DCAAM 7640.1, DCAA Contract Audit Manual

Chapter 5

Audit of Compliance with Defense Federal Acquisition Regulation Supplement for Contractor Business Systems

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5-000 Audit of Compliance with Defense Federal Acquisition Regulation for Contractor Business Systems **

5-001 Scope of Chapter **

a. This chapter provides audit guidance on performing examinations engagements of contractor business systems for compliance with the Defense Federal Acquisition Requirements Regulation Supplement (DFARS) and contract terms. The contractor business systems covered in this section include the accounting system, material management and accounting system (MMAS), and the cost estimating system.

b. There is an additional section regarding pre-award accounting system audits for contractors that are subject to the Federal Acquisition Regulations (FAR) SF 1408 criteria. Additionally, a section has been added for business system reviews of Non-DoD contractors that are not subject to the DFARS business system requirements (section 5-306).

c. There is also an additional section regarding the Contractor Information Survey (section 5-800). The Contractor Information Survey is used at smaller contractors where they have had little or no audit effort in three (3) to five (5) years.

5-100 Section 1 – General Guidance for Audits of Contractor Business Systems **

5-101 Introduction **

a. This section outlines the auditor's fundamental requirements and responsibilities for performing contractor business system audits. The auditor should use this guidance when planning contractor business system audits of compliance with the applicable DFARS business systems criteria and the Preaward Accounting System, FAR SF 1408 requirements.

b. These fundamental requirements and responsibilities apply to audits of each of the contractor's business systems that are used to propose, charge, or bill significant costs to Government contracts.

c. The audit guidance discussed in this chapter generally applies to all contractors regardless of size. However, the auditor should consider the size, industry and complexity of the contractor when planning the types of audit procedures that are applied.

5-102 Background Information**

a. DFARS 252.242-7005, Contractor Business Systems requires the contractor to establish and maintain acceptable business systems that comply with the terms and conditions of applicable business system clauses identified below. After audit or review of a business system, the contracting officer is responsible for determining if the system is acceptable.

b. The three business systems audited by DCAA and their respective CAM sections are listed below:

Audit of Compliance with DFARS 252.242-7006, Accounting System Administration	**5-300**
Audit of Compliance with DFARS 252.242-7004, Material Management and Accounting System	**5-400**
Audit of Compliance with DFARS 252.215-7002, Cost Estimating System Requirements	**5-500**

The three business systems reviewed by DCMA are discussed at 5-700.

c. The objective of contractor business system examinations is to provide an audit opinion on whether the contractor's system complies in all material respects with the DFARS business system requirements. The audit report provides the contracting officer with the necessary information to make an informed decision on whether the system is acceptable.

5-103 General Audit Policy **

5-103.1 Business System Audit Policy and Approach **

a. It is DCAA's policy that each business system (i.e., accounting, estimating, MMAS) that has a significant impact on Government contract costs be audited once every four years, unless risk factors at the contractor warrant conducting the audit sooner. When the contractor changes the system, the auditor should give a high priority to the audit of the system change to determine if the updated system complies with DFARS requirements. The auditor should meet annually with top contractor representatives, such as senior management, internal auditors, audit committee members, or others during the annual planning coordination process to obtain information regarding any significant changes in policies and procedures affecting internal controls for its business systems. The auditor should request and review any audit leads, as well as a copy of the management representation letter provided by the contractor's external auditors, in conjunction with the audit of the company's financial statements. At large, multi-segment contractor locations, the management representation letter should be requested by the corporate auditor and/or the Corporate Audit Directorate (CAD). CAD auditors should provide any relevant information from the management letter to auditors at the affected segments.

b. In determining the significance of a contractor business system, the auditor should carefully consider the relationship of the business system to Government contracts. For example, if a contractor incurs a significant amount of labor costs which are assigned to Government contracts, the contractor's compensation and labor subsystems would be considered significant during the risk assessment of a contractor’s accounting business system. Likewise, if a contractor does not purchase significant amounts of materials for Government contracts, the contractor's material systems may not have significant risk for the accounting business system audit.

c. Auditors should obtain sufficient appropriate audit evidence of compliance with all applicable DFARS criteria for business system examinations. Sufficient, appropriate evidence is necessary to support the auditor’s opinion and report. Audit evidence is cumulative in nature and is primarily obtained from procedures performed throughout the course of the engagement. It may, however, also include audit evidence obtained from other sources such as previous engagements, if the audit evidence is relevant to addressing the audit objectives in the current business system audit.

d. The auditor’s professional judgment should be used to gather information and objectively evaluate the sufficiency and appropriateness of evidence to express an opinion by considering the level of risk that has been identified for the business system’s compliance with each DFARS criterion. If the auditor determines an area of a business system related to a DFARS criterion is low risk, the audit procedures performed in that area should be reduced.

e. When a contractor that participates in self-governance programs furnishes the FAO with an initial internal control evaluation and compliance test plan, the FAO should consider this information during the risk assessment planning for compliance with the applicable DFARS business system requirements. The objective is to coordinate with the contractor on the relevant control activities and compliance testing to gain an understanding of the control activities that are relevant to the business system requirements.

f. SEC registered public companies are required to follow additional reporting requirements because of the Sarbanes-Oxley Act of 2002, such as including in their annual reports filed with the SEC, management’s report on internal control over financial reporting. Furthermore, the external auditors are required to attest to management’s assessment of the company’s internal controls over financial reporting. Auditors may be able to rely on work performed to support the information in the SEC filings when conducting business system audits provided the requirements of 4-1000 “Relying Upon the Work of Others” is followed. Auditors should consider the potential opportunities for increased coordination with the contractor when planning and performing audits (see 4-202).

5-103.2 Coordinated Business System Audit Process at Multi-Segment Contractor Locations **

a. Auditing compliance for contractor business systems at multi-segment contractors requires cognizant auditors to identify audit responsibilities at each geographical location to ensure appropriate audit coverage when contractor locations share components of a business system, such as policies and procedures, common technologies (e.g., software), or common management. The following should be considered as part of this coordinated process.

(1) To initiate the coordinated audit process, the lead FAO cognizant of the contractor segment responsible for the design and maintenance of the shared system should coordinate with other cognizant FAOs to gain an understanding of the contractor’s business system to determine the extent of common or shared aspects of the system. This understanding includes identifying where the control activities relevant to DFARS compliance are performed. The lead FAO should coordinate with the segments to document (i) where the common aspects exist, (ii) where the control activities are performed, and (iii) the FAO(s) responsible for performing the specific business system compliance audit procedures. FAOs cognizant of segment locations should initiate assist audits and use the One Audit Approach (OAA) with off-site locations as necessary. FAOs cognizant of off-site locations should not self-initiate business system audits.

(2) All draft reports should be provided to the CAD to ensure consistency of audit recommendations.

5-104 Audit Objectives **

a. The objective of each business system audit is to gather sufficient appropriate evidence to express an opinion on the contractor's compliance with the applicable business system criteria (e.g., DFARS, FAR, applicable laws and regulations, and contract terms) during the audit period. The audit report will serve to support the contracting officer’s compliance determination. The audit period is the period of time to which the evaluation of the business system relates.

b. Additionally, business system audits are used to support the assessment of control risk for other related audits (e.g., incurred cost, proposals, labor, material, etc.) to determine the degree of reliance that can be placed on the contractor's business systems as a basis for planning the scope of substantive testing in other related audits.

c. In those cases where the auditor can rely on the contractor's business system to record, process, summarize, and report in a manner consistent with the applicable DFARS and Government contract laws and regulations, control risk would be considered low. In these cases, the auditor should be able to reduce substantive testing.

d. In those cases where the contractor's business system(s) cannot process, summarize and report consistently with the requirements, expanded testing in other related audits is often needed.

e. At those contractors with outstanding business system deficiencies, the auditor should recommend actions to the ACO to encourage the contractor to correct the deficiencies (e.g., suspension of costs, disapproval of system, penalties).

f. While the discovery of fraud or other unlawful/improper activity is not the primary objective of any audit, the auditor should be attentive to any condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

**5-105 Scope of Audit **

a. While the nature and extent of audit effort depends upon contractor size and the amount and type of Government business (materiality and sensitivity), the scope of the business system audit should include:

- gaining and documenting an understanding of the key internal controls for the DFARS business system (i.e., accounting, MMAS and estimating systems, etc.) being audited. This includes both manual and automated (IT) activities;

- designing and performing audit procedures to evaluate compliance with the DFARS business system requirements; and

- reporting on the contractor's compliance with the DFARS business system requirements.

b. The auditor should consider the contractor's control environment and overall accounting controls when assessing risk for each business system for compliance with the applicable DFARS requirements. In addition, the auditor should consider the adequacy of any applicable general information technology (IT) system controls as they affect the operation of internal control activities for the business systems being examined.

c. The components of internal control and the relevant control objectives identified within the business systems listed above apply to every contractor and should be considered in the context of the following:

- the contractor's size;

- the contractor's organization and ownership characteristics;

- the nature of the contractor's business;

- the diversity and complexity of the contractor's operations;

- the contractor's methods of transmitting, processing, maintaining, and accessing information; and

- applicable legal and regulatory requirements.

Smaller contractors may have less formal internal controls that accomplish these control objectives.

d. With a sound understanding of the critical aspects of each system, the auditor can more effectively and efficiently develop the audit procedures necessary to audit compliance with laws and regulations in business system audits.

e. In establishing the scope of audit, the auditor should leverage information from prior business system audits, related audits and permanent files, when possible.

Once a full business system audit has been performed, it should serve as a baseline for establishing the scope of subsequent audits of that system. In addition, subsequent audits should cover major system changes. This should include audit procedures to validate that the business system changes have controls in place to comply with the applicable DFARS business system (i.e., accounting, MMAS and estimating systems) criteria, FAR requirements, applicable laws and regulations, and contract terms.

5-106 Obtaining an Understanding of the Contractors Business Systems **

a. Generally Accepted Government Auditing Standards (GAGAS) require the auditor to obtain a sufficient understanding of the contractor's internal controls to assess control risk to plan the audit and to determine the nature, timing, and extent of tests to be performed. CAM 2-306.2 prescribes the guidance regarding obtaining and documenting the contractor's internal controls to assess control risk and to determine the nature, timing, and extent of tests to be performed. Additionally, the auditing standards require auditors to obtain an understanding of relevant portions of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements (e.g., DFARS, FAR, CAS, contract terms, etc.). In planning the examination, such knowledge should be used to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design audit procedures to test for DFARS compliance.

b. The first step in evaluating the contractor's business system is to obtain an understanding of the relevant internal controls over compliance with the DFARS system requirements. This understanding will serve as the foundation for evaluating key internal controls over the DFARS business system criteria under examination. It will allow the auditor to design more effective and efficient audit procedures to determine compliance with the applicable DFARS criteria for the business system being examined. To acquire a basic understanding of the business system being audited, the auditor should:

- review the objectives and audit procedures listed in the appropriate section of Chapter 5 and the respective audit program;
- review the contractor's system explanation and related documentation; e.g., system policy and procedure manual, flowcharts, etc.;
- review relevant working papers from the permanent files and prior audits;

- make inquiries of appropriate contractor management, applicable DCMA staff, supervisory, and staff personnel;
- inspect relevant documents; and
- observe actual contractor operations, when possible.

c. The auditor should request that contractor personnel provide walk-throughs of the key internal controls over compliance with DFARS, then request business system demonstrations and an entrance conference. For full business system audits (i.e. not follow up audits), the contractor should provide a walkthrough of formal policies and procedures related to ensuring compliance with all the DFARS business system requirements. The contractor demonstrations are an essential element for the auditor obtaining and documenting the understanding of the relevant internal controls. The information gained from the walk-throughs and business system demonstrations should be used to identify risk and appropriately scope the audit.

If a full business system audit was previously performed, audit teams should leverage the information previously gathered from the contractor walk-through/demonstrations to the maximum extent possible and confirm whether there have been significant changes to any key internal controls supporting DFARS compliance. For key internal controls that have changed, the auditor should request a contractor walk-through and demonstration to gain an understanding. The auditor should leverage information from the prior audit where possible to prevent duplication and increase efficiency.

d. Request that the contractor explain processes/internal controls of the business system that are key to DFARS compliance and provide clarification on those implemented processes/internal controls as needed to help confirm the auditor's understanding. The auditor should perform real-time observations (when possible), observing actual processing activities and examining related documents to validate the understanding of the system, and trace one or more transactions through the business system from the initial starting point through to the various processing steps, resulting in related cost estimates, reports, or billings on Government contracts. This can aid in confirming the auditor's understanding of the system and its processes. If the auditor already has a sufficient understanding of the system based on prior audit experience, the auditor should use judgment and determine if these procedures are necessary.

e. The extent of audit effort expended in gaining an understanding of the contractor's accounting and management business systems is a matter of auditor judgment. Characteristics that should be considered include:

- the size, industry and complexity of the contractor;
- level of previous experience with the contractor;

- nature and extent of systems documentation;
- the significance of costs proposed, charged, or billed to the Government by the system; and
- materiality judgments for specific accounts and transactions handled by the system.

f. Once the auditor has gained an understanding of the contractor's relevant internal controls over compliance with the DFARS system requirements, it should be documented in the audit working papers and related permanent files. This documentation will typically take the form of system flowcharts, narrative descriptions, and copies of relevant documents and reports. The method(s) used and extent of documentation required are a matter of professional judgment. However, the documentation should be clear, concise and provide sufficient information to communicate the auditor's understanding in a clear and summarized manner.

