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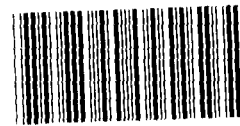
GAO

Report to the Chairman, Subcommittee on
Readiness, Committee on Armed Services,
House of Representatives

February 1988

PROMPT PAYMENT ACT

Military Exchanges Had Problems in Paying on Time



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**Accounting and Financial
Management Division**

B-228722

February 9, 1988

The Honorable Dan Daniel
Chairman, Subcommittee on Readiness
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

This is our response to your June 12, 1986, letter requesting that we determine whether military exchanges are paying commercial vendors on time as required by the Prompt Payment Act. You also asked us to obtain information on vendor complaints, the reasons for their dissatisfaction, and any exchange initiatives to minimize payment problems. Further, we evaluated the adequacy of disbursement system controls for assuring timely payments and examined opportunities for system improvements.

Our review confirmed that the Navy exchanges and the joint Army/Air Force exchanges were experiencing difficulties in paying their bills when due. About 24 percent of our sample of invoice payments were paid late, and another 11 percent were paid too early. Appropriate interest penalties generally had not been paid, and in some cases discounts were taken after allowable periods expired and had not been refunded.

Based on our assessment of payment practices, existing vendor payment systems, and discussions with responsible officials, we concluded that both of the exchange systems needed to improve their payment-timing performance. Several exchange managers acknowledged that their payment practices, systems, and internal controls were not adequate to ensure compliance with prompt payment objectives. They were aware of some of the specific weaknesses and had been working to reduce payment delays.

Also, the Navy exchanges, which had received a large number of vendor complaints, have made a concerted effort to resolve those problems and restore vendor confidence in conducting business with them. We did not find a significant vendor complaint problem with Army/Air Force exchanges. Our report contains several recommendations for correcting the internal control, payment system, and administrative weaknesses that led to payment-timing errors.

Background

In 1982, the Congress passed the Prompt Payment Act, which provides specific criteria for determining when bills from vendors are due. It requires the federal government to pay interest on overdue invoices and to take discounts only when payments are made within the allowed discount period. The implementing regulations for prompt payment requirements are set forth in Office of Management and Budget (OMB) circular A-125 and other supplemental guidance. The circular specifically states that military post and base exchanges are subject to these requirements.

Military exchanges operate under the Department of Defense and exist to improve the quality of life of the military community by (1) offering goods and services at uniformly low prices and (2) channeling profits to support service personnel morale, welfare, and recreation programs. The Army and Air Force operate a joint exchange command, the Army/Air Force Exchange Service, which processed invoices totaling \$3 billion during fiscal year 1986. The Navy's exchange system is operated as a component of the management activities of the Navy Resale and Services Support Office. The Navy exchange system processed invoices totaling \$1.1 billion during fiscal year 1986. Both exchange services are non-appropriated fund activities and are primarily self-supporting entities. Appendixes I and II provide payment-timing criteria and describe the exchange systems and their payment procedures.

Objectives, Scope, and Methodology

Our review objectives were to

- determine whether military exchanges are paying on time, neither late nor too early,
- evaluate payment system procedures and internal controls for ensuring timely payments,
- determine whether payment system internal controls for preventing payment-timing errors need to be enhanced, and
- obtain information on the nature and extent of vendor complaints and any exchange initiatives to resolve payment-timing problems.

Using July and August 1986 payment records, we randomly selected 250 invoices from the six payment systems used by Navy and Army/Air Force exchange systems. We reviewed the supporting documents for each invoice to determine its due date and compared this date to the actual date of payment. Our results are not statistically projectable to the universe of the exchanges' vendor payments; however, they do give perspective regarding payment performance. Our review, conducted

between November 1986 and April 1987, was performed in accordance with generally accepted government auditing standards. Appendix III contains additional details on our scope and methodology.

Many Sample Payments Were Late or Too Early

Our analyses of the 250 randomly selected invoices paid by the exchanges showed that:

- 60 invoices, or 24 percent, were paid late;
- 28 invoices, or 11 percent, were paid too early; and
- 162 invoices, or 65 percent, were paid on time.

Although this data applies solely to the 250 invoices we reviewed, the results are somewhat comparable to those of our earlier governmentwide study in which we noted that improvements were needed to enhance payment-timing performance.¹

We used the criteria in OMB's circular to classify sample cases as late, early, or on time. Payments are late if the check is dated after the payment due date and early if the check is dated 3 or more calendar days before the due date, except for payments involving discounts. Discounted payments (lower prices in exchange for earlier payment) are on time if the check is dated on or before the date the offered discount expires. All other payments are considered on time if the check is dated within the 3-day period which includes the due date and the 2 previous days.

