

New DCAA Audit Guidance Targets Contractors' Unallowable Health Benefit Costs

Written by Administrator
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Continuing a trend started in late 2008, DCAA audit guidance issued August 4, 2009 spells trouble for Government contractors. The guidance warns DCAA auditors of contractors that are "inappropriately charging" costs associated with ineligible dependents and/or spouses to the Government. The audit guidance directs that auditors should question costs associated with ineligible dependents in both forward pricing rate proposals and annual incurred cost submissions. Ineligible dependents/spouses include those that are (1) too old to receive benefits, (2) divorced or deceased, or (3) covered by another plan but did not notify the contractor of that fact. Auditors will be developing tests to assure that only spouses and dependents that are eligible for benefits in accordance with the contractor's policies are receiving benefits.

The guidance notes that some contractors offer employees "grace periods" in which to report status changes, and directs that all costs associated with ineligible dependents should be questioned, even if incurred during grace periods that are otherwise consistent with company policy. Contractors that offer employees such grace periods must calculate the "cost impacts" associated with their practice "even if the contractor will not seek restitution from the [ineligible] employees." Where contractors refuse to calculate those impacts, DCAA auditors are directed to "develop a reasonable estimate" of the unallowable health benefit costs and "suspend the costs until the contractor provides a cost impact and/or an audit is complete."

Moreover, the audit guidance asserts that costs associated with ineligible spouses/dependents are not only unallowable, they are expressly unallowable, and thus subject to the penalty provisions of FAR 42.709. Court decisions on this matter tend to favor a contractor, basically saying that penalties should not be imposed where there are reasonable differences of opinion about the allowability of certain costs. (Ref. General Dynamics Corp., ASBCA No. 49372, June 2002.) That being said, it is far from clear that inclusion of costs associated with patently ineligible dependents in claimed health care expenses results from a matter of judgment or opinion. (The "grace period" issue may be subject to more judgment.) In any case, who wants to litigate the issue?

There are other troubling aspects of the audit guidance:

-- DCAA auditors are advised that many contractors use third-party plan administrators. When auditing health plan costs, auditors are directed that the contractor must provide "the same level of access to the third party service provider records that he or she would receive from contractor maintained records." Auditors are reminded to initiate "access to records" procedures should a contractor deny them access to the third party's records. Previous DCAA audit guidance imposes a course of action that can lead to suspended costs, for an unresolved "access to records" issue. (Ref. MRD 08-PAS-042(R) dated 12/19/2008.)

-- DCAA auditors "should verify that contractors have adequate procedures to ensure payment of insurance premiums or claims are only being made related to employees and their eligible dependents." A contractor's failure to have adequate procedures in this area will be treated as "an internal control deficiency in the contractor's accounting system and a CAS 405 noncompliance, if applicable." Further, inclusion of costs related to ineligible dependents/spouses in cost estimates may be treated as inadequacies in the contractor's estimating system. Previous

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DCAA audit guidance (MRD 08-PAS-403(R), dated 12/19/2008) directs that a single control objective failure should lead to a recommendation of system inadequacy. An inadequate estimating system is a nuisance, but an inadequate accounting system can prevent a contractor from receiving any cost-reimbursement contract. (Ref. FAR 16.301-3(a)(1).) Accordingly, a threat to the adequacy of a contractor's accounting system internal controls must be taken very seriously.

Finally (as if the above was not sufficient to cause worry), the audit guidance reminds DCAA auditors that the cognizant Administrative Contracting Officer (ACO) should be "notified of any potential risks related to ineligible dependent care costs in prior fiscal years" so as to "ensure that active negotiations of open incurred cost years are put on hold until any necessary adjustments are made." In other words, an audit finding in a current year can affect the finalization of prior years' indirect cost rates, which could delay final contract close-outs and submission of final invoices.

Given the foregoing, contractors should immediately review their procedures associated with verifying dependent eligibility and shore them up as appropriate. To the extent costs associated with ineligible dependents/spouses are identified, they should be treated as unallowable costs. Contractors should also consider consulting with legal counsel to determine their position regarding DCAA access to the records of any third party service providers. In cases where it is decided to grant access to those records, it may be necessary to renegotiate or even amend existing service agreements.

See the troubling audit guidance [here](#) .