5-107 Determining if Relevant Control Objectives and Related Control Activities Exist **

a. The auditor should identify those control objectives associated with the contractor's compliance with the DFARS business systems requirements, applicable laws and regulations, and contract terms. If the control objectives are met there would be reasonable assurance that material errors or misstatements would be prevented or detected in a timely manner. Control objectives can be classified into the three general areas:

(1) financial reporting control objectives which are concerned with ensuring the preparation of reliable financial statements;

(2) operational control objectives which are concerned with ensuring that the contractor's resources are being used effectively and efficiently; and

(3) compliance control objectives which are concerned with ensuring that the contractor complies with applicable laws and regulations.

While control objectives in each of these areas can have an impact on contract costs, DCAA auditors should focus on compliance controls when planning and performing business system audits.

b. The auditor should identify the control activities designed and implemented by the contractor to achieve compliance with the DFARS business system audit criteria and contract terms.

c. Once the auditor has obtained an adequate understanding of the business system's key internal controls, a determination should be made as to whether relevant internal control activities exist that will materially affect the applicable DFARS business system requirements and contract terms.

d. If the auditor determines that relevant internal control activities do not exist, no control testing will be performed.

e. If the auditor determines that relevant internal control activities can be identified, the auditor should plan and perform appropriate tests of those controls to determine compliance with the applicable DFARS criteria.

f. The auditor will be able to rely on the tests of controls performed in the business system audits to reduce substantive testing in a specific audit area in other related audits if these controls were found to be operating effectively and are current and relevant to the other audit being performed. If the auditor relies on those tests of controls, the auditor should reference the business system assignment and incorporate or reference working papers from that assignment to clearly document the specific procedures completed that provide sufficient evidence of the operating effectiveness of the applicable internal controls.

5-108 Tests of Controls **

a. Examining key internal controls may involve selecting a sample/judgmental selection of transactions, processes, or contracts, and should consider risk, and evaluating whether they are operating effectively. See 2-306.4, for designing substantive procedures based upon the assessed level of audit risk.

b. The auditing standards require auditors obtain an understanding of relevant portions of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. In planning the examination, such knowledge should be used to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. 2-306 details planning the engagement to identify types of risk and substantive testing procedures.

c. Auditors should design and perform tests of controls to obtain sufficient appropriate evidence about the operating effectiveness of relevant controls if:

(1) the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of other procedures;

(2) procedures other than tests of controls cannot alone provide sufficient appropriate evidence; or

(3) the subject matter is internal control.

d. If the auditor designed and performed tests of controls to rely on their operating effectiveness and identified deviations in those controls, the audit team should make specific inquiries and perform other procedures as necessary to understand these matters and their potential consequences. The audit team also should determine whether:

(1) the tests of controls that have been performed provide an appropriate basis for reliance on the controls,

(2) additional tests of controls are necessary, or

(3) the potential risks of misstatement need to be addressed using other procedures.

e. To obtain evidence of the effectiveness of internal control activities, the auditor should perform physical observations, inquiries of appropriate personnel, or inspection of relevant documents. No one specific test is always necessary, applicable, or equally effective in every circumstance. In fact, a combination of these types of tests is often required to provide the necessary level of assurance that controls are working effectively. For the selected items, audit evidence should be gathered to ascertain that there are no material weaknesses. The type of audit procedures selected depends upon the nature of the control to be tested and the available evidence to review the control. Auditors should use the standard audit programs and tailor their audit procedures to fit their individual circumstances.

f. The nature of the control influences the type of evidential matter that is available to review the control. For example, if the control provides documentary evidence, the auditor may decide to inspect the documentation. For other controls, such documentation may not be available or relevant. For example, segregation of duties controls generally do not provide documentary evidence. In such circumstances, the auditor may obtain evidential matter about the effectiveness of operation through observation or inquiry.

g. The timing of audit effort and the period covered by the audit should also be considered in selecting the appropriate audit procedures to confirm DFARS compliance. Timing of an audit procedure refers to when it is performed or the period or date to which the audit evidence applies. The auditor should consider the timing of audit procedures and their impact when determining the extent of testing needed to give an opinion. If audit procedures are performed at an interim date (e.g., during a specific quarter of the year or half the year), the auditor should determine the need to cover the remaining period by performing audit procedures for the intervening period.

Evidential matter should relate to the audit period and, unless it is documentary evidence, should be obtained during the audit period when sufficient corroborative evidence is most likely to be available. When the evidence relates only to a specific point in time, such as evidence obtained from physical observation, the auditor should obtain additional evidence that the control was effective during the entire audit period. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection of procedures manuals to determine that the control was in operation during the entire period.

h. The auditor should determine the extent of testing to be performed. This determination is a matter of auditor judgment taking into consideration:

- the information gathered in developing an understanding of the internal control structure;
- the nature of the control to be tested;
- audit leads and or prior audit findings;
- identified risk;
- the nature and availability of evidential matter; and
- the contractor's monitoring and testing efforts.

The extent of testing is also significantly impacted by the FAO's total audit experience with the contractor. For instance, the extent of required testing of the estimating system is influenced by the current experience on forward pricing audits. In most instances, where there is significant proposal activity, the auditors have gained a great deal of knowledge of the estimating system controls during proposal audits.

i. When identified control activities are accomplished as part of the contractor's IT operations, the auditor should consider the need for assistance from IT specialists and coordinate with their HQ/regional offices when necessary.

5-109 Assessing Control Risk **

a. Control risk is the likelihood that a material misstatement or noncompliance in an account or area subject to audit will not be prevented or detected and corrected on a timely basis by the contractor's internal controls. In assessing control risk, the auditor considers the effectiveness of established control activities to accomplish stated control objectives. The more effective the control activities, the lower the control risk.

b. The auditor should assess control risk for each relevant control objective that pertains to the contractor's compliance with the applicable DFARS business system requirements and contract terms under examination. Only when the internal controls have been tested and determined to be effective, can the auditor rely on them and reduce the amount of substantive testing in the applicable audit area. Further details in assessing control risk can be found in 2-306.3.

c. If the internal controls are found not to be operating effectively, the auditor cannot rely on them (when performing other than business system audits) and will need to design substantive audit procedures to account for the lack of effective internal controls in the applicable audit area.

d. The assessment of control risk should be documented in the audit working papers in sufficient detail to enable the members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent of the assessment and the control risk factors identified relevant to the assertion.

e. Assessments of low risk for specific control objectives mean the auditor can rely on the contractor’s internal controls and can reduce testing in other related audits to analytical procedures and/or a combination of tests of details.

5-110 Business Systems Reporting **

a. Reporting on contractor business system compliance with the applicable DFARS criteria, laws and regulations, and contract terms must be made in all audit reports. The business system audit report for the contractor’s business systems should follow the general guidance in this section, 10-200, and the proforma audit report.

If the audit opinion is other than unqualified, the basis of the audit opinion (i.e., type of modified opinion) and the type of opinion should be documented. Refer to 10-208.5 for further guidance regarding audit opinions. In the report, document material weaknesses and system deficiencies that do not comply with the DFARS criteria regarding provisions of laws, regulations, contracts, and grant agreements or fraud, waste, or abuse. Less than material noncompliance that warrants attention of those charged with governance (the contractor and contracting officer) should be included in an Appendix.

Material Weakness means a deficiency or combination of deficiencies in the internal control over information in contractor business systems, such that there is a reasonable possibility that a material misstatement of such information will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is — (1) probable; or (2) more than remote but less than likely.

A *system deficiency* is a deficiency or combination of deficiencies in the internal control over information in contractor business systems that does not rise to the level of a material weakness.

A *less than material noncompliance that warrants attention of those charged with governance (the contractor and contracting officer)* is a noncompliance that does not have a material impact on the acceptability of the business system but is important enough to be communicated.

For all reported deficiencies including those that are less than material noncompliances, yet warrants the attention of those charged with governance (the contractor and contracting officer), prepare a statement of condition and recommendation (SOCAR) and include the SOCAR in the audit report as an exhibit or appendix. The following table depicts where to document noncompliances found during a business system examination.

Condition	Exhibit	Appendix	Opinion Type
Material Weakness	X		Generally Adverse
System Deficiency	X		Generally Qualified
Less than Material Noncompliance that Warrants the Attention of those Charged with Governance		X	Generally Unqualified

In certain circumstances, the auditor may determine that material weaknesses and system deficiencies identified during a business system audit require immediate consideration of the contracting official to ensure timely resolution of the identified business system noncompliance(s). In those rare instances, the auditor should open a business system deficiency report assignment (11090) to report the issue, while continuing towards completion of the originating business system audit.

GAGAS requires that the auditor state in the originating examination report that they are issuing an additional report (e.g., business system deficiency report). The auditor should include a reference to the separate report (e.g., business system deficiency report) and state that the business system deficiency report is an integral part of the originating business system audit. The Statements of Condition and Recommendations Exhibits in the audit report should document any material weaknesses/system deficiencies with DFARS criteria disclosed during the examination. The report should also comment on the contractor's efforts to correct the deficiencies and include the contractor's comments regarding the auditor finding.

When auditors detect potential instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements or fraud, waste, or abuse that do not warrant attention of those charged with governance (the contractor and contracting officer), the auditors' determination of whether and how to communicate such instances to audited entity officials is a matter of professional judgment.

b. If a material weakness or system deficiency is identified for any of the six contractor business systems defined in DFARS 252.242-7005 in other than business system audits, (e.g., forward pricing proposals, annual incurred cost audits, etc.), or assignments not resulting in the issuance of an audit report (e.g. real-time testing of labor, purchase existence and consumption, paid vouchers, etc.), a separate Business System Deficiency Report Assignment should be established using activity code 11090. Because of the importance of timely communication of such matters, the deficiency report should be issued as soon as possible.

GAGAS requires auditors to report certain findings identified in an examination engagement, even when those findings are related to areas outside the specific objectives of the engagement. This includes, among other things, material weaknesses and system deficiencies in internal control; and deficiencies in internal control that are a less than material noncompliance that warrants the attention of those charged with governance (the contractor and contracting officer).

To facilitate tracking and timely resolution of noncompliances with the DFARS criteria identified in other than business system audits, DCAA will report the findings in a separate deficiency report. The Deficiency Report Assignment is an integral part of the originating GAGAS examination engagement (e.g., incurred cost audit), not a separate examination. As a result, it is not necessary to document in the deficiency report assignment many of the procedures generally required to comply with GAGAS for an examination, since the GAGAS procedures would be documented in the originating GAGAS examination engagement. The deficiency report assignment working papers will reference the originating assignment and include the working papers from that assignment that contain support for the noncompliance with the DFARS criteria. Otherwise, it generally will not be necessary to reference or incorporate other working papers from the originating assignment (e.g., related to the risk assessment). Both the deficiency report and the report on the originating GAGAS examination will note that the separate deficiency report is an integral part of the examination engagement, and each report will reference the other.

If the evaluation of the identified noncompliance with the DFARS criteria and the elements of a finding were not fully developed in the originating assignment, the auditor should perform procedures to accomplish that as part of the Deficiency Report Assignment so as not to delay issuance of the report on the originating examination. However, such effort should generally not be extensive since the objective is not to evaluate the contractor's compliance with all aspects of the applicable DFARS criterion or criteria. The objective is only to establish whether the noncompliance identified in the originating audit is a material noncompliance; and, therefore, represents a material weakness in compliance with the DFARS criteria, or is a system deficiency in internal control. When reporting material weaknesses and or system deficiencies, identify an approximate dollar impact/effect of the deficiencies, where applicable. The calculation used to quantify the impact does not need to be exact but should provide a reasonable estimate.

c. The auditor is required to identify the audit period in the audit report. The audit period is the period of time for which the business system was evaluated.

d. Contractor Business System Deficiency Withholds

(1) The reported issues found when examining contractors with "Covered contracts", may be subject to withhold payments if the ACO makes a final determination to disapprove a contractor's business system in accordance with the clause at 252.242-7005. DFARS 252.242-7005, defines a "Covered contract" as a contract that is subject to the Cost Accounting Standards under 41 U.S.C. chapter 15, as implemented in regulations found at 48 CFR 9903.201-1. (See the FAR Appendix) (10 U.S.C. 2302 note, as amended by section 816 of Public Law 112-81).