Further analyses disclosed that the 60 late payments were made from 1 to 119 days after the due date. Thirty of these were discounted payments taken after the allowable discount period had ended. The remaining 30 late payments were paid after the due date for the full amount of the invoice.

Compounding the late payment problem, the locations we visited generally were not paying the vendors' interest penalties as required by the act. Thirteen of the 60 late payments required an interest penalty of at least \$1, the minimum payable according to the OMB circular, but none were paid. Most of these were caused by taking discounts after the allowable period had expired. The remaining 47 late payments did not

¹In our August 1986 report, Prompt Payment Act: Agencies Have Not Fully Achieved Available Benefits (GAO/AFMD-86-69, August 28, 1986), we estimated that agencies paid about 24 percent of their vendor invoices late and an additional 23.5 percent too early.

require an interest penalty. These involved invoices either paid within the interest-free time frame allowed by the act, commonly known as the grace period, or where the penalty due was less than \$1.

Interest penalties due but not paid, including eight from Navy exchanges, totaled about \$97. Although the unpaid interest on our 250 sample payments is small, much more may not have been paid when one considers that the Army/Air Force and Navy exchange systems processed almost 6 million invoices in 1986.

On the other hand, 28 of our sample payments—19 for Army/Air Force and 9 for Navy—were paid too early. Early payments ranged up to 22 days before the due date.

Both late and early payments create adverse effects. Payment delays, including taking discounts too late and not paying required interest penalties, can raise vendor costs by increasing the amounts they must borrow to sustain operations. Conversely, early payments can reduce the exchange systems' interest income on its cash deposits. Equitable treatment for both parties requires that payments to vendors be made as close as possible to, but not later than, due dates.

Tables 1 through 4 of appendix IV contain the payment performance results for the two exchange systems, including the number of late, early, and on time payments; show how late or how early these payments were in relation to their due dates; and depict the number of late payments requiring, as well as those not requiring, an interest penalty.

Improved Payment Systems and Administrative Practices Would Reduce Late and Early Payments

A number of payment system weaknesses and administrative problems contributed to the late and early payments. Cumulatively, these created an environment with insufficient controls to achieve the objectives of the Prompt Payment Act.

- Internal control weaknesses in three of the six payment systems led to improperly taking discounts, not paying interest penalties, and not consistently calculating exact due dates.
- Navy officials overrode the adequate payment-timing features in two of the automated systems to avoid losing cash discounts and paying interest penalties.
- The five automated payment systems contained inaccurate due-date terms for many contracts.

- Start dates for 30-day payment periods were calculated inaccurately, causing early payments, and bills for certain types of expenses were paid as soon as possible.

Additional Controls Needed in Three Automated Payment Systems

The Army/Air Force exchange's two automated systems and Navy's payment system which processed invoices for purchases by overseas exchanges had neither the capability to avoid taking offered discounts if the discount period had expired nor the capability to include applicable interest penalties for late payments. Also, the Navy system could only calculate accurate due dates if the due-date terms called for payment in a multiple of "5" days.

Systems Cannot Identify End of Discount Period

These three automated payment systems calculated due dates based on payment terms entered into the systems. However, they did not have features to automatically recalculate payment due dates if a discount was offered, but for one reason or another, was not taken by the end of the applicable discount period. In those situations, the systems took any offered discounts regardless of when the offered period expired instead of calculating the payment due date for the full amount of the invoice.

Of the 100 Army/Air Force invoices examined at Montgomery, Alabama, and San Antonio, Texas, 8 of the 24 offered discounts were taken too late. Although the act requires that agencies voluntarily refund improperly taken discounts, neither we nor the Army/Air Force exchange staff could document that these eight had been repaid.

Because the Army/Air Force exchange payment system in the regions did not have a mechanism to automatically detect that these payments had been made after the discount due date, field staff normally were not aware of improperly taken discounts unless notified by the vendor. Although our sample at headquarters did not contain any invoices in which discounts were taken improperly, a headquarter's official said the headquarter's payment system also lacked this feature. Therefore, if discounts were taken after the discount period, headquarters staff would also have to rely upon the vendors to identify them.

