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DOD PAYMENTS TO SMALL BUSINESSES

Implementation and Effective Utilization of Electronic Invoicing Could Further Reduce Late Payments





Highlights of [GAO-06-358](#), a report to congressional committees

Why GAO Did This Study

The National Defense Authorization Act for Fiscal Year 2004 requires GAO to report on the timeliness of Department of Defense (DOD) payments made to small businesses. GAO's report focuses on (1) whether, at DOD payment centers for which data were available, small business invoices were more likely to be paid late; (2) whether systemic weaknesses in DOD payment processes result in late payments to contractors—including small business contractors; and (3) the impact of late payments on small businesses. To calculate timeliness rates, GAO used the data DOD was able to provide for 9 of its 20 vendor payment locations as well as its one contract pay location. GAO used a case study approach for the third objective because data limitations did not permit the use of statistically reliable sampling techniques for assessing the experiences of DOD small business contractors as a whole. Case study contractors were selected because they experienced a high frequency of late payments and may not be reflective of all small businesses.

What GAO Recommends

GAO makes five recommendations to strengthen the implementation of a Web-based tool known as Wide Area Work Flow (WAWF), which could speed the processing of payment documents and improve the timeliness of DOD payments, including payments to small businesses. DOD concurred with GAO's recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-358.

To view the full product, including the scope and methodology, click on the link above. For more information, contact McCoy Williams at (202) 512-9095 or williamsm1@gao.gov.

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What GAO Found

DOD paid small business invoices late more often than all invoices paid at the nine locations for which data were available. Ten percent of all invoices at these locations were paid late—compared with 14.5 percent of small business invoices. According to DOD officials, the disparity may have occurred because DOD's cash management and prioritization practices tend to favor paying larger vendors first. Although DOD has reported significant improvements in its metrics related to late payments, these improvements have come through dedicating additional resources to the problem and not through addressing the underlying weaknesses that cause late payments. Resolving the payment timing disparity will involve improving the overall timeliness of DOD payments to contractors regardless of size.

Systemic weaknesses in DOD's payment processes result in late payments to contractors, including small business contractors. DOD continues to process mostly paper payment documents, which can often result in redundant data entry; misplaced documents; higher than necessary transaction processing fees; and ultimately, payment delays. To its credit, DOD has invested in a Web-based tool, WAWF, that could facilitate the electronic exchange of payment data and documents, but the initiative lacks the requisite management focus and strategic direction needed to be successful. For example, the WAWF program lacks performance metrics and does not have a clear strategy for ensuring that WAWF will be effectively utilized. Finally, in many cases, the military services and defense agencies are not required to acknowledge receipt and acceptance electronically. Instead, they submit paper documents that must be matched with contractor invoices to complete the payment transaction, which can lead to payment delays.

Disruptions of cash flow caused by late payments—depending on the extent and duration—can significantly affect the day-to-day operations of small businesses. To illustrate, GAO interviewed 17 small business owners that were paid late multiple times during fiscal year 2004. They provided the following perspectives:

- Fourteen of the 17 said that because DOD paid late, they had to obtain a line of credit or use personal resources to finance day-to-day operations.
- Eleven of the 14 that relied on a line of credit said that they paid 2 to 4 percent more for the credit than the rate used by DOD to calculate late payment interest.
- In 3 cases, contractors said that their cash flow problems were so significant that they were concerned about their ability to stay in operation.

Although the Prompt Payment Act requires interest payments when certain bills are paid late, 10 contractors stated that they often did not receive interest on late payments. GAO could not substantiate these statements because DOD was unable to provide the information needed to do so. According to one contractor, after GAO asked DOD to research his claim, DOD determined that the contractor was entitled to interest of about \$1,000.

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Abbreviations

| | |
|-------|---|
| BTA | Business Transformation Agency |
| BUMED | Navy Bureau of Medicine and Surgery |
| CCR | Central Contractor Registration database |
| CVFR | current value of funds rate |
| DCMA | Defense Contract Management Agency |
| DFARS | Defense Federal Acquisition Regulation Supplement |
| DFAS | Defense Finance and Accounting Service |
| DISA | Defense Information Systems Agency |
| DOD | Department of Defense |
| EDI | electronic data interchange |
| NFIB | National Federation of Independent Businesses |
| OSBP | Office of Small Business Programs |
| SBA | Small Business Administration |
| WAWF | Wide Area Work Flow |

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United States Government Accountability Office
Washington, DC 20548

May 19, 2006

Congressional Committees

Small businesses are an important player in the U.S. economy—employing half of all private sector employees and generating 60 to 80 percent of net new jobs annually over the past decade. As such, the federal government’s long-standing policy has been to maximize federal procurement opportunities for small businesses.¹ To ensure that small businesses receive a share of federal procurement contract dollars, the Congress has mandated that the Small Business Administration (SBA) negotiate annual procurement goals with each federal agency. In fiscal year 2004, the Department of Defense (DOD) reported meeting its procurement goal—awarding prime contracts totaling a reported \$44.8 billion, or 23.1 percent of total contract award dollars, to small business contractors.² However, as we have reported in the past,³ DOD’s payment processes often results in late payments to contractors—which for some small business contractors could lead to financial hardship.