(2) If the contracting officer makes a determination to disapprove a contractor's system, they will take withholds against the applicable covered contracts containing the business system clause. Assistance may be requested from the audit team in making a determination for whether the business system contains material weaknesses. The contracting officer has the sole discretion and authority to identify the covered contracts from which to withhold payments. The contracting officer has the sole authority to promptly notify the contractor, in writing, of the contracting officer's determination to implement payment withholding in accordance with the clause at 252.242-7005, Contractor Business Systems.

(3) The contracting officer, in consultation with the auditor or functional specialist, shall monitor the contractor's corrective action progress in correcting the deficiencies.

(a) If the contractor notifies the contracting officer that the contractor has corrected the material weaknesses, the contracting officer shall request the auditor or functional specialist to review the corrective action taken to verify that the deficiencies have been corrected. The audit team will perform appropriate audit follow-up in determining the progress made for whether the contractor corrected the deficiencies. See CAM 5-111 Follow-Up Business System Audits.

5-111 Follow-Up Business System Audits **

a. This section provides audit guidance on performing follow-up business system audits to determine if the contractor's system complies with the applicable Defense Federal Acquisition Regulation Supplement (DFARS) business system requirements related to the previously reported material weakness and/or system deficiencies. These fundamental requirements and responsibilities apply to follow-up business system audits of each of the contractor's business systems under DCAA's audit cognizance (Accounting Systems, Post Award Accounting Systems, Cost Estimating Systems, and Material Management and Accounting Systems (MMAS)). The follow-up audit should be completed under the appropriate activity code for the applicable contractor business system.

b. After a contractor has been cited for one or more business system deficiencies, the auditor and contracting officer will monitor the contractor's progress toward correction of the deficiencies. If the contractor fails to make adequate progress, the contracting officer shall take whatever action is necessary to ensure that the contractor corrects the deficiencies.

c. When the contractor notifies the contracting officer that the contractor has corrected the deficiencies, the contracting officer shall request the auditor review the correction(s) to determine if the deficiencies have been resolved.

d. The contracting officer makes the final determination that the contractor has corrected the deficiencies. FAOs should be mindful that once the contracting officer is notified by the contractor that all corrective actions have been implemented, the contracting officer will determine that:

- the contractor corrected all material weaknesses and/or system deficiencies as directed by the contracting officer's final determination; or

- there is a reasonable expectation that the corrective actions have been implemented; or

- the contractor has not corrected all material weaknesses and/or system deficiencies as directed by the contracting officer's final determination; or

- there is not a reasonable expectation that the corrective actions have been implemented.

e. Material weaknesses and system deficiencies are generally considered outstanding until the contractor has corrected the deficiency and DCAA has performed a follow-up business system audit and found the revised business system practice(s) to be compliant with the DFARS business system requirements.

f. FAOs should initiate a follow-up business system audit when the FAO is notified by the contractor (either directly or through the contracting officer) that it has implemented the appropriate corrective actions and sufficient transactions/costs are readily available to adequately examine the revised business system practices. What constitutes sufficient transactions will depend on factors such as the nature of the deficiency and the affected control, the frequency of the control's application, and the volume of transactions to which it is applied. The audit team should coordinate with the contractor to gather this information. If the audit team believes enough transactions are not available to examine the corrective actions and provide an audit opinion, the audit team should not continue audit efforts and coordinate with the contracting officer and contractor to determine the best time to perform the audit. If the audit team determines that enough transactions are available for audit, the audit team should continue the audit and initiate a planning meeting with contractor personnel prior to the formal entrance conference.

g. Material weaknesses and system deficiencies reported by the FAO and included in the Administrative Contracting Officer's (ACO)'s final determination will be covered under the follow-up business system audit.

The scope of the follow-up business system audit will be limited to determining if the contractor corrected the previously reported material weaknesses and/or system deficiencies and the system complies with DFARS. The audit report will evaluate the revised business system practices and opine on the business system's compliance with the relevant DFARS business system requirements. Less than material noncompliances warranting the attention of those charged with governance (the contractor and contracting officer) that were reported in a previous business system audit do not need to be included in the scope of audit because these instances of noncompliance do not materially affect the Department's ability to rely upon the information produced by the system.

If the previously reported material weaknesses and system deficiencies were not sustained by the contracting officer, but the contractor updated, modified, or changed their system and stated the non-compliance(s) has been corrected, the audit team should discuss including the deficiencies in the follow-up business system audit with the ACO. Elevate significant disagreements with the ACO to DCAA management when necessary. When the contractor has not changed its business system practices, a follow up audit should not be performed.

The business system audit program should be tailored as needed to reflect the audit procedures necessary to determine DFARS compliance with the area(s) related to the previously reported material weaknesses and/or system deficiencies.

h. The audit team should obtain and document an understanding of the revised business system practices to plan the audit. To be consistent with the purpose and scope of the follow-up business system audit, the material weaknesses and/or system deficiencies previously reported should be included in the system demonstration and walk-through.

i. The FAO should notify the ACO on a real time basis of any revised business system practices that are determined to be noncompliant with the DFARS business system requirements. In addition, the FAO should notify the contracting officer on a real time basis of any additional deficiencies that were not originally reported but were identified during the follow-up audit. Auditors should discuss these findings with the contracting officer and develop the elements of the findings to the extent necessary to assist contractor management and oversight officials of the audited entity in understanding the need for taking additional corrective action.

j. If the corrective actions did not successfully correct the reported deficiencies this should be discussed with the contracting officer, and the audit report will state that those deficiencies continue to exist and are noncompliant with the DFARS business system requirements. If the follow-up business system audit determined the deficiencies have been corrected and the business system now complies with the applicable DFARS business system requirements, this should be discussed with the contracting officer, and the follow-up business system audit report should be prepared and issued in a timely manner.

k. The FAO will issue a new audit report advising recipients of the original report of the status of the corrective actions. The audit report will include a description of the previously reported deficiencies, status of the revised business system practices, and status of any prior recommendations. The follow-up audit report should reference the previous report(s). To give the contracting officer a basis for understanding the significance of the findings, auditors should quantify the results in terms of dollar value or other measures. If a follow-up business system audit discloses a material weakness or system deficiency that was not previously reported, it should be reported in the follow-up business system audit report.

FAOs should follow CAM 5-110 to determine the appropriate audit opinion and prepare the audit report. The audit report should be modified to reflect that a follow-up business system audit was performed.

5-200 Section 2 – Preaward Surveys of Prospective Contractor Accounting Systems **

5-201 Introduction **

This section provides guidance for performing preaward surveys of prospective contractor accounting systems.

5-202 Preaward Survey of a Prospective Contractor's Accounting System **

a. A preaward survey of a prospective contractor's accounting system is an examination of the accounting system at either a large or small contractor before contract award. The audit is performed at the request of a contracting officer to determine the acceptability of a contractor's accounting system for accumulating costs under a prospective Government contract. It is usually requested as part of an overall preaward survey of a contractor conducted by a contract administration office under FAR 9.106 or DFARS 209.106 or PGI 209.106. The audit scope should be limited to obtaining an understanding of the design of the prospective accounting system so as to appropriately complete Standard Form 1408 (SF 1408), "Preaward Survey of Prospective Contractor Accounting System" (see FAR 53.209-1(f)) and those procedures essential to reach an informed opinion on whether or not the design of the prospective contractor's accounting system is acceptable for accumulating costs under a Government contract. It is not necessary to conduct an in-depth evaluation of the operational effectiveness of the accounting system.

b. When performing the preaward survey of a prospective contractor's accounting system, the auditor will determine the acceptability of the design of the contractor's system and determine if the system is:

(1) in operation; or

(2) set up, but not in operation,

The SF 1408 also discusses accounting systems which are either anticipated or nonexistent. It is not possible to perform an examination level engagement under those circumstances since procedures would most likely be limited to inquiry alone. If requested to perform an audit for an accounting system that is either anticipated or nonexistent, the auditor or supervisory auditor should notify the requestor that we are unable to provide an audit report or SF 1408 but will be available to do so once the system is set up or in operation.

c. The requestor can be supported by providing a current preaward accounting system report, performing an examination to opine on the design of the system, or performing a follow-up audit. If a prior preaward survey of a prospective contractor's accounting system has been performed and is relatively current, it should be provided to the requestor. If the prior preaward survey is not current, perform an examination of sufficient scope and depth to evaluate the acceptability of the design of the contractor's accounting system for accumulating costs under a Government contract. If a recent preaward audit disclosed deficiencies that are considered material weaknesses and or system deficiencies, a follow-up audit can be performed to evaluate corrective actions taken provided the original audit was completed in the last 12 months and there have been no significant revisions to the design of the accounting system unrelated to the corrective actions. The scope of the follow-up audit is limited to verifying there have been no significant revisions to the design of the system (other than those required as corrective action to cited deficiencies) and whether the corrective action adequately addresses the deficiencies. If the follow-up discloses no significant revisions to the system design and that the contractor corrected the deficiencies, the report should indicate that the contractor has effectively implemented corrective action. The audit report should also include that the accounting system is suitably designed, in all material respects, for award of a prospective contract in accordance with the criteria contained in FAR 53.209-1(f). A proforma version of the preaward accounting system follow-up report is available as other audit guidance.

d. If requested to perform a preaward accounting system audit on a contractor that has an active Government contract, the auditor should check the FAO's files to determine if prior work has been performed that will provide the contracting officer the information necessary to fill in the SF 1408 without the performance of the preaward audit (e.g., if a prior preaward or post contract award accounting system audit has been performed). If prior information does exist, contact the contracting officer to determine if the prior report will meet their needs. Additionally, if there are known system deficiencies or voucher processing problems, this information should be provided to the contracting officer as well. Auditors should not issue an opinion stating the design is acceptable for award when there are known deficiencies. If no information is on file, the auditor should proceed with performing the preaward as requested.

e. A customer requested preaward survey of a prospective contractor's accounting system should be started as soon as practicable. An untimely response to such a request could delay the award of a contract. Acknowledge the request in accordance with 4-104.

f. If the contracting officer also requires an assessment of the company's financial condition during the preaward survey of the prospective contractor's accounting system, refer the requestor to DCMA. However, in all audit situations, auditors should be alert to conditions which may indicate unfavorable or adverse financial conditions or other circumstances which could impede a contractor's ability to perform on Government contracts.

5-203 Audit Reports **

Audit reports should be responsive to the specific needs identified by the audit request and in discussions, if any, with the requestor. The preaward survey report provides an opinion on whether the accounting system design is compliant with the criteria contained in FAR 53.209-1(f), SF 1408, is not compliant with the criteria contained in the SF 1408, or compliant with a recommendation that a follow-on accounting system audit be performed after contract award. The audit report should be appropriately tailored to the specific circumstances of the audit. Audit reports should also provide sufficient information (e.g., SF 1408 for the preaward) to support audit conclusions. Refer to 10-211.2c for guidance in presenting the Statement of Conditions and Recommendations, if applicable.

5-300 Section 3 – Audit of Compliance with DFARS 252.242-7006, Accounting System Administration **

5-301 Introduction **

a. This section provides guidance for auditing accounting systems for covered defense contractor's compliance with DFARS 252.242-7006, applicable regulations and contract terms.

b. As indicated in DFARS 242.7502, contractors with cost type or contracts with progress payments based on a percentage or stage of completion shall maintain an acceptable accounting system.

c. In accordance with DFARS 242.7503, a Contracting Officer when contemplating a cost type contract or contract with progress payments made on the basis of costs incurred by the contractor or on a percentage or stage of completion, should insert the clause at DFARS 252.242-7006 in solicitations and contracts.

d. An understanding of the internal control environment, accounting framework and organizational structure will serve as a framework for evaluating the overall effectiveness of the internal controls. The accounting framework and organizational structure may also be used for risk assessment when evaluating other contractor business systems, when applicable (e.g., the contractor accounting system has not changed, the accounting system audit is current).

e. Overall accounting controls include the contractor's controls to assure it remains financially capable to perform on Government contracts, and it maintains a current description of the accounting system, including a current, accurate, and complete Disclosure Statement (if CAS covered) and a current chart of accounts.

f. Refer to CAM 2-306.2 and 2-306.3 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk as it relates to the examination of the accounting system.

5-302 Contract Clause DFARS 252.242-7006 **

a. The clause of DFARS 252.242-7006 Accounting System Administration provides 18 criteria with which an acceptable accounting system must comply.

b. As prescribed in DFARS 252.242-7006(a)(1), an acceptable accounting system means a system that complies with the system criteria in DFARS 252.242-7006(c) (refer to 5-305) to provide reasonable assurance that

(1) applicable laws and regulations are complied with;

(2) the accounting system and cost data are reliable;

(3) risk misallocations and mischarges are minimized; and

(4) contract allocations and charges are consistent with billing procedures.

5-303 General Audit Policy **

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor business systems.

b. Auditors should obtain sufficient, appropriate and relevant evidence across all applicable DFARS criteria. The extent of testing will be dependent on the identified level of risk related to the system's compliance with individual DFARS criteria.

c. These environmental and overall accounting control objectives apply to both large and small contractors.