Headquarters officials also told us that the volume of payments processed made it impractical for them to perform manual post audits to identify late payments. We agree that manually reviewing such records to identify improperly taken discounts would not be administratively efficient or effective. Based on the payment volume, automating such

payment techniques would seem appropriate. Upgrading these automated payment systems to recognize expired discount periods and to recalculate the due date based on the full amount of the invoice would eliminate these problems and satisfy prompt payment objectives.

Coupled with the system problem, regional accounts payable personnel believed that improperly taken discounts did not have to be refunded unless requested by the vendor. The way the topic is presented in the Army/Air Force exchange accounting procedures manual² for regional offices may have contributed to the assumptions made by payment technicians. It stated that "when payment is not made within the stipulated time, the vendor may request a refund for the cash discount," and it provided instructions for processing such requests. The manual did not, however, recite the legislative requirement that agencies are to voluntarily refund improperly taken discounts. If the manual had been more specific on this point, this confusion may not have existed.

At Navy exchange headquarters, which processes payments for overseas exchanges, 15 of the 25 sample payments we reviewed offered discounts for early payment, and 6 were taken after the discount period had expired. As with the Army/Air Force exchange, we could not document that these improperly taken discounts had been refunded. Although the Navy Exchange System had similar types of policies and problems with the payment system at the time of our review, our examination of its test data using various payment terms confirmed that it has subsequently corrected this discount-payment problem. As a result, all of the Navy exchange payment systems can now automatically identify when any offered discount period has ended and instead base the due date on the payment terms for the full amount of the invoice.

Similar System Weaknesses Caused Interest Penalties Not To Be Paid

Problems similar to those which caused discounts to be taken improperly also resulted in unpaid interest penalties. As was the case with discounts, exchange staff may not have known that payments were late. Neither the Army/Air Force exchange automated systems nor Navy's system which processed payments for overseas purchases had features that could automatically identify late payments and include any applicable interest penalties with the check issued. These systems were developed prior to passage of the act and had not been updated to include these capabilities.

²Accounting Procedures—CONUS Exchange Regions. CONUS is defined as the continental United States.

Actions have been taken or are underway to remedy these problems. When Navy upgraded its payment system in June 1987 to recalculate payment due dates when offered discounts were not taken, it also included a feature that automatically calculates interest penalties on late payments and includes them in the check issued. Our review of the Navy exchange's test data confirmed that all three of its payment systems can currently determine if interest is due and include the proper amount owed with the payment.

As a result of implementing steps to better comply with prompt payment requirements, Navy reported paying over \$330,000 in interest penalties as of June 1987, about 5 months into its fiscal year. This compares to less than \$49,000 paid in all of fiscal year 1986. According to a Navy official, the increase is partly attributable to the systems improvement work.

The Army/Air Force exchange has taken some steps to upgrade its payment systems. Based on a consultant's assessment of its automated processing systems, the exchange established a task force in October 1987 to review its communications network, general ledger system, and payment systems. Although the task force will examine aspects of both the regional and headquarters systems, its primary focus will be on the regionally-based payment system.

The task force report is due to the Army/Air Force exchange's board of directors during January 1988. According to an Army/Air Force headquarters official, an implementation team will then execute any recommendations approved by the board. The results of our review indicate that it would be appropriate to incorporate automated system features such as the calculation of interest penalties into the redesign effort for the regionally-based payment system. Similarly, the need for modern payment systems would also suggest that the headquarters system have similar features.

Regarding the Army/Air Force exchange's payment experience, it reported paying interest penalties totaling \$1,030 and \$1,309 for fiscal years 1985 and 1986, respectively. An exchange official told us that the exchange would have paid somewhat less in fiscal year 1987 but that it had paid \$3,634 in interest penalties to settle a dispute with a vendor.

One Navy Payment System Could Not Calculate Exact Due Dates

The approximately 25-year old Navy system which processed purchases by overseas exchanges could only calculate due dates in 5-day increments. To illustrate, three Navy exchange invoices in our sample offered a cash discount if paid within 12 days. The automated system's rounding rules increased the discount period from 12 to 15 days, thereby improperly extending the discount period.

A Navy official did not know why this was done, but the best rationale that he could offer for the payment system rounding up as opposed to rounding down was for cash management purposes. Navy exchange officials were aware of this problem and were in the process of identifying what automated system features would have to be changed to enable the system to calculate exact due dates in the same way Navy's other two automated systems do.

