

Chapter 17 – Correction Costs for Internal Control Deficiencies

Authoritative Sources

[FAR 31.201-3](#) Determining Reasonableness

An internal control system comprises the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its

assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Internal controls extend to functions other than those relating to accounting controls; e.g., performance reports, employee training programs, and quality controls (see CAM Section 5-107). This subsection provides guidance relating to the costs of correcting deficiencies in internal control systems or excessive costs that result from the lack of effective internal controls.

This chapter addresses the following topics:

- 17-1.** Correction Costs of Quality Control Program Deficiencies
- 17-2.** Costs Related to Extraordinary Reviews of Unsettled Overhead Costs
- 17-3.** Costs Related to Contractor Self Governance Programs

17-1 Correction Costs of Quality Control Program Deficiencies

Purpose of Quality Control

Effective contractor quality control or product assurance systems provide systematic control of quality and reliability in all phases of the operation including design, procurement, production, testing, storage, and handling of materials. Quality assurance systems consist of both quality control and inspection. The quality control system is responsible for maintaining the quality of the product within established standards. Inspection is a sorting process that classifies material, parts, or products as acceptable or unacceptable. As quality control becomes increasingly effective, the need for inspection correspondingly decreases. Weaknesses in or lack of effective control can result in:

1. Inadequate products or services;
2. Unnecessary and ineffective use of resources, including labor, material, and equipment;
3. Unreliable and inadequate analysis of quality assurance requirements and inspection results;
4. Unnecessary inspections and work stoppages;

5. Unreliable management reporting systems;
6. Unnecessary administrative effort; and
7. Unreliable test equipment.

Allowability of Costs

The cost of maintaining an acceptable quality control system is allowable, if reasonable. Where minor deficiencies are cited by the Government, making corrections to the system should be considered to be part of maintaining an acceptable quality control system and related costs are allowable. However, where significant corrections to the quality control system are needed because of the contractor's earlier negligence in establishing and/or maintaining acceptable controls, an unreasonable amount of increased costs to the Government would result through duplicative efforts to reinstitute a quality control program. These costs should be disallowed on a basis of reasonableness (FAR 31.201-3).

FAR 46.311 requires certain contracts to contain the contract clause at FAR 52.246-11, Higher-Level Contract Quality Requirement (Government Specification). This clause requires contractors' compliance with the specified Government quality control specification requirements. Where this clause is contained in a contract, the contractor has a contractual obligation to establish and maintain a quality control program to assure adequate quality throughout all areas of contract performance, including design, development, fabrication, processing, assembly, inspection, test, maintenance, packaging, shipping, storage, and site installation. In these situations, the contract clause provides a contractual mechanism for requiring contractor corrective actions at no increased cost to the Government. Where a contractor is in violation of the Government quality requirements specified in a solicitation, a comment should be included in DCAA audit reports indicating that contract award should not be made until the deficiencies are corrected by the contractor. In addition, where contractor deficiencies are cited on existing contracts, the auditor should recommend the use of advance agreements for limiting Government liability and segregation of the costs of correcting quality control system deficiencies (to allow audit visibility). If the contractor refuses to segregate these costs, recommend suspension of payment until proper accounting and segregation of costs are made.

17-2 Costs Related to Extraordinary Reviews of Unsettled Overhead Costs

All contractors doing business with the Government are required by FAR 31.201-6 to have adequate internal controls to assure that unallowable costs are not included in billings and claims submitted to the Government. Some contractors may undertake large-scale reviews of unsettled overhead costs to identify unallowable costs that may have not been segregated and removed from overhead claims during the original processing of the transactions and/or the initial preparation of the billings or claims. This extraordinary effort is often the result of the contractor's earlier

negligence in establishing, maintaining, and/or implementing an adequate system of internal control.

When the circumstances cited above are encountered and the contractor is incurring or is expected to incur significant costs, the auditor should notify the contractor that the costs associated with such extraordinary reviews of unsettled overhead costs are considered to be unreasonable and will be questioned under FAR 31.201-3, Determining reasonableness. The reasons to be cited are:

1. The costs are not of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of a contract. The costs are duplicative of costs incurred for the same purpose in prior periods. The Government has already reimbursed the contractor for the costs of preparing billings and claims for reimbursement. The fact that this task was not adequately accomplished does not entitle the contractor to additional reimbursement.
2. The costs are the result of the contractor's failure to follow the requirements of generally accepted sound business practices and contract terms.
3. The costs result from actions taken which were not those of a prudent businessman in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government, and the public at large.

17-3 Costs Related to Contractor Self Governance Programs

Contractor activities under self-governance programs are to be encouraged as a matter of DoD policy. Costs of such activities are allowable if reasonable in amount.