5-304 Accounting Systems Audit Objectives **

The audit objective is to determine if the contractor's accounting system complies with DFARS 252.242-7006, Accounting System Administration, applicable regulatory requirements and contract terms to support the ACO's determination of contractor compliance regarding its accounting system.

5-305 Scope of Audit **

a. When performing an Accounting System Administration requirements audit, the auditor will obtain an understanding of the contractor's compliance with DFARS 252.242-7006(c); determine if the contractor is compliant with the accounting system criteria prescribed in DFARS 252.242-7006(c); and report material weaknesses, system deficiencies with DFARS criteria and less than material noncompliances that warrants the attention of those charged with governance (the contractor and contracting officer).

b. While the nature and extent of audit effort depends upon contractor size, amount of Government business and audit risk (materiality and sensitivity), to be able to opine on compliance with DFARS 252.242-7006(c) criteria, all18 criteria must be examined.

The auditor must plan an audit to obtain sufficient, appropriate evidence to opine on whether the contractor's accounting system complied with DFARS 252.242-7006.

c. The pervasiveness of IT activities in most organizations requires that the auditor consider the impact these activities have on the contractor's control environment. The auditor should try to eliminate any duplicate effort with respect to audits of IT internal controls in other areas (i.e., labor, material, indirect/OH, etc.). However, if the auditor determines that it would be most effective to audit these controls as a part of the Control Environment, Accounting Framework and Organizational Structure, then the auditor should apply adequate testing of the IT controls that are key to complying with the 18 DFARS criteria. This information should be considered when determining the contractor's compliance with each of the 18 DFARS criteria, applicable regulatory requirements, and contract terms.

d. The assessment of the risk of a material misstatement due to fraud is also part of the assessment of audit risk for the contractor's control environment and overall accounting system controls and should be assessed. If fraud is suspected, the circumstances should be reported in accordance with 4-700.

e. The following paragraphs contain guidance for evaluating the contractor's compliance with the 18 DFARS 252.242-7006(c) Accounting System Administration criteria. The criteria is as follows:

The Contractor's accounting system shall provide for—

(1) A sound internal control environment, accounting framework, and organizational structure:

Control Environment

The control environment has a pervasive influence on the way business activities are structured, objectives established, and risks assessed. It also influences control activities, information and communication systems, and monitoring activities.

There are many variations of contractor's control environment, accounting framework and organizational structures for large and small contractors. For example, at some smaller less complex contractor organizations, the contractor may not have formal policies and procedures, or descriptions of how the contractor complies with the DFARS accounting system criteria and only one person performing all the accounting functions. Larger contractors generally have active management involvement, descriptions of the accounting procedures and written policies over compliance with DFARS 252.242-7006(c). There are many variations of contractor control environments and auditors should keep in mind that in some cases the cost of implementing controls may outweigh the benefit for the smaller less complex contractor environments. Therefore, auditors should consider the risk and the types of controls in place based on the type of contractor environment and ensure the auditor is applying reasonable procedures based on the circumstances for the contractor environment.

In addition to the contractor adhering to a sound internal control environment to comply with DFARS 252.242-7006(c)(1), the contractor should comply with the following FAR clauses for its control environment:

FAR 52.203-13 Contractor Code of Business Ethics and Conduct. This clause is inserted into solicitations and contracts if the value of the contract is expected to exceed $6,000,000 and the performance period is 120 days or more. Also, the contractor is required to implement a Business Ethics and Awareness and Compliance Program and Internal Control System (refer to 52.203-13(c) for the minimum requirements.)

FAR 52.203-14 Display of Hotline Posters. This clause is inserted into contracts if the value exceed $6,000,000 or a lesser amount established by the agency and the agency has a fraud hotline poster or contract is funded with disaster assistance funds.

Exceptions:

Implementation of a Business Ethics and Awareness and Compliance Program and Internal Control System prescribed under FAR 52.203-13(c) is not a requirement if the contractor has represented itself as a small business concern pursuant to the award of this contract or if this contract is for the acquisition of a commercial item as defined at FAR 2.101.

The clause for displaying hotline posters is not a requirement if the contract is for the acquisition of a commercial items or will be performed entirely outside the United States (refer to FAR 3.1004(b)) or if contractor has implemented a business ethics and conduct awareness program(refer to FAR 52.203-14(c)).

Accounting Framework

Based upon the size and complexity of the contractor, auditors should obtain from contractor management the policies and procedures that are in place to support its accounting framework/organization structure. This information will also be used to support the auditors understanding of the contractor's accounting system. The contractor's accounting framework should contain at a minimum the following information:

- Chart of Accounts (with descriptions of charges applicable to each account) and explanation of how changes to the chart of accounts are made;

- Written descriptions of the indirect pools and allocation bases. (Note: If the contractor is a small contractor and does not have a formal chart of accounts or indirect pool(s) and allocation base(s) descriptions, document what the contractor is using to make these determinations);

- Descriptions should be for all primary pools (e.g., overhead, G&A) and intermediate pools, if any (e.g., occupancy costs allocation to overhead and G&A).

Organizational Structure Based upon the size and complexity of the contractor, auditors should obtain and document the contractor's organizational structure (e.g., ask the contractor to provide an organizational chart or a flow chart of its operations). If available, have the contractor walk you through the current organization chart (or flowchart) and determine whether it delineates clear lines of authority, duties and responsibilities, and segregation of duties and responsibilities of accounting and billing functions considering the size of the contractor. (Note: If examining a small contractor and it does not have an organization chart (or flowchart), have the contractor describe at the walkthrough, its policy on delegation of authority, and delineation of duties and responsibility, and segregation of duties and responsibilities of accounting and billing functions. Your understanding should be documented as part of the risk assessment and considered throughout the business system examination.

(2) Proper segregation of direct costs from indirect costs:

As defined in DFARS 252.242-7006, an acceptable accounting system means, in part, a system that is properly recording, classifying, and presenting accurate and timely financial data for reporting in compliance with applicable laws and regulations. DFARS criterion (2), requires the proper segregation of direct and indirect costs to arrive at total cost. The contractor should record and classify its direct/indirect costs to ensure its.

- direct costs are appropriately segregated in direct cost accounts and meet the requirements prescribed in FAR 31.202; and

- its indirect costs are appropriately segregated in indirect accounts and meet the requirements prescribed in FAR 31.203.

(3) Identification and accumulation of direct costs by contract:

FAR 31.202, Direct Costs, applies to DFARS criterion (3). FAR requires that direct costs identified as contract specific are direct costs of that contract and are to be charged directly to the contract. Also costs specifically identified with other final cost objectives (e.g., other contracts, etc.) of the contractor are direct costs of those cost objectives and should be charged to their applicable contracts. DCAA tests compliance with this DFARS criterion by determining if the direct costs (i.e., direct labor, direct materials, ODC, etc.) of the contract are properly identified and accumulated in contract specific cost accounts.

(4) A logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives:

DFARS criterion (4) requires the contractor's compliance with FAR 31.203, which pertains to grouping logical indirect costs and appropriate bases for the allocation of indirect costs to intermediate or final cost objectives. The auditor should determine if the contractor has a logical and consistent method for accumulating and allocating its indirect costs to intermediate and final cost objectives by determining if the contractor has:

- Established logical (homogeneous) indirect cost pool(s);
- Defined the allocation base for each indirect cost pool; and
- Established there is a logical causal/beneficial relationship between the indirect cost pool and its allocation base.

Note: The indirect cost pool and base structure should not be overly complex in accordance with FAR 31.203(c). FAR 31.203(c) states, in part "When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation."

If a contractor has CAS covered contracts, the auditor should review the current Disclosure Statement to assist in the determination of compliance with the system criterion.

(5) Accumulation of costs under general ledger control:

(6) Reconciliation of subsidiary cost ledgers and cost objectives to general ledger:

These DFARS criteria require evidence that the contractor's accounting system accumulates costs under the general ledger control (criterion 5) and its subsidiary ledgers or its equivalent are reconcilable to the general ledger (criterion 6). The detail that supports each of the general ledger accounts may generally be found in what is known as a subsidiary ledger or its equivalent. Therefore, it is important that subsidiary ledgers or its equivalent are reconciled to the general ledger to ensure the data in the general ledger is correct and timely.

(7) Approval and documentation of adjusting entries:

DFARS criterion (7) requires that the contractor's adjusting journal entries (e.g., correcting, transferring, closing, and credits) are recorded timely and properly classified and that adjustments have adequate documentation, and are properly authorized. We test adjusting journal entries because they present an opportunity for potential manipulation of the accounting records outside established routine controls. An appropriate review process and required detailed supporting documentation mitigate the risk of unauthorized adjustments resulting in inaccurately reported costs.

(8) Management reviews or internal audits of the system to ensure compliance with the Contractor's established policies, procedures, and accounting practices:

DFARS criterion (8) requires ongoing contractor management reviews and monitoring activities of its operations. This also includes the monitoring of its indirect cost for its indirect rates billed to government contracts. The amount of review the contractor should perform will vary depending on the size and complexity of contractor operations. For large contractors a formal plan should be in place for how it monitors its organization. Smaller, less complex contractors' review processes are more likely to be informal and may be accomplished by management's direct or close involvement in operations.

(9) A timekeeping system that identifies employees' labor by intermediate or final cost objectives:

(10) A labor distribution system that charges direct and indirect labor to the appropriate cost objectives:

DFARS criteria (9) and (10) are interconnected. Unlike other costs, labor is not supported by external documentation such as an invoice, purchase order or receipt. Responsibility for accuracy is maintained throughout the contractor's organization. The risk associated with the accurate recording, distribution, and payment of labor may be significant. DFARS Criterion (9) requires the contractor's timekeeping system (paper or electronic) to record employee labor hours by cost objectives (e.g., project number, contract number or name, or other direct or indirect identifiers), to have traceable direct labor hours to applicable work authorization documents and have timesheets (paper or electronic) certified by employees for the hours recorded and approved by supervisors.

Additionally, DFARS criterion (10) requires the contractor's labor distribution system to accurately document the employee labor hours (from timesheets) and dollars (from payroll records) by employee, by project name or job code and indirect accounts. The labor distribution records should be reconcilable to the cost accumulation records (e.g., job cost ledgers or equivalent for direct labor and the general ledger for indirect labor).

(11) Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account:

DFARS criterion (11) requires the contractor's accounting system records costs (generally to the job cost ledger) and present accurate and timely (i.e., at least monthly) reporting of those contract costs.

(12) Exclusion from costs charged to Government contracts of amounts which are not allowable in terms of Federal Acquisition Regulation (FAR) part 31, Contract Cost Principles and Procedures, and other contract provisions:

DFARS criterion (12) requires the contractor’s system exclude from costs charged to Government contracts amounts which are not allowable in terms of FAR Part 31 and/or other contract provisions. In addition, FAR 31.201-1(b) provides allowable costs to the Government are limited to those allocable costs which are allowable pursuant to FAR Part 31 and applicable agency supplements. The contractor’s accounting system must be able to segregate and accumulate unallowable costs, and appropriately exclude unallowable costs (the preferred method is for unallowable costs to be identified when recorded and accumulated in specified unallowable accounts) from indirect cost pool when calculating indirect expense rates.

(13) Identification of costs by contract line item and by units (as if each unit or line item were a separate contract), if required by the contract:

DFARS criterion (13) requires the contractor job cost ledgers or equivalent record, classify, analyze, summarize and present costs by contract line item and by units if required by the contract.

(14) Segregation of preproduction costs from production costs, as applicable:

DFARS criterion (14) requires manufacturing contractors identify and segregate its non-recurring pre-production costs in its job cost ledgers or equivalent.

(15) Cost accounting information, as required:

DFARS 252.242-7006(c)(15)(i) By contract clauses concerning limitation of cost (FAR 52.232-20), limitation of funds (FAR 52.232-22), or allowable cost and payment (FAR 52.216-7);

DFARS criterion (15)(i) requires the contractor to establish procedures to ensure the limitation of costs or funds and the allowable cost and payment clauses for reporting contract cost information are adhered to when billing cost to Government contracts. These reporting requirements influence the reimbursable amounts on Government flexibly priced and T&M contract billings. The following are a description of the limitation of costs or fund clauses and the allowable cost and payment clause:

Limitation of Cost (FAR 52.232-20): Contractor is required to provide the contracting officer advance notice (60 days which may be varied in the contract from 30 to 90 days) whenever the total cost incurred on the contract will exceed a specified percentage (75 percent which may be varied in the contract from 75 to 85 percent) of the estimated cost or will be greater or substantially less than the estimated cost specified in the contract.

Limitation of Funds (FAR 52.232-22): Contractor is required to provide the contracting officer advance notice (60 days which may be varied in the contract from 30 to 90 days) whenever the total cost incurred on the contract will exceed (i) a specified percentage (75 percent which may be varied in the contract from 75 to 85 percent) of the funds currently allotted or, (ii) for cost sharing contracts, the amount allotted to the contract by the Government plus the contractor's corresponding share.