Overriding Existing System Controls Caused Improper Discounts and Nonpayment of Interest Penalties

While building adequate automated controls into a payment system is important, it is just as important that they be properly used. Although two of Navy's automated payment systems already had the capability to (1) recalculate payment due dates if a discount had been offered but not taken by the end of the discount period and (2) recognize late payments and automatically include required interest penalties, Navy officials generally overrode these automated internal controls to avoid losing offered discounts and paying interest penalties.

The Prompt Payment Act allows agencies 15 days after receipt of an invoice to notify the vendor of any defects that would prevent timely payment. Navy headquarters had established at least 14 conditions for which an invoice could be considered inadequate and its regional offices had the flexibility to identify additional ones, if needed. When an invoice failed to satisfy one or more of those conditions, Navy officials believed that they could take discounts even if the discount period had ended and that they did not have to pay interest penalties that might otherwise be due.

Whenever vendors were notified of defects that would prevent timely payment, generally by letter, accounts payable staff routinely entered a code in the payment system, which in effect extended payment due dates. This resulted in either taking the offered discount, regardless of whether the discount period had expired, or in preventing the systems from paying any interest penalties due. Prompt payment requirements do not release an agency from paying in a timely fashion merely because vendors submit an improper invoice. Rather, the notification that an

invoice is improper allows the agency to establish a new payment due date depending on when the vendor corrects the invoice. In addition, we believe that some of the stated conditions for extending payment periods, such as (1) a department number missing from the invoice and (2) the regional office receiving only one copy of the invoice, should not necessarily prevent Navy exchanges from meeting due dates.

Thirty of the 100 sample cases at San Diego, California, and Jacksonville, Florida, were processed subject to 15-day notices (letters) to vendors. Five of these involved discounts taken improperly because the payment period was extended through use of 15-day letters containing reasons we believe should not have affected timely payment of invoices. For the remaining 25 cases, 1 additional payment was late, but we could not assure ourselves that the 15-day letter caused the late payment because the sample case also involved a discrepancy between written contractual terms and payment terms on the automated system. This confusion regarding what terms to use to calculate the due date is discussed later in the report.

A Navy exchange internal report confirmed the questionable usage of these 15-day letters based on a review conducted during a field visit to Jacksonville in September and October 1986. The report noted that, in most instances, the invoices labeled as inadequate could have been processed without any delay.

Management officials at the San Diego and Jacksonville regional exchanges told us that they used the 15-day letter as a mechanism to extend payment periods in order to fulfill Navy's objectives of taking advantage of as many offered discounts as possible and to avoid paying interest penalties. Although the Navy exchange system continues to highlight these goals, its officials realize these objectives should not be reached at the expense of payment equity.

Therefore, in August 1986, Navy exchange management reduced, from 14 to 4, the number of allowable circumstances for labeling an invoice as improper. These circumstances included merchandise substitutions, differences in unit costs, incomplete invoices, and an "other" category. Our review of payment records for San Diego and Jacksonville showed a significant reduction in the use of these codes signifying an improper invoice.

We reviewed the extent to which these codes were used for large segments of the July and December 1986 payments. Our work indicates

that San Diego, which processes about 36,000 payments a month, had reduced its approximate usage of these codes from over 9,000 in July 1986 to about 100 in December 1986. Comparable results were noted for Jacksonville, which processes about 25,000 payments a month. Its estimated usage dropped from about 4,000 to about 500 for the same time frame. A Navy exchange headquarters official said that the Navy exchange system did not maintain records on how often the regions had used these codes, but that our analysis would have yielded results that would be representative of those months' transactions.

Inaccurate Due-Date Terms

We found numerous instances where payment due-date terms on Army/Air Force and Navy automated payment systems did not agree with those in written purchasing agreements.

To test the accuracy of payment terms used to establish due dates, we compared terms in 180 contractual agreements to those in the automated system and identified 47 differences. Although these discrepancies (26 percent) did not always result in early or late payments, we found that when payment timing was off, incorrect due-date terms were sometimes the cause. At least five late payments and one early payment in our sample were caused by entering the wrong due-date terms into the automated systems.

Management officials at both exchange services' regional offices attributed some of these differences in due-date terms to data entry errors by their respective procurement staffs. We also confirmed a Navy official's assertion that some payment-timing errors were caused by using out-dated contractual due-date terms when processing payments at headquarters.

Officials at both of the exchange services agreed that correct due-date terms are essential for calculating accurate payment dates and that periodic reviews are needed. Navy officials have started to examine the accuracy of due-date terms in their payment systems and said they would conduct periodic reviews. Army/Air Force officials said they would have to assess the extent of this problem and, based on the results of the review, determine what actions would be appropriate.

