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 a general overview of the three primary contractor business systems audited by the Defense Contract Audit Agency (DCAA): the Accounting System, the Material Management and Accounting System (MMAS), and the Cost Estimating System.

b. For detailed procedures on how to perform an audit of these systems, auditors should refer to the specific business system guidebooks located on the DCAA VIPER site.

c. The specific audit programs and related planning and audit performance documents for conducting the audit are available on the DCAA HQ-Q SharePoint site.

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

5-101 Introduction **

a. This section outlines the auditor's fundamental requirements 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.

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

5-102 Background Information **

a. DFARS 252.242-7998 (relocated from DFARS 252.242-7005, effective March 16, 2026, via DFARS deviation 2026-O0050), 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 are listed below:

Audit of Compliance with DFARS 252.242-7999, Accounting System Administration
Audit of Compliance with DFARS 252.242-7997, Material Management and Accounting System
Audit of Compliance with DFARS 252.215-7002, Cost Estimating System Requirements

5-103 Business System Audit Policy and Approach **

a. 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. Corporate 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. 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.

d. 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 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.

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 Agency policy.

5-105 Scope of Audit **

a. 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:

- Contractor's size;
- Contractor's organization and ownership characteristics;
- Nature of the contractor's business;
- Diversity and complexity of the contractor's operations;
- 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.

b. 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.

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 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 and corrected in a timely manner.

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. After understanding the business system's key internal controls, the auditor must determine if any of them will materially affect the relevant DFARS 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. Auditors can reduce substantive testing in a specific audit if they rely on control tests from a related business system audit. This is only permissible if the controls from the prior audit were proven effective and are still current and relevant. When relying on these prior tests, the auditor must reference the original business system assignment and its working papers to document the evidence of the controls' effectiveness.

5-107 Tests of Controls **

a. 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. While we do not express an opinion on internal controls, we do test the key internal controls that are related to DFARS compliance.

b. 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.

c. 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.

d. 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.

e. 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.

f. 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.

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

- Information gathered in developing an understanding of the internal control structure;
- Nature of the control to be tested;
- Audit leads and or prior audit findings;
- Identified risk;
- Nature and availability of evidential matter; and
- Contractor's monitoring and testing efforts.

The extent of testing is also significantly impacted by the office'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.

h. 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/directorate offices when necessary.

5-108 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 are, 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.

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.

5-109 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.

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. 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. When auditors identify material weaknesses or system deficiencies in any of the six DFARS 252.242-7998 contractor business systems during non-system audits—such as forward pricing proposals, incurred cost audits, or real-time testing—they must promptly establish a separate Business System Deficiency Report Assignment using activity code 11090. This requirement aligns with GAGAS standards, which mandate reporting findings even when they fall outside the specific objectives of the current engagement. This includes reporting both material weaknesses and internal control deficiencies that, while less than material, still warrant the attention of the contractor and the contracting officer. Given the importance of rapid communication, the deficiency reports should be issued as soon as possible to facilitate timely resolution.

To ensure efficient tracking of DFARS noncompliances, DCAA incorporates these findings into a separate deficiency report that remains an integral part of the originating GAGAS examination rather than a standalone audit. Because it is part of the primary engagement, auditors do not need to duplicate procedural documentation, such as risk assessments, within the deficiency assignment working papers. Instead, the deficiency assignment should reference the primary audit and include only the specific working papers that support the identified noncompliance. Finally, to maintain a clear audit trail, both the primary examination report and the deficiency report must cross-reference each other and explicitly state that the deficiency report is a component of the original engagement 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 DFARS 252.242-7998. DFARS 242.70, states a "Covered contract" means 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 (10 U.S.C. 3841 note prec).

(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 DFARS 252.242-7998, 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 must 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.

**5-110 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 deficiencies (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, 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) 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.

5-111 DCMA Cognizance of Business Systems **

DCMA is cognizant over three of the six business systems as defined by DFARS 252.242-7998: 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 Contract Audit Standards and Assurance (CASA) Systems and Programs Division (CSPD) or your Directorate before any assistance is provided to DCMA.