Allowable Cost and Payment (FAR 52.216-7): This FAR clause is inserted into cost reimbursement contracts and Time-and-Materials (T&M) contracts for other than commercial items. For T&M contracts, the clause only applies to the part of the contract that reimburses allowable cost of materials (FAR 52.232-7(b)(4)).

DFARS 252.242-7006(c)(15)(ii) To readily calculate indirect cost rates from the books of accounts:

DFARS criterion (15)(ii) requires the accounting system be designed so it is able to periodically (e.g., monthly), readily calculate year-to-date indirect rates from its accounting records. Interim indirect rate calculation facilitates management monitoring of provisional indirect billing rates. Also, FAR 52.216-7(e)(1) requires the billing rates to be the anticipated final rates and may be revised by the contracting officer or the contractor to prevent substantial overpayment or underpayment.

(16) Billings that can be reconciled to the cost accounts for both current and cumulative amounts claimed and comply with contract terms:

DFARS criterion (16) requires the contractor maintain adequate reliable cost data so that billings can be reconciled to the cost accounts for both current and cumulative amounts and comply with contract terms. This requirement helps prevent substantial overpayment or underpayment; it also ensures appropriate historical data (i.e., material cost/quantities, labor cost/hours, etc.) are available for the contractor to develop and support estimates for follow-on procurements of same or similar services or items.

(17) Adequate, reliable data for use in pricing follow-on acquisitions:

DFARS criterion (17) requires the contractor ensures appropriate historical data (i.e., material cost/quantities, labor cost/hours, etc.) are available for the contractor to develop and support estimates for follow-on procurements of same or similar services or items. The contractor's accounting system should be able to segregate direct and indirect costs, identify costs by contract, exclude unallowable costs, identify costs by contract line item and units and segregate non-recurring costs from recurring production costs to maintain adequate reliable data for pricing follow-on acquisitions.

(18) Accounting practices in accordance with standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, Generally Accepted Accounting Principles:

DFARS criterion (18) requires the contractor's accounting practices be in accordance with standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, GAAP. At a minimum, smaller contractors should maintain an accrual basis accounting system with dual entry accounting that posts transactions to general ledgers and sub-ledgers and generates accurate financial reports. For larger more complex contractor environments that are subject to CAS, the contractor's system should also comply with the applicable cost accounting standards.

5- 306 Non-DoD Contractors Accounting Systems Audits **

Auditors may consider applying FAR 53.209(f) SF1408 criteria, after contract award, to non-DoD contractors when examining a non-DoD contractor's accounting system. The FAR criteria may be applied if the contracting officer, the non-DoD contractor and the auditor agree that the DFARS 252.242-7006(c) accounting system criteria is not suitable criteria to examine the non-DoD contractor since the contractor does not have government defense contracts.

5-307 Business Systems Reporting **

The auditor should follow the guidance in 5-110 and 10-200 for reporting on business systems.

5-308 Post Award Accounting System Audits **

a. The objective of the post award accounting system audit is to determine if the contractor's accounting system complies with the DFARS 252.242-7006, Accounting System Administration, requirements and contract terms and to report the results of audit to the cognizant contracting officer. The post award accounting system audit is an examination of a smaller less complex contractor accounting systems after contract award for flexibly priced contracts or contracts which provide for progress payments based on costs or on a percentage or stage of completion.

b. A post award accounting system audit is usually performed at the request of the contracting officer when:

(1) a follow-up audit to a preaward survey is recommended; or

(2) a preaward survey was not conducted prior to contract award, and the contracting officer determines that an audit is now required to support contract requirements; or

(3) auditors may self-initiate a post award accounting system audit, based on audit risk at for smaller less complex contractors.

c. The post award accounting system audit uses the same DFARS 252.242-7006, Accounting System Administration criteria as the accounting system audit.

d. The post award accounting system audit program includes comprehensive steps to gain a detailed understanding of the contractor's accounting system (e.g., tracing costs billed to source documentation) sufficient to render an opinion on compliance with the DFARS 252.242-7006, Accounting System Administration, requirements.

e. If the auditor determines that the smaller less complex contractor's accounting system is so complex it requires audit procedures contained in the audit program for a major contractor, the auditor should discontinue the audit under 17741 and use the Activity Code 11070, Accounting System Audit. The 11070 audit program is very similar to the 17741 audit program, since both small and large defense contractors with cost type contracts are subject to the DFARS requirements; however, the 11070 audit program steps considers more complex accounting and billing environments that are utilized at larger defense contractors.

f. In all audit situations, auditors should be alert to conditions which may indicate unfavorable or adverse financial conditions or other circumstances which could impede a contractor's ability to perform on Government contracts. During performance of post award audit risk assessments, auditors should follow the guidance in 2-306.1 when documenting consideration of inherent risk and adjust the audit scope and associated audit procedures appropriately for any increased risk.

5-308.1 Post Award Accounting Systems for Non-DoD Contractors with Cost Type Contracts **

a. A responsible government contractor (FAR subpart 9.1), is required to have an acceptable accounting system. FAR 53.209 SF1408 Preaward Survey of Prospective Contractor-Accounting System criteria, is the standard for determining if the design of the prospective contractor (i.e., both Non-DoD and DoD contractors) has an acceptable accounting system prior to contract award, unless the contractor has all fixed price type contracts.

b. After contract award, auditors may consider applying FAR 53.209-1(f) SF 1408 criteria for non-DoD contractors when examining a non-DoD contractor's accounting system. The FAR criteria are suitable criteria for performing accounting system audits of non-DoD contractors with cost-type contracts. The FAR criteria may be applied if agreement is not reached with the ACO and the non-DoD contractor that the DFARS 252.242-7006(c) accounting system criteria is suitable criteria because the contractor does not have government defense contracts (i.e., the ACO or the non-DoD contractor does not agree that DFARS 252.242-7006(c) applies and there is not a DFARS contract requirement).

c. The FAR 53.209-1(f) SF 1408 and the DFARS 252.242-7006(c) criteria are very similar and are both suitable criteria for examining either DoD or non-DoD contractor's accounting system. FAR 53.209-1(f) SF 1408 contains the criteria to ensure the design of the accounting system is acceptable prior to contract award. The FAR criteria is also suitable criteria to measure after contract award to opine on the design of the accounting system and the measurement of operational effectiveness by applying detailed testing of transactions, re-performance of controls and adding audit steps for the applicable billing requirements such as the allowable cost and payment clause (FAR 52.216-7). Also, consideration for any contract terms (e.g., ceiling limitations) should be reflected when planning the accounting system audit criteria.

d. Additionally, consideration should be given to agency specific criteria (e.g., Health and Human Services regulations, (HHSAR)) that the non-DoD contractor may be required to follow for an acceptable accounting system and to any contract terms.

5-308.2 Audit Reports **

The post award accounting system report provides an opinion on whether the accounting system is compliant with DFARS 252.242-7006, Accounting System Administration, requirements and contract terms. Audit reports should also be responsive to the specific needs identified by the audit request and in discussions, if any, with the requestor.

The audit reports should be appropriately tailored to the specific circumstances of the audit and should provide sufficient information to support audit conclusions.

5-400 Section 4 – Audit of Compliance with DFARS 252.242-7004, Material Management and Accounting System **

5-401 Introduction **

a. This section provides audit guidance for evaluating the contractor's compliance with DFARS 252.242-7004, Material Management and Accounting Systems (MMAS), applicable regulations and contract terms.

As prescribed by DFARS subpart 242.7204, the MMAS contract clause will be included in all contracts exceeding the simplified acquisition threshold that are not for the acquisition of commercial products or commercial services, and are either cost reimbursement contracts or fixed-price contracts with progress payments made on the basis of costs incurred by the contractor as work progresses under the contract. Contracts with small business, educational institutions and nonprofit organizations should not contain the MMAS contract clause.

b. An understanding of the internal control environment, accounting framework and organizational structure will serve as a framework for evaluating the overall effectiveness of the internal controls, as they relate to the DFARS 252.242-7004(c), MMAS requirements and the subject matter under examination. If possible, a determination should be made to ensure that the contractor's accounting system has not changed and the accounting system audit is current.

c. Overall accounting controls include the contractor's internal controls to assure it remains financially capable to perform on Government contracts.

d. Refer to 2-306.2 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal controls and assessing control risk as it relates to the examination of the MMAS.

5-402 DFARS Subpart 242.72 Contractor Material Management and Accounting System **

a. In evaluating the acceptability of the contractor's MMAS, the contracting officer, in consultation with the auditor and functional specialist, if appropriate, shall determine whether the contractor's MMAS complies with the system criteria for an acceptable

MMAS as prescribed in the clause at DFARS 252.242-7004, Material Management and Accounting System and pursue correction of any deficiencies.

b. DFARS 242.7203 Government Review Procedures to Establish Qualified MMAS Contractors:

DFARS 242.7203(a) requires a review be conducted when a contractor has $40 million of qualifying sales to the Government during the contractor's preceding fiscal year; and the ACO, with advice from the auditor, determines an MMAS review is needed based on a risk assessment of the contractor's past experience and current vulnerability. DFARS 242.7203(b) defines qualifying sales as sales for which certified cost or pricing data were required under 10 U.S.C. Chapter 3702, as implemented in FAR 15.403, or that are contracts priced on other than a firm-fixed-price or fixed-price with economic price adjustment basis. Sales include prime contracts, subcontracts, and modifications to such contracts and subcontracts.

5-403 Contract Clause DFARS 252.242-7004 Material Management and Accounting System **

a. The clause at DFARS 252.242-7004 Material Management and Accounting System provides system criteria with which an acceptable material management and accounting system must comply.

b. Contractors that do not have DoD contracts are not contractually required to comply with the DFARS criteria.

5-404 General Audit Policy **

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor business systems.

b. Auditors should obtain sufficient, appropriate and relevant evidence for all applicable DFARS criteria. The extent of testing will be dependent on the identified level of risk related to the system's compliance with individual DFARS criteria.

c. DCAA has primary responsibility to audit DoD contractor's MMAS systems. It is DCAA's policy to assist the ACO in providing audit support to assist the ACO in determining compliance with DFARS 252.242-7004 and report in accordance with 5-110.

d. The contractor is subject to the disclosure and maintenance requirements at DFARS 252.242-7004(c)(1) – (3). Therefore, the auditor must check if the contractor has

- policies, procedures, and operating instructions that adequately describe its MMAS (criterion (1));

- provide to the ACO upon request, the results of internal reviews conducted to ensure compliance with established MMAS policies, procedures, and operating instructions (criterion (2)); and

- if the contractor disclosed significant MMAS changes to the ACO at least 30 days prior to implementation (criterion (3)).

5-405 Material Management and Accounting System (MMAS) Audit Objectives **

a. The audit objective is to determine if the contractor's MMAS complies with the system criteria for an acceptable MMAS as prescribed in the clause DFARS 252.242-7004 MMAS to support the ACO's determination of contractor compliance regarding its MMAS.

b. The contractor is responsible for having adequate internal controls to ensure system and data integrity and ensure compliance with the 10 MMAS system criteria outlined in the contract clause at DFARS 252.242-7004(d), specifically MMAS system criterion (1). This standard requires the contractor to have an adequate system description including policies, procedures, and operating instructions that comply with the FAR and Defense FAR Supplement.

5-406 Scope of Audit **

a. When performing a Material Management and Accounting System (MMAS) audit, the auditor will obtain an understanding of the contractor's compliance with DFARS 252.242-7004; determine if the contractor is compliant with the material management system criteria prescribed in DFARS 252.242-7004(d); and report both material weaknesses and system deficiencies with DFARS criteria.

b. While the nature and extent of audit effort depends upon contractor size, amount of Government business and audit risk (materiality and sensitivity), to be able to opine on compliance with DFARS 252.242-7004(d) criteria; all 10 system criteria must be examined. The auditor must plan an audit to obtain sufficient, appropriate evidence to opine on the contractor's compliance with DFARS 252.242-7004.

There may be times when a limited scope review is appropriate, such as when the contractor discloses a change to a part of its system, follow-up on corrective actions, and specific requests by the ACO based on risk identified by buying commands…etc. In this case, the auditor would only opine on compliance of the specific DFARS criteria examined.

c. The auditor should coordinate with DCAA auditors at other contractor divisions/segments, the ACO, and the contractor. To ensure positions and interpretations are consistent, the auditor should contact the CAD, or other segment auditors to determine similarities of systems among segments, deficiencies found at other divisions, and interpretations of compliance/noncompliance to specific standards.