Other Factors Caused Early Payments

We also identified a number of other problems which led to early payments. These included (1) using existing contractual provisions rather than more favorable payment terms offered on vendors' invoices,

(2) establishing inaccurate starting dates for 30-day payment periods, and (3) paying operation and maintenance expenses as soon as possible after receipt and approval of the invoice.

The policy of both exchange services was to pay based on the vendor's invoice if it offered better terms than those provided in contractual agreements. Two of the 28 early payments were caused by exchange staff not processing the bills using the more favorable invoice terms. An accounts payable supervisor told us that these were probably paid too soon because of an oversight by payment technicians.

Other early payments resulted from starting the payment period too soon. For example, some 30-day payment periods were based on when the exchange activity (store) received an invoice, when, in fact, the contract called for calculating the due date based on when the regional payment center had received the invoice.

Officials at the Army/Air Force Exchange Service said they pay operation and maintenance invoices (about 20,000 for fiscal year 1986) as soon as possible even though purchase orders or contracts do not require expedited payments. Their cited reason for doing this was that unless local firms received their checks immediately, they tended to demand cash payments. They told us they were more concerned about the potential problem associated with controlling increased cash amounts on hand to accommodate such local purchases than with issuing checks too early.

Exchange officials also said that they had authority to incur operation and maintenance expenses of up to \$1,000 for supplies and \$2,500 for services without a purchase order, which would ordinarily contain due-date terms. In view of the minimal savings available from delaying payments on small invoice amounts, Army/Air Force officials expressed concern about the added administrative costs that would be associated with paperwork for establishing due dates for payments made in less than 30 days.

The basic problem with such payment practices is that they do not adhere to the OMB circular which calls for paying on or shortly before the 30th day unless the applicable purchasing agreement contains other due-date terms. We noted that the Navy exchange did not have this problem with operation and maintenance payments. Navy officials said that when they procure locally through service contracts, standing retail accounts, and manual purchase orders, they are generally successful in

obtaining 30-day payment terms calling for payment within 30 days of the later of receipt of the invoice or acceptance of goods or services.

Exchanges Seek To Promptly Address Vendor Complaints and Inquiries

At the time of our review, the exchange services we visited were handling vendor correspondence in an effective and timely manner. Some vendor inquiries, such as those concerning adjustments for pricing errors, were answered quickly because minimal research was needed. Inquiries about nonreceipt of a payment sometimes required more time if research efforts revealed the need for additional documentation (like proof of shipment) from the vendor.

We examined vendor correspondence files at the three Army/Air Force exchange sites we visited. We did not find any indication that they were experiencing problems resolving vendor complaints and inquiries in a reasonable and timely fashion.

Starting in 1985, Navy exchange officials recognized that they had a serious backlog of vendor inquiries and they began to implement a series of management initiatives to resolve payment problems which had caused these complaints. In August 1985, Navy established a team at its headquarters to resolve a backlog of about 3,500 documented complaints and inquiries from its vendors. As of the end of our fieldwork, April 1987, Navy headquarters had only 353 open inquiries.

Many complaints occurred because the Navy exchange had sent checks to the wrong location. A major reason for this was that Navy's payment system did not have the capability to send payments for an individual vendor to multiple addresses. By early 1986, Navy had modified its automated payment systems to allow it to send checks to various vendor-designated addresses.

In addition to upgrading the payment system to execute these initiatives, Navy exchange headquarters staff visited field offices to periodically assess accounts payable operations. They also provided temporary staffing to assist in resolving vendor problems, realigned the correspondence sections, and required monthly status reports on correspondence workload for monitoring by headquarters. At the time of our site visit, February 1987, San Diego's backlog had declined significantly, from about 8,000 inquiries in August and September 1986 to approximately 300 inquiries. Because Jacksonville had changed its method of accounting for vendor inquiries, we were unable to compare the over 1,200 inquiries on hand during our January 1987 site visit to those on hand in

September 1986. However, by the end of our fieldwork in April 1987, Jacksonville's inquiries on hand had declined to about 900.

Not all of the backlogged correspondence stemmed from nonreceipt of payment or from delayed payment. Some vendors were requesting information on how to properly credit Navy's account because of problems with their own accounting systems. There were also many inquiries regarding differences between the invoice amount and the amount the exchange had paid. According to a Navy official, many vendor payments are sent directly to banking institutions. He noted that these facilities generally process the check but do not forward any accompanying documentation which would explain variances in amounts paid, thus triggering these inquiries.

