military and commercial products. ([Return](#))

Split-dollar life insurance plans - These insurance plans are used by some contractors to reward executives and key employees for their performance or to induce them to remain with the company. ([Return](#))