Coordinate the audit with the ACO to assure full understanding of their concerns related to the contractor's MMAS and compliance with the DFARS criteria. Further, the auditor should coordinate closely with other responsible Government representatives such as Government property specialists and engineering and other technical representatives. Tasks assigned for the Government team must be clearly defined to take advantage of the available Government expertise and mission requirements of all members. Most important, the Government team must make every effort to avoid duplication of effort. Early discussions with the contractor should be established to assure adequate disclosures in a reasonable period. Be sure that the contractor and ACO have a good understanding of what is expected in terms of the format and timing of the disclosures and the expected level of detail (including sufficient evidence).

d. The following paragraphs contain guidance for evaluating the contractor's compliance with the 10 DFARS 252.242-7004(d) Material Management and Accounting System criteria, the criteria are as follows:

"System criteria. The MMAS shall have adequate internal controls to ensure system and data integrity, and shall —"

(1) Have an adequate system description including policies, procedures, and operating instructions that comply with the FAR and Defense FAR Supplement:

DFARS criterion (1) requires the contractor to have an adequate system description, which includes procedures and work instructions that provide sufficient information on how the process works at a level of detail that allows for an understanding of the system.

The contractor's procedures and work instructions must provide sufficient information on how the Bill of Material (BoM) and the Master Production Schedule (MPS) (SAP-Grouping Pegging and Distribution at some contractors) systems are intended to operate and comply with FAR and DFARS. The BoM is the accurate record of the material parts and quantity required for the manufacturing process. The MPS details what and how much material, labor, and capacity is required and when these resources are needed.

The contractor's procedures and work instructions must provide sufficient information on how the contractor conducts its inventory cycle counts and its inventory accuracy measurements.

The contractor's procedures and work instructions must provide sufficient information on how the system is intended to process material transfer transactions.

The contractor's allocation procedures and work instructions must provide sufficient information on how the system is intended to operate.

The contractor's procedures and work instructions must provide sufficient information on how the material accounting system processes initial material costing.

The contractor’s procedures must comply with FAR and DFARS.

(2) Ensure that costs of purchased and fabricated material charged or allocated to a contract are based on valid time-phased requirements as impacted by minimum/economic order quantity restrictions.

(i) A 98 percent bill of material accuracy and a 95 percent master production schedule accuracy are desirable as a goal in order to ensure that requirements are both valid and appropriately time-phased.

(ii) If systems have accuracy levels below these, the Contractor shall provide adequate evidence that –

(A) There is no material harm to the Government due to lower accuracy levels; and

(B) The cost to meet the accuracy goals is excessive in relation to impact on the Government;

DFARS criterion (2) requires the contractor to have accurate reporting developed to measure and monitor purchased material and production material time-phasing. The contractor must have procedures and internal controls when creating and revising their BoMs and MPS (SAP-GPD at some contractors). As well, as reasonable methods to measure their accuracy.

The contractor’s system shall be able to generate accurate production order BoMs, and controls should be in place for changes made during the production build process to avoid manual intervention unless these are supported by a formal engineering approval.

The MPS accuracy metric should measure the accuracy of the schedule in relation to the delivery date of the material as close to the production need date as possible and whether the production order starts on-time.

(3) Provide a mechanism to identify, report, and resolve system control weaknesses and manual override. Systems should identify operational exceptions, such as excess/residual inventory, as soon as known.

DFARS criterion (3), requires the contractor to have a system capable of monitoring and tracking exceptions and adjustments. The manual adjustments must be valid, with an underlying business purpose, which must be compliant with contract terms and provisions.

The contractor must have accurate and timely exception reports for monitoring BoM processes pertaining to the creation or revision to BoMs and may affect current or future material requirements. The contractor should have evidence of timely resolution for reported issues.

The contractor's exception reports for MPS (SAP-GPD at some contractors) should pertain to the planned material that is ordered in a specific quantity for production orders and not allocated material that is ordered in bulk. Exception reports for planned material should measure time-phasing and report the exceptions for overstock and understock conditions. If the contractor does not use reports, but instead uses online forms for the monitoring process, it should be verifiable. The contractor should also have evidence of timely resolution for reported issues.

The exception reports for transfer material cost should be scheduled periodically and the contractor should provide evidence of timely resolution for reported issues. The process of reporting, tracking, and resolving material transfer and loan exceptions should produce historical records to measure the effectiveness of the process. The contractor should provide auditable evidence for identifying, reporting, and resolving the exceptions in a timely manner, to be compliant with FAR and DFARS.

A contractor should have a system in place for monitoring its common inventory material. Exception reports for material allocations usually compare monthly amounts at the contract level. The contractor should have historical data as evidence of the monitoring effort and have a process for identifying, reporting, and resolving any weakness or exception, in a timely manner.

The contractor's exception reporting for initial material cost must be adequate and compliant with FAR and DFARS. The exception reports should be scheduled periodically, and the contractor should provide evidence of timely resolution for reported issues. The process of reporting, tracking, and resolving material cost exceptions should produce historical records to measure the effectiveness of the process.

The contractor policies and procedures should describe who is responsible for monitoring the excess and obsolete material reports and the actions the contractor has taken regarding this material. The contractor procedures should also outline steps necessary to research and investigate the material/part numbers for future requirements. Once the excess or obsolete material is identified on the report a contractor representative should take responsibility for the material to ensure a timely resolution.

(4) Provide audit trails and maintain records (manual and those in machine-readable form) necessary to evaluate system logic and to verify through transaction testing that the system is operating as desired.

DFARS criterion (4) requires the contractor to maintain complete and accurate records, this includes contractor's historical records for all purchased and produced material.

The contractor must maintain complete and accurate records traceable through the BoM and MPS audit trail. The contractor must have Manufacturing Bill of Material (MBoM) traceable material/parts numbers and quantities, accurate and necessary for the manufacturing of the item, to the Electronic Bill of Material (EBoM) and the drawings. The MPS schedule should have an audit trail for each unit of production as it passes through the stations and work center.

The contractor must have accurate records of the inventory procedures for the received and issued material, and storage locations. Their system should be able to trace the material and note any inconsistencies.

The contractor's historical records should identify all transferred and loan/payback material during the period under audit. The transfer cost audit trail for purchased and in-house production orders should have a detailed record for every purchase order line item and production order batch.

The contractor should have records in the form of detailed historical transactions in the allocated material pools each month. The transactions should be billed based upon consistent, equitable, and unbiased methodologies.

The contractor cost audit trail for purchase and in-house production orders should have a detailed record for every purchase order line item and production order batch.

(5) Establish and maintain adequate levels of record accuracy and include reconciliation of recorded inventory quantities to physical inventory by part number on a periodic basis. A 95 percent accuracy level is desirable. If systems have an accuracy level below 95 percent, the Contractor shall provide adequate evidence that-

(i) There is no material harm to the Government due to lower accuracy levels; and

(ii) The cost to meet the accuracy goal is excessive in relation to the impact on the Government.

DFARS criterion (5) requires the contractor MMAS system to provide for current or/and periodic inventory on-hand at the part number level. The inventory balance on-hand should reconcile between the system of record (i.e., general ledger) to the subsidiary systems on a periodic basis. The contractor should have established procedures that prescribe how inventory record accuracy is verified as to quantity and location. Also, the contractor should have established policies, practices, and procedures governing the material classification (i.e., A, B, C strata), location, requisition, and responsibilities for contract inventory.

(6) Provide detailed descriptions of circumstances that will result in manual or system generated transfers of parts.

DFARS criterion (6) requires the contractor to provide the Government and users of the system descriptive reasons for transfer activity and a reasonable process to make the material transfers (manual or system generated). The transfer of parts between contracts, or other line items used to accumulate costs at the contract level, must be for valid business purposes and comply with contract terms and regulations.

(7) Maintain a consistent, equitable, and unbiased logic for costing of material transactions as follows:

(i) The Contractor shall maintain and disclose written policies describing the transfer methodology and the loan/pay-back technique.

(ii) The costing methodology may be standard or actual cost, or any of the inventory costing methods in 48 CFR 9904-411-50(b). The Contractor shall maintain consistency across all contract and customer types, and from accounting period to accounting period for initial charging and transfer charging.

(iii) The system should transfer parts and associated costs within the same billing period. In the few instances where this may not be appropriate, the Contractor may accomplish the material transaction using a loan/pay-back technique. The "loan/pay-back technique" means that the physical part is moved temporarily from the contract, but the cost of the part remains on the contract. The procedures for the loan/pay-back technique must be approved by the ACO. When the technique is used, the Contractor shall have controls to ensure-

(A) Parts are paid back expeditiously;

(B) Procedures and controls are in place to correct any overbilling that might occur;

(C) Monthly, at a minimum, identification of the borrowing contract and the date the part was borrowed; and

(D) The cost of the replacement part is charged to the borrowing contract.

DFARS criterion (7) requires the contractor to have a consistent inventory costing methodology, across all contracts, customer types, and between accounting periods, in compliance with contract terms and regulations.

The contractor should have a reasonable methodology for its material transfers or loan paybacks; including a method for identifying and solving problems or issues with transfers or loan paybacks. If common material is transferred or loan payback techniques are used for material costing the contractor's policies and procedures, operating instructions and actual practices should comply with DFARS 252.242-7004(d)7(i)(ii) and (iii)(A)(B)(C)(D), requirements.

All initial material costing methods used by the contractor must be consistent, equitable, unbiased, and comply with CAS 411, for contractors with CAS covered contracts and DFARS 252.242-7004(d)(7).

(8) Where allocations from common inventory accounts are used, have controls (in addition to those in paragraph (d)(2) and (7) of this clause) to ensure that:

(i) Reallocations and any credit due are processed no less frequently than the routine billing cycle;

(ii) Inventories retained for requirements that are not under contract are not allocated to contracts; and

(iii) Algorithms are maintained based on valid and current data.

DFARS criterion (8) requires the contractor to have policies and procedures, operating instructions and actual practices for common inventory allocation methods in compliance with contract terms and regulations. The contractor's methodology must consistently allocate common inventory to contracts regardless of type (e.g., cost reimbursement, fixed price, commercial, etc.).

(9) Have adequate controls to ensure that physically commingled inventories that may include material for which costs are charged or allocated to fixed-price, cost-reimbursement, and commercial contracts do not compromise requirements of any of the standards in paragraph (d)(1) through (8) of this clause. Government-furnished material shall not be-

(i) Physically commingled with other material; or

(ii) Used on commercial work; and

DFARS criterion (9) requires the contractor to have policies and procedures, and actual practices that comply with the written policies and procedures on commingled inventory. The contractor must have an inventory that is tracked both physically and systematically on an individual part number basis (i.e., each) and is stored in a manner that allows for specific identification to the contract. This includes physically commingled inventory stored at the same contractor location and used on different types of contracts (e.g., cost reimbursement, fixed-priced, commercial, etc.). The contractor practice must result in costs that are in compliance with contract terms and regulations.

(10) Be subjected to periodic internal reviews to ensure compliance with established policies and procedures.

DFARS criterion (10) requires the contractor to have a recurrent system evaluation process, which may include management reviews, internal audits, or personnel performing duplicate validations, to ensure compliance with established policies and procedures.

The contractor's BoM and MPS (SAP-GPD at some contractors) creation and change process should have quality reviews and approval procedures embedded in the process. The same is true for the BoM and MPS accuracy test. Contractors must also conduct independent periodic business system reviews to ensure the correct procedures are being followed, the internal controls are working, and the calculations are correct.

The contractor must have internal reviews of inventory processes and procedures to validate compliance. The internal reviews shall provide valuable information such as whether the inventory is being properly accounted for, or findings, and the corrective actions taken. The internal reviews of inventory should also include ensuring the procedures are followed.

The contractor's material transfer and loan/payback process should have management review procedures embedded in the process. Management should perform periodic reviews of the process to verify the steps in the procedure were complete and accurate.

The contractor's monthly common material allocation process should have quality review and approval procedures embedded in the process. Management should perform a final review of the process to verify the steps in the procedure were complete and accurate prior to posting the monthly journals for allocated material for each contract.

The material cost process should have management review procedures embedded in the purchasing and production process. Management should perform periodic reviews of the process to verify the steps in the procedure were complete and accurate.

5-407 Business Systems Reporting **

The auditor should follow the guidance in 5-110 and 10-200 for reporting on business systems.

5-500 Section 5 – Audit of Compliance with DFARS 252.215-7002 Cost Estimating System Requirements **

5-501 Introduction **

a. Refer to 5-101 for the auditor's fundamental requirements for auditing the contractor's compliance with the DFARS business system criteria.

b. This section provides guidance for auditing the cost estimating system (hereafter referred to simply as "estimating system") and discusses the requirements of DFARS 215.407-5 and 252.215-7002.

c. "Estimating System" is a term used to describe the contractor's policies, procedures, and practices for budgeting and planning controls, and generating estimates of costs and other data included in proposals submitted to customers in the expectation of receiving contract awards. An estimating system includes the contractor's (1) organizational structure; (2) established lines of authority, duties, and responsibilities; (3) internal controls and managerial reviews; (4) flow of work, coordination, and communication; and (5) budgeting, planning, estimating methods, techniques, accumulation of historical costs, and analyses used by a contractor to generate cost estimates (DFARS 252.215-7002(a)).

d. Contractors may have a budgeting process for a variety of reasons, such as to control incurred contract costs. However, DFARS 252.215-7002 specifically relates the budgeting activities to those that the contractor uses to generate estimates of costs and other data included in proposals submitted to customers in the expectation of receiving contract awards. Therefore, the budgeting aspects related to the estimating system are those that relate only to proposal preparation.