By the end of our field work, April 1987, the Navy exchange was notifying vendors within 30 days of receipt of their letters to explain that the problems had been resolved or that they were being researched and to identify a contact person for the vendors.

Inadequate Documentation To Calculate Exact Due Dates

As a final matter, we could not calculate precise due dates for some of the invoices we randomly selected for review. Although required by policy, Army/Air Force and Navy exchanges did not always record the dates when goods were accepted or proper invoices were received at the designated paying offices. In addition, although Navy exchange policy requires that purchase orders be retained for at least 2 years, we found that Navy had discarded recent purchasing agreements which contained due-date terms for some of these invoices. As a result, we could not determine when payment was due for 54 invoice payments—10 for Army/Air Force and 44 for Navy. Accordingly, we randomly selected replacement invoices to obtain 250 to evaluate.

A prerequisite for fulfilling the act's objectives is to record specific event dates in the payment process. We were unable to calculate precise due dates for certain invoices because this information was unavailable. As a result, the due dates established by the exchanges for those invoices were probably not exact. Also, documentation to support the paid invoices needs to be available for a reasonable time frame so that payment inquiries can be researched. For example, purchase orders are needed to determine the applicable payment terms.

Conclusions

Military exchanges we visited were experiencing problems in adhering to prompt payment requirements. We are not projecting the results of our work to other exchange activities, but payment timing at all of the regional offices would have been affected because they use the same payment systems.

Successful implementation of the initiatives we have discussed would rectify the internal control problems such as payment system and administrative weaknesses. Because the exchanges are interested in improving their payment record, they have already completed some of these actions. Continued progress along these lines should lead to better performance and fulfill the objectives of the Prompt Payment Act.

Recommendations

We recommend that the Secretary of Defense direct the Secretaries of the Army, the Air Force, and the Navy to improve payment timeliness by military exchanges by

- enforcing policies to record the specific dates needed to calculate exactly when bills are due and to retain applicable supporting payment documentation long enough to allow research on payment inquiries and
- periodically reviewing whether payment due-date terms on the automated payment systems are consistent with contractual provisions.

We also recommend that the Secretary of Defense direct the Secretaries of the Army and the Air Force regarding their military exchanges to

- clarify their regional accounting procedures manual to specify that improperly taken discounts should be refunded voluntarily and
- establish due-date terms in written agreements for any types of payments that will be made in other than 30 days.

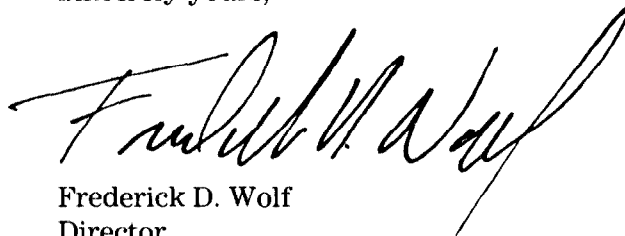
In addition, we recommend that the Secretary of Defense direct the Secretaries of the Army and the Air Force to require the exchange system to incorporate additional automated features as part of the ongoing systems modification work. The regional and headquarters payment systems should include features to (1) routinely compute an interest penalty payment for invoices paid after a grace period and to (2) recalculate a payment due date based on terms for the full invoice amount when an offered discount period has expired. Such revisions would allow more efficient administration of prompt payment objectives and provide the same system capabilities already available in the Navy exchange payment systems.

Agency Comments

We requested official written comments on October 14, 1987. In mid-November, we met with Department officials to discuss their views, which we have incorporated into the report, as appropriate. They generally agreed with the thrust of our report and told us that they would provide their written comments shortly; however, we had not received them as of January 4, 1988, when we finalized the report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days after the date of this report. At that time, we will send the report to the Secretary of Defense; the Director, Office of Management and Budget; the House and Senate Committees on Armed Services; the Senate Committee on Governmental Affairs; the House Committee on Government Operations; and other interested parties. Copies will also be made available to others upon request.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Frederick D. Wolf". The signature is written in a cursive style with a large, sweeping flourish at the end.