Concerned about the impact late payments have on small business contractors, the Congress included in the National Defense Authorization Act for Fiscal Year 2004 a requirement for us to report on the timeliness of DOD payments to small business contractors.⁴ Specifically, we were asked

¹ A small business concern is defined in accordance with the Small Business Administration’s definition, 13 C.F.R. pt. 121. Small businesses may be eligible to participate in several programs—including small disadvantaged, 8(a), HUBZone, veteran owned, service-disabled veteran-owned, and women-owned small businesses. See 48 C.F.R. §§ 19.000, 219.000.

² For fiscal years 2004 and 2005 DOD’s procurement goal was to award to small businesses 23 percent of its total contract awards. As of the date of this report, DOD’s fiscal year 2005 procurement statistics were not available.

³ GAO, *Financial Management: DOD’s Metrics Program Provides Focus for Improving Performance*, [GAO-03-457](#) (Washington, D.C.: Mar. 28, 2003), and *Financial Management: Seven DOD Initiatives That Affect the Contract Payment Process*, [GAO/AIMD-98-40](#) (Washington, D.C.: Jan. 30, 1998).

⁴ Pub. L. No. 108-136, § 851, 117 Stat. 1392, 1556 (Nov. 24, 2003). For the purpose of this report and as specified by the National Defense Authorization Act of 2004, timeliness is defined in accordance with the Prompt Payment Final Rule, 5 C.F.R. pt. 1315.

to provide estimates of the total amount of contract payments made to small businesses and the percentage of total contract payments to small businesses that were not made in a timely manner. However, DOD was unable to provide us with a complete population of transaction-level payment data that would be needed to provide such estimates. Therefore, as agreed with your offices, we (1) determined whether, at selected DOD payment locations, small business invoices were more likely to be paid late when compared with the payment of all invoices; (2) determined whether systemic weaknesses in DOD payment processes result in late payments to contractors—including small business contractors; and (3) assessed the impact that late payments can have on small business contractors.

DOD separates its payment of commercial invoices into two business lines—(1) contract pay—which pays invoices for larger, more complex contracts and (2) vendor pay—which processes payments for smaller, less complex contracts, purchase orders, and other miscellaneous payments. DOD's contract payment business line is managed and operated through a single DOD location, whereas DOD's vendor payment business line is managed and operated by 20 separate payment locations. For fiscal year 2004, DOD reported total commercial payments subject to the Prompt Payment Act, as amended,⁵ of \$206 billion—of which \$119 billion were paid through DOD's contract pay business line and \$87 billion were paid through its vendor pay business line. To determine whether small business invoices were more likely to be paid late when compared with the payment of all invoices, we requested transaction-level detail for all DOD commercial payments subject to the Prompt Payment Act and all interest penalties paid in fiscal year 2004. We received all the payment data requested for DOD's contract payment business line. However, DOD was able to provide us with data for only 9 of its 20 vendor payment locations. The \$24 billion of payments generated from these 9 vendor pay locations represented approximately 28 percent of the total \$87 billion of vendor payments subject to the Prompt Payment Act. According to DOD officials, they were unable to provide us with payment data for the remaining 11 locations because they could not reconcile the data with previously

⁵ 31 U.S.C. ch. 39. DOD also makes commercial payments that are not subject to the Prompt Payment Act that include, among other things, contract financing payments, progress payments, interim payments, and advance payments.

reported prompt payment metrics—which is critical for ensuring that the data are complete.

Using the payment data from the nine vendor pay locations and one contract pay location, combined with data we obtained from the Central Contractor Registration (CCR) database—which contains the most comprehensive listing of small business contractors—we calculated the extent to which small business invoices are paid late as compared with all invoices. Specifically, we used the data from CCR to identify invoice and interest payments associated with small business contractors. However, payment data for the nine vendor pay sites did not always contain complete identifier data that would allow us to determine whether the transactions were associated with small businesses; some sites contained fairly complete data and others were missing identifiers for a large percentage of transactions. Because we were not able to identify all small businesses, our calculations compare the percentage of invoices paid late that were submitted by known small businesses with the percentage of all invoices paid late. To determine the percentages of invoices paid late, we divided the number of invoices paid late by the total number of invoices paid during the same period. To ensure that the DOD data we used to support this report were sufficiently reliable for our analyses, we conducted detailed reliability assessments of the data sets that we used. We restricted these assessments, however, to the specific variables that were pertinent to our analyses. We found that all the data sets used in this report were sufficiently reliable for these analyses. See appendix II for a further discussion of these calculations and limitations.

To determine the cause of late payments, we performed audit work at 6 of DOD's 20 vendor payment locations and DOD's 1 contract pay site, which collectively represent \$169 billion, or 82 percent of all payments subject to the Prompt Payment Act. We selected vendor pay sites based on, among other things, the amount of interest penalties paid at each location—selecting sites that paid both high and low amounts of interest. Using DOD payment and other data, we identified small business contractors that were paid late multiple times during fiscal year 2004 and documented the difficulties experienced by 17 of these contractors. We selected our case study examples from the DOD payment data provided and identified small business contractors that DOD paid late most frequently. Of those small business contractors that were paid late most frequently, 17 expressed a willingness to share information on late payments with us. We relied on a case study approach to achieve this objective, principally because, as noted previously, DOD was unable to provide us with a complete universe of small business contractors that were paid late—which would be needed

to perform statistically reliable sampling techniques that would allow us to comment on the experiences of DOD small business contractors as a whole. Our findings