5-502 DFARS 215.407-5-70 and 252.215-7002 Requirements **

DFARS 215.407-5-70 requires all DoD contractors to have an acceptable estimating system; requires certain large business contractors to disclose and maintain their estimating systems, in writing, and be subject to audit; and provides guidelines concerning the characteristics of an acceptable estimating system. The details of an acceptable estimating system are defined in the clause at DFARS 252.215-7002, Cost Estimating System Requirements.

5-502.1 Applicability of DFARS Business System Requirements **

a. DoD policy requires all contractors to have an acceptable estimating system that consistently produces well supported proposals acceptable as a basis for negotiating fair and reasonable prices (DFARS 215.407-5-70(b)(1)). As defined in DFARS 252.215-7002(a), an “acceptable estimating system” is an estimating system that complies with the system criteria in DFARS 252.215-7002(d), and provides for a system that

(1) is maintained, reliable, and consistently applied;

(2) produces verifiable, supportable, documented, and timely cost estimates that are an acceptable basis for negotiation of fair and reasonable prices;

(3) is consistent with and integrated with the contractor’s related management systems; and

(4) is subject to applicable financial control systems.

Additionally, DFARS 215.407-5-70(c)(4) states that the acceptable system shall provide for the use of appropriate source data, utilize sound estimating techniques and good judgment, maintain a consistent approach, and adhere to established policies and procedures.

b. Any large business contractor that in its preceding fiscal year received DoD prime contracts or subcontracts of at least $50 million requiring certified cost or pricing data is also subject to the estimating system disclosure, maintenance, and review requirements (DFARS 215.407-5-70(b)(2)) and is also subject to the requirements in paragraphs (d) and (e) of DFARS 252.215-7002.

c. Any large business contractor, which in its preceding fiscal year received DoD prime contracts or subcontracts of at least $10 million (but less than $50 million) requiring certified cost or pricing data may also be subject to the estimating system disclosure, maintenance, and review requirements of DFARS 215.407-5-70(b)(2) and may also be subject to the requirements in paragraphs (d) and (e) of DFARS 252.215-7002. Such coverage is required if the PCO, with the concurrence or at the request of the ACO, determines it to be in the best interest of the Government (e.g., significant estimating problems are believed to exist or the contractor's sales are predominantly to the Government). The additional coverage will apply if during contract performance the contracting officer provides written notification to the contractor.

d. The disclosure, maintenance, and review requirements of DFARS 215.407-5-70 (c)(4), (e), and (f) do not apply to educational institutions, Federally Funded Research and Development Centers (FFRDCs), nor University Associated Research Centers (UARCs) operated by educational institutions (see DFARS 242.7001, Contract clause). These requirements also do not apply to small business (as defined under 15 U.S.C. 637(b)(6) and the rules and regulations of the Small Business Administration in Part 121 of Title 13 of the Code of Federal Regulations) because they are not covered by the Cost Accounting Standards (see DFARS 242.7000(a)).

5-502.2 System Disclosure and Maintenance Requirements **

a. Large business contractors (see 5-502.1b and c) are required to disclose and maintain an acceptable estimating system, disclosing it in writing to the contracting officer responsible for contract administration (DFARS 252.215-7002(d)(1)). Disclosure is considered acceptable when the contractor has provided the cognizant ACO with documentation that accurately describes the policies, procedures, and practices that are currently used in preparing cost proposals and provides sufficient detail for the Government to reasonably make an informed judgment regarding the acceptability of the contractor's estimating practices (DFARS 252.215-7002(d)(2)(i) and (ii)).

b. Significant changes to the cost estimating system must be disclosed to the cognizant ACO on a timely basis (DFARS 252.215-7002(d)(3)(ii)).

c. If the contractor wishes the Government to protect the data and information as privileged or confidential, the contractor must mark the documents with the appropriate legends before submission. (DFARS 252.215-7002(d)(1)).

5-503 General Audit Policy **

a. Refer to 5-103 for DCAA's general audit policy for the audit of contractor compliance with the DFARS business system criteria.

b. Auditors should obtain sufficient, appropriate and relevant evidence across all applicable DFARS criteria. The extent of testing will be dependent on the identified level of risk related to the system’s compliance with individual DFARS criteria.

c. The auditor is responsible for evaluating the contractor's estimating system or methods (FAR 15.407-5(a)) to determine if the contractor is complying with the DFARS business system criteria for its estimating system (DFARS 252.215-7002). This is accomplished by performing an estimating system audit to determine if the contractor meets the definition of an acceptable estimating system (see 5-502). The auditor should determine the accuracy and reliability of a contractor's estimates; identify areas requiring special emphasis in the audit and negotiation of individual price proposals, and recommend improvements when deficiencies are identified in a contractor's estimating system. When appropriate, auditors should establish estimating system audits to reduce the scope of reviews to be performed on individual proposals, expedite the negotiation process, and increase the reliability of proposals (FAR 15.407-5(a)). Auditors should use the results of an estimating system audit to assist with identifying risk in future forward pricing proposal audits.

5-504 Estimating System Audit Objectives **

a. The objective of an estimating system audit is to determine if the contractor complies with DFARS 252.215-7002, Cost Estimating System Requirements, for an acceptable estimating system to support the ACO's determination of contractor compliance regarding its estimating system (DFARS 215.407-5-70(c)(2)).

b. There is a clear interrelationship between estimating system, forward pricing proposal, and Truth in Negotiation (TiN) compliance audits. It is important that the auditor recognize that the results in one or more of these areas will have a direct relationship on the scope of audit in the other area(s). In addition to meeting the DFARS 215.407-5-70(c)(3) and FAR 15.407-5(a) requirements for review, an estimating system audit serves as the fundamental basis for determining audit risk and scope for future forward pricing proposal audits (FAR 15.407-5(a)) and TiN compliance audits.

5-504.1 Scope of Audit **

a. When performing an estimating system audit the auditor will obtain an understanding of the contractor's estimating system, determine if the contractor is compliant with the estimating system criteria prescribed in DFARS 252.215-7002(d)(4), and report both material weaknesses and system deficiencies.

b. While the nature and extent of audit effort depends upon contractor size, amount of Government business, and audit risk (materiality and sensitivity) to be able to opine on compliance with DFARS 252.215-7002, all the applicable criteria should be examined. The auditor must plan an audit to obtain sufficient, appropriate evidence to opine on the contractor's compliance with DFARS 252.215-7002.

c. When auditing the contractor's compliance with the DFARS 252.215-7002 system requirements (specific criteria), the auditor must gain an understanding of and test compliance with the contractor's overall estimating policies, procedures, and practices for budgeting and planning controls and for generating estimates of costs and other data included in price proposals. The auditor must consider the entire universe of certified forward pricing proposals the contractor submitted to customers rather than limiting the audit scope to those proposals that DCAA audited. Additionally, the auditor should determine if testing at a functional department level as opposed to a specific proposal or cost element level is more effective when designing substantive procedures. For example, when testing compliance to determine if the estimators have sufficient and adequate training (DFARS 252.215-7002(d)(4)(iii)), it will be more effective to test from a universe of employees whose job duties include estimating, rather than testing at a specific proposal or cost element level.

5-504.2 Estimating System Audit Considerations **

a. When auditing the contractor's compliance with the 17 DFARS 252.215-7002(d) criteria, the auditor should consider the following:

(1) DFARS 252.215-7002(d)(4)(i): An acceptable estimating system shall accomplish the following functions: establish clear responsibility for preparation, review, and approval of cost estimates and budgets.

The contractor's estimating system must have a segregation of duties between the preparation of estimates, the review of those estimates, and the approval of those estimates and that the responsibilities of those roles are clearly defined. Segregation of duties is a recognized component of the internal control environment and activities. The auditor should review recent forward pricing proposals to determine the personnel involved with the proposals and look for evidence that different personnel fulfilled the responsibility of preparation, review, and approval. The auditor may find it useful to evaluate DFARS 252.215-7002(d)(4)(ii) before evaluating this requirement. The auditor may find the needed evidence outside of the forward pricing proposal itself, such as in duty rosters or assignment logs.

(2) DFARS 252.215-7002(d)(4)(ii): An acceptable estimating system shall accomplish the following functions: provide a written description of the organization and duties of the personnel responsible for preparing, reviewing, and approving cost estimates and budgets.

The contractor must have a written description of the estimating organization and the duties of the estimating personnel. A documented organizational structure with segregation of duties is a recognized component of the internal control environment. The auditor should review the contractor's written organization chart(s), position descriptions, etc. for the positions within the estimating function(s) to determine if there is evidence of segregation of duties that are clearly defined. The contractor's estimating function(s) could span multiple departments.

(3) DFARS 252.215-7002(d)(4)(iii): An acceptable estimating system shall accomplish the following functions: ensure that relevant personnel have sufficient training, experience, and guidance to perform estimating and budgeting tasks in accordance with the Contractor's established procedures.

The contractor's estimating system must ensure that the personnel involved in the estimating process have the training, experience, and guidance needed to perform their assigned duties in accordance with the contractor’s established estimating policies, procedures, and practices. The requirement for continued training, professional experience, and guidance is a recognized component of the internal control environment and activities. The auditor should assess the estimating personnel’s relevant training, background and estimating work experience, and the type of guidance that they receive (other than direct supervision). The auditor may need to evaluate the personnel records for training, background education qualifications, relevant certifications, relevant length of service, etc.

(4) DFARS 252.215-7002(d)(4)(iv): An acceptable estimating system shall accomplish the following functions: identify and document the sources of data and the estimating methods and rationale used in developing cost estimates and budgets.

The contractor’s estimating system must require sufficient and appropriate documentation to support the basis of estimates included in price proposals. Support would generally include the sources and types of data used, methods applied, and the rationale used in developing the estimates. The auditor should inspect the estimating system documentation requirements for preparing estimates and assess if those requirements meet the intent of the DFARS requirement. The auditor will likely have to evaluate a selection of recent forward pricing proposals to determine if the estimating techniques (data, methods, and rationale) used in the proposal were clearly identified and documented.

(5) DFARS 252.215-7002(d)(4)(v): An acceptable estimating system shall accomplish the following functions: provide for adequate supervision throughout the estimating and budgeting process.

The contractor’s estimating system must provide for adequate supervision. Segregation of duties that includes supervision is a recognized component of the internal control environment and activities. The auditor should assess the separation of supervision from the other roles involved in the estimating process and the auditor should assess the level of and the effectiveness of the supervision. The auditor should expect to find evidence of the supervisory process, such as the issuance of initial estimating guidance, approval signatures, and correcting edits. The auditor may inquire of the supervisors to determine how involved the supervisors are during the estimating process.

(6) DFARS 252.215-7002(d)(4)(vi): An acceptable estimating system shall accomplish the following functions: provide for consistent application of estimating and budgeting techniques.

The contractor must use consistent estimating techniques (e.g., methods/processes) in like or similar circumstances within a forward pricing proposal and across forward pricing proposals. For example, if the contractor developed a Cost Estimating Relationship (CER) to be used for all engineering support labor, the contractor should use that CER for all proposals when proposing costs for the engineering support labor. The contractor should not use a discrete estimating method rather than the CER on one proposal solely for the purpose of proposing more labor hours than the CER would produce. The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor uses its estimating techniques consistently. Inconsistent practice provides opportunities for the contractor to maximize cost estimates to meet the contractor's needs in any one proposal, contrary to providing fair and reasonable cost estimates. The auditor must determine if any estimating techniques are specifically mandated in the disclosed estimating system documentation and, if so, assess if those estimating techniques are reflected in the forward pricing proposal basis of estimate and determine if the contractor consistently complies with its disclosed estimating system.

(7) DFARS 252.215-7002(d)(4)(vii): An acceptable estimating system shall accomplish the following functions: provide for detection and timely correction of errors.

The contractor must have a process for detecting errors in cost estimates and budgets and correcting those errors on a timely basis. This is closely related to the requirements in DFARS 252.215-7002(d)(4)(i) and DFARS 252.215-7002(d)(4)(ii). If the contractor has an adequate process for preparation, review, and approval, the probability of detection and timely correction of errors will be higher. To be effective, error detection should be performed by more than just those who prepared the estimates. An error detection and correction process is a recognized component of internal control activities. The auditor may find that the contractor has a tracking log or other method to document its cost estimates and budget review process for detecting and correcting errors. The auditor should request evidence to demonstrate that the error detection and correction processes were performed. The system requirement does not specify how the contractor is to provide for detection and timely correction of errors; thus, the auditor should determine the contractor's practice and test compliance based on the contractor's disclosed practice. The auditor should not expect all contractors to be using the same method or means (e.g., audit trail) in detecting and correcting errors.