Frederick D. Wolf
Director

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Abbreviations

DCI	data collection instrument
GAO	General Accounting Office
OMB	Office of Management and Budget

Prompt Payment Criteria

The Prompt Payment Act established governmentwide payment standards for determining when federal agencies should pay commercial vendors. Agencies are to pay invoices in accordance with terms specified in the purchase order or contract. If these documents do not include payment terms, payment is due within 30 days of the later of (1) the date the payment office designated in the contract receives a proper invoice or (2) the date the agency accepts the goods or services. Exceptions to the 30-day rule are that payment is due 7 and 10 days after delivery for meat and perishable agricultural commodities, respectively. Agencies may use other payment terms for perishable agricultural products, but the criteria for paying for meat items may not be amended. The act also provides general guidelines on prompt payment discounts.

The act also requires agencies, in the absence of contractual provisions stating otherwise, to pay interest penalties when invoices are paid after the due date. The act allows a grace period—an extra 15 days after the payment due date (3 days for meat or a meat food product, and 5 days for perishable agricultural products) in which to pay and avoid interest penalties.

Interest penalties must also be paid on improperly taken discounts. However, OMB circular A-125 provides that an interest penalty need not be paid if the improperly taken discount is repaid within 15 days (3 days for meat and meat food products, and 5 days for perishable agricultural commodities) after the last day that a discount could have been properly taken. The circular also specifies that interest penalties of less than \$1 need not be paid.

OMB circular A-125 and the Treasury Financial Manual also instruct agencies to avoid early payments. OMB has defined payments as early if checks are dated 3 or more days before the due date, except when cash discounts are taken. The Treasury Financial Manual establishes the start of a discount period as the “date of an invoice that is authorized for payment by an agency” unless the related contract or the invoice specifies other terms.

Additional Background Information on Exchange Operations

The Navy exchange and the joint Army/Air Force exchange systems offer a variety of products and personal services at retail facilities such as department-type stores, convenience stores, military clothing stores, barber and beauty shops, laundry and dry cleaning services, automotive service facilities, florists, and vending machines.

The joint Army/Air Force Exchange Service has its headquarters office in Dallas, Texas. It is managed by a board of directors which reports to the Chiefs of Staff and Secretaries of the Army and the Air Force. It operates 274 exchange facilities through 5 continental United States regions, 1 distribution region in Atlanta, Georgia, and 16 overseas area offices.³

The Navy exchange is headquartered in Staten Island, New York. As part of the Navy Resale and Services Support Office, it is managed by the Chief of Naval Operations and the Secretary of the Navy. It has 146 exchange activities operated through 7 field services offices and 6 independent offices in the continental United States, and 15 overseas offices.⁴

Bill Payment Process

In fiscal year 1986, the Army/Air Force and the Navy exchanges processed over 4 million invoices totaling \$3 billion and about 1.7 million invoices totaling \$1.1 billion, respectively. Exchange payment staff are responsible for examining invoices and other documentation to determine if bills are accurate and properly supported. Based on applicable payment terms, staff are to schedule invoices for payment as close as possible, but not later than, the due date.⁵ Required documentation usually includes a proper invoice, a contract or other purchasing agreement, and evidence of receipt and acceptance of goods. After these examinations, essential information to the payment cycle is either manually processed or entered in automated payment systems for scheduling payment and printing of the checks to vendors.

The Army/Air Force and the Navy exchange services each operate three payment systems to process invoices for purchases from U.S. vendors.

³Statistics regarding the number of exchanges were obtained from the publication, Facts for Vendors 1986.

⁴Data pertaining to the number of Navy exchange facilities for 1986 were obtained from computer listings provided by exchange officials.

⁵An exception was noted in one of the Army/Air Force Exchange Services's payment systems in which invoices are to be paid immediately upon receipt and approval for payment.

**Appendix II
Additional Background Information on
Exchange Operations**

Each has a headquarters-operated system which processes invoices from U.S. vendors for purchases by overseas exchanges, a system operated in the regions for purchases by domestic exchanges, and another system also at the regional offices which makes disbursements for purchases such as those that require expedited payment—meat and perishable agricultural products—and operation and maintenance type expenditures. The first two systems for each exchange service are automated, include payment terms, and have the ability to calculate payment due dates and take offered discounts. In each instance, checks are issued at the headquarters level. Navy's third payment system, operated in the regions for expedited payments and operation and maintenance outlays, has the same features, but checks are issued at the regional offices. Army/Air Force's counterpart system, however, does not contain these automated features. After an invoice is approved for payment, the check is issued at the regional level.

Additional features of the Navy exchanges' two regional payment systems include the capability to (1) pay the full amount of an invoice if the discount due date has expired and (2) calculate and include an interest penalty for overdue bills. By the time we had finished our audit work in April 1987, Navy's test data confirmed that it had added these features to its system which paid invoices for domestic purchases by overseas exchanges.

Scope and Methodology

We conducted our review between November 1986 and April 1987. We visited the Army/Air Force exchange headquarters office in Dallas, Texas, and two field locations—Montgomery, Alabama, and San Antonio, Texas. We also did site work at the Navy exchange headquarters office in Staten Island, New York, and two of its field offices—San Diego, California, and Jacksonville, Florida.

We selected regions with relatively high sales volume for fiscal year 1986. Sales for the two Army/Air Force regional offices—Montgomery, Alabama, and San Antonio, Texas—account for 44 percent of total domestic regional sales. The two Navy exchange field service offices—Jacksonville, Florida, and San Diego, California—had 42 percent of the sales by regional and independent exchanges.

Using July/August 1986 payment records, we randomly selected 250 invoices from the six payment systems—three for each exchange system. We covered each of the payment systems by examining 25 invoices at each of the headquarters offices and 50 from each of the four field offices. We oversampled from each of the systems to assure ourselves that we could substitute for (replace) any invoices which were not subject to prompt payment requirements or for which we could not calculate a precise due date. We did not perform a reliability test on the fiscal year 1986 automated payment data provided by the exchanges for our use in randomly selecting payments for review because we are not making statistical projections.

Title 7 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies requires all disbursements to be supported by basic payment documents, including contracts, receiving reports, and invoices. Accordingly, we reviewed such supporting documentation for each invoice in our sample. We recorded necessary payment information on a standardized data collection instrument (DCI) which we developed to analyze payment timing. If the contractual document did not specify payment terms, we applied criteria provided in the Prompt Payment Act, OMB circular A-125, and the Treasury Financial Manual to determine when payment should have occurred. We compared the actual payment date of each invoice with the date payment should have been made.

The sampling methodology is not statistically projectable to the universe of vendor payments made by Army/Air Force and Navy exchanges. Therefore, our payment-timing results are applicable only to our sample of 250 invoices.

We examined exchanges' policies and procedures for processing commercial invoices to determine whether their guidance was consistent with prompt payment requirements. We evaluated payment system features for assuring timely payments by developing and completing an internal control questionnaire. To assure ourselves that exchanges were using correct due-date terms, we compared payment terms on the automated systems with those in 180 written purchasing agreements, most of which were in our sample.

We interviewed management officials to obtain pertinent information on exchange operations. Finally, we examined correspondence to determine the nature and extent of vendor complaints and identified current and planned management initiatives to correct existing payment problems.

We performed our work in accordance with generally accepted government auditing standards.

Payment Performance by the Army/Air Force and Navy Exchanges

Table IV.1: Payment Timing for Army/Air Force and Navy Exchanges

Payment timing	Number of invoices		Total	
	Army/Air Force	Navy	Number	Percent
Late				
During a grace period	15	8	23	9
After a grace period	5	2	7	3
After a discount period	8	22	30	12
Total late	28	32	60	24
Early	19	9	28	11
On time	78	84	162	65
Total	125	125	250	100

Table IV.2: Number of Days by Which Late Payments Missed Due Dates

Days after due date	Number of invoices	Cumulative percent
1 to 15	41	68
16 to 30	10	85
31 to 45	4	92
46 to 60	2	95
61 to 90	2	98
over 90	1	100
Total	60	

Table IV.3: Invoices Paid 3 or More Days Before Due Dates

Days after due date	Number of invoices	Cumulative percent
3 to 9	16	57
10 to 15	7	82
16 to 19	2	89
20 to 35	3	100
Total	28	

**Appendix IV
 Payment Performance by the Army/Air Force
 and Navy Exchanges**

**Table IV.4: Late Payments Involving
 Improper Discounts and Interest
 Penalties Due Vendors**

Payments with:	Number	Percent
Improper discounts taken		
Interest penalty owed and paid	0	0
Interest penalty owed but not paid	9	15
Interest penalty less than \$1, not owed ^a	21	35
Total	30	50
No discount offered		
Interest penalty owed and paid	0	0
Interest penalty owed but not paid	4	7
Interest penalty less than \$1, not owed ^a	3	5
Paid in grace period, no penalty	23	38
Total	30	50
Grand Total	60	100

^aPrompt payment regulations state that interest penalties of less than \$1 need not be paid.

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