(8) DFARS 252.215-7002(d)(4)(viii): An acceptable estimating system shall accomplish the following functions: protect against cost duplication and omissions.

The contractor's estimating system must ensure a cost item is not estimated more than once and that a needed cost element item is not omitted. Duplication of costs can happen when a CER, a factor, a standard, and/or an indirect rate is used and something in the estimated cost is also estimated discretely as a separate line item. Like error detection, safeguarding against duplication and omission is a recognized component of internal control activities. The auditor should evaluate recent forward pricing proposals where a CER, a factor, a standard, and/or an indirect rate was used and gain an understanding of the elements of costs being estimated by the CER, a factor, a standard, and/or an indirect rate. The auditor should then look for the same elements of cost proposed separately (thereby duplicating the element of cost). The auditor should also look in recent forward pricing proposals for examples of the same element of cost appearing as more than one line item. The auditor needs to evaluate recent forward pricing proposals' solicitation statement of work to determine if an element of cost is clearly missing from the proposal. Testing for omission is closely related to the requirements in DFARS 252.215-7002(d)(4)(xvi), which requires that the estimating system consistently generate sound proposals that are compliant with the provisions of the solicitation.

(9) DFARS 252.215-7002(d)(4)(ix): An acceptable estimating system shall accomplish the following functions: provide for the use of historical experience, including historical vendor pricing data, where appropriate.

The contractor's estimating system must ensure that the contractor uses historical experience when appropriate as the basis for estimates. Historical experience is not necessarily just electronic data files of accounting records. Historical experience may be available from a prior similar contract or production lot, or from a similar commercial effort. The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor did not use historical experience when there clearly was a seemingly appropriate opportunity to do so and then have the contractor explain why it did not use the historical experience.

(10) DFARS 252.215-7002(d)(4)(x): An acceptable estimating system shall accomplish the following functions: require use of appropriate analytical methods.

The contractor's estimating system must ensure analytical methods, such as regression analysis, are used when they are better estimators than other methods/techniques. The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor did not use an analytical method when there clearly was a seemingly appropriate opportunity to do so and then have the contractor explain why it did not use the analytical method.

(11) DFARS 252.215-7002(d)(4)(xi): An acceptable estimating system shall accomplish the following functions: integrate data and information available from other management systems.

The contractor's estimating system must ensure relevant data and information from elsewhere within the contractor's business systems is utilized, as appropriate. This is not necessarily limited to computer-processed data. This can be related, in part, to the requirements in DFARS 252.215-7002(d)(4)(ix), which requires the appropriate use of historical experience, which could be data and information from other management systems. The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor did not use data and information from elsewhere within the business systems when there clearly was a seemingly appropriate opportunity to do so and then have the contractor explain why it did not use that data and information.

(12) DFARS 252.215-7002(d)(4)(xii): An acceptable estimating system shall accomplish the following functions: require management review, including verification of compliance with the company's estimating and budgeting policies, procedures, and practices.

The contractor’s estimating system must ensure that management at a higher level than the forward pricing proposal supervisor is involved to provide assurance that the estimating personnel are complying with the contractor’s estimating system policies, procedures, and/or processes. This could be accomplished on a current forward pricing proposal basis, or through a higher-level function, such as an internal audit, or both. Because DFARS 252.215-7002(d)(4)(xiii) requires an internal review process, the management review requirement must be different from the internal review requirement. A management review process is a recognized component of internal control activities and monitoring. The contractor may have a tracking log or other method to document its management reviews. The auditor should request evidence to demonstrate that the contractor performed management reviews.

(13) DFARS 252.215-7002(d)(4)(xiii): An acceptable estimating system shall accomplish the following functions: provide for internal review of, and accountability for, the acceptability of the estimating system, including the budgetary data supporting indirect cost estimates and comparisons of projected results to actual results, and an analysis of any differences.

The contractor’s estimating system must include an internal review process to maintain the acceptability of the estimating system. This could be accomplished by a regular internal monitoring process, or by an internal audit, or both. Because DFARS 252.215-7002(d)(4)(xii) requires a management review process, the internal review requirement must be different from the management review requirement. A critical element of the internal review is that the contractor compares its estimates (projected results, not negotiated amounts) to the eventual actual costs so that the contractor can adjust its estimating methods for future estimates. In addition, the requirement applies to both direct and indirect cost estimates. An internal review process is a recognized component of internal control activities and monitoring. The contractor may have a tracking log or other method to document its internal reviews. The auditor should request evidence to demonstrate that the internal reviews were performed.

(14) DFARS 252.215-7002(d)(4)(xiv): An acceptable estimating system shall accomplish the following functions: provide procedures to update cost estimates and notify the Contracting Officer in a timely manner throughout the negotiation process.

The contractor must update its forward pricing proposal, when appropriate, and provides timely notification to the PCO throughout the negotiation process. As required in 10 U.S.C. Chapter 271: Truthful Cost or Pricing Data (Truth in Negotiations), the cost or pricing data submitted must be accurate, complete, and current. The contractor may have a tracking log or other method to document its forward pricing proposal updates and notifications. The auditor should look for evidence that all forward pricing proposal updates were logged, and that notification was provided to the PCO in a timely manner.

(15) DFARS 252.215-7002(d)(4)(xv): An acceptable estimating system shall accomplish the following functions: provide procedures that ensure subcontract prices

are reasonable based on a documented review and analysis provided with the prime proposal, when practicable.

The contractor’s estimating system must require that the contractor comply with the FAR 15.4 and other requirements related to subcontractor costs, such as the requirement to obtain competitive bids and the requirement to perform cost or price analyses. This criterion is the only DFARS business system requirement that is directed only to one cost element (subcontract costs). The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor performed all the FAR 15.4 requirements related to subcontract proposals.

(16) DFARS 252.215-7002(d)(4)(xvi): An acceptable estimating system shall accomplish the following functions: provide estimating and budgeting practices that consistently generate sound proposals that are compliant with the provisions of the solicitation and are adequate to serve as a basis to reach a fair and reasonable price.

The contractor’s estimating system must require the contractor to prepare forward pricing proposals that meet the requirements of the solicitation and that result in proposals that are adequately prepared to serve as a basis for negotiating a fair and reasonable price. This does not necessarily mean that the auditor or the PCO never takes exception to the contractor’s estimates. The contractor may fully comply with the FAR and DFARS requirements relevant to forward pricing proposals, and yet fail to accurately estimate future costs. The auditor should evaluate a selection of recent forward pricing proposals to determine if the contractor has sufficiently addressed the solicitation. The auditor may also consider the audit findings (if the selected forward pricing proposals were previously audited by DCAA) and the Price Negotiation Memorandum (PNM) to determine if the nature of any exceptions leads the auditor to believe that the forward pricing proposals, as presented to the PCO, were consistently not an acceptable basis for negotiating a fair and reasonable price. If the contractor consistently estimates future costs significantly higher than negotiated, this could be an indicator that the contractor is not complying with the system requirement.

(17) DFARS 252.215-7002(d)(4)(xvii): An acceptable estimating system shall accomplish the following functions: have an adequate system description, including policies, procedures, and estimating and budgeting practices, that comply with the Federal Acquisition Regulation and Defense Federal Acquisition Regulation Supplement.

The contractor must have a written description of its estimating system that addresses all the DFARS 252.215-7002 requirements and all of the FAR and other DFARS requirements related to a forward pricing proposal. Additionally, DFARS 252.215-7002(d)(1) specifically requires that the contractor disclose its estimating system, in writing, to the ACO. The auditor should evaluate the contractor’s written system description, including all policies, procedures, desk instructions, etc., to determine that all FAR and DFARS requirements relevant to forward pricing proposals are addressed. The auditor should gain an understanding of the contractor’s estimating system based on the contractor’s written description of the system. The auditor should assess if the contractor's disclosure includes each of the DFARS 252.215-7002(d)(4) system requirements in sufficient detail for the government to make an informed judgment regarding the acceptability of the estimating practices (DFARS 252.215-7002(d)(2)(ii)).

5-505 Business System Reporting **

a. The auditor should follow the guidance in 5-110 and 10-200 for reporting on the contractor's compliance with the DFARS business system criteria for cost estimating system. If significant noncompliance is found during the performance of any forward pricing related audit, the auditor should also consider if the contractor is noncompliant with any criteria in DFARS 215-407-5-70 and/or DFARS 252-215-7002. If the auditor determines the contractor is noncompliant with these DFARS requirements, then the auditor must report the system deficiency, as required by GAGAS (7.42-7.45).

b. The auditor should send a copy of the estimating system audit report and a copy of the official notice of corrective action required to each contracting office and contract administration office having substantial business with the contractor. The auditor should consider significant deficiencies not corrected by the contractor in subsequent forward pricing proposal analyses and negotiations. (FAR 15.407-5(b)).

5-505.1 Other Than Large Business Contractor Reporting **

a. During any forward pricing related audit, the auditor may find evidence of a material weakness or system deficiency within the contractor's estimating system. For example, during multiple audits of forward pricing proposals the auditor may find that the contractor routinely fails to perform the FAR 15.4 required cost or price analysis of its subcontractors. If the contractor does not meet the DFARS definition of a large business contractor, the contractor's estimating system is generally not subject to a DCAA audit (5-502.1). However, because all contractors are required to have an acceptable estimating system (5-502 and 5-502.1a and b), the auditor should issue an estimating system deficiency report for the other than large business contractor's failure to comply with DFARS 215-407-5-70(b)(1) and (c)(4) and DFARS 252-215-7002(a) and (b).

b. All contractors are required to have an acceptable estimating system. The contractor's failure to meet the estimating system requirements must be cited for noncompliance regardless of the size of the contractor if the identified noncompliance results in material weakness or system deficiency with the applicable DFARS criteria.

c. When citing noncompliance at an other than large business contractor, the auditor should find the most applicable requirements from DFARS 252.215-7002 related to the identified material weakness and/or system deficiency and describe how the contractor has failed to have an acceptable estimating system.

5-600 Section 6 – Contracting Officer Processing of the Business System Report **

a. The contracting officer, in consultation with the auditor, shall determine whether the contractor's business system complies with the applicable business system criteria, as prescribed in DFARS.

b. Within 30 days of receiving a DCAA audit report, if the contracting officer makes a determination that there is a material weakness and/or a system deficiency, the contracting officer should provide an initial determination of deficiencies and a copy of the report to the contractor and require the contractor to submit a written response (PGI 215.407-5-70(e)(2)(ii)(A)). The contracting officer will request the contractor to respond, in writing, within 30 days (DFARS 215.407-5-70(d)(2)).

c. The contracting officer, in consultation with the auditor, within 30 days of receiving the contractor's response, will evaluate the contractor's response and make a final determination that either: (DFARS 215.407-5-70(d)(2) and PGI 215.407-5-70(e)(2)(ii)(C))

(1) The business system is acceptable and approved and no material weaknesses and/or system deficiencies remain; or

(2) Material weaknesses and/or system deficiencies remain; notify the contractor of any remaining material weaknesses and/or system deficiencies, indicating the adequacy of any proposed or completed corrective action; and (a) request that contractor, within 45 days of receipt of the final determination, either correct the deficiencies or submit an acceptable corrective action plan showing milestones and actions to eliminate the deficiencies; and (b) disapprove the business system (DFARS 215.407-5-70(d)(3)).

d. The contracting officer shall promptly distribute copies of its determination to approve a system, disapprove a system and withhold payments, or approve a previously disapproved system and release withheld payments to the auditor; payment office; affected contracting officers at the buying activities; and cognizant contracting officers in contract administration activities.(DFARS 215.407-5-70(f)).

5-700 Section 7 – DCMA Cognizance of Business Systems **

DCMA is cognizant over three of the six business systems as defined by DFARS 252.242-7005: Earned Value Management System, Contractor Purchasing System Administration, and Contractor Property Management System Administration. If DCMA requests assistance for any of these systems, please coordinate with HQs Policy Systems and CAS (PSC) or your Region/CAD before any assistance is provided to DCMA.

5-800 Section 8 – Contractor Information Survey **

5-801 Introduction **

This section provides guidance on performing the Contractor Information Survey (hereafter referred to simply as “CIS”).

5-802 Contractor Information Survey **

a. The CIS is a tool for obtaining information about contractors to assist the audit team in identifying potential areas where future audit effort may be warranted.

b. The CIS assists the auditor in gaining an understanding of the contractor’s organizational structure and business, the overall design of the contractor’s accounting system, and basic information related to internal control.

c. The CIS is not to be used as an internal part of the risk assessment process or as the basis for documenting an understanding of internal control for any audit assignment.

d. Regional and CAD leadership will work with Management teams to establish when it is appropriate to use the CIS. The CIS will primarily be used at smaller contractor locations where they have had little or no audit effort in three (3) to five (5) years. Auditors should complete the CIS in accordance with Regional or CAD direction and modify the survey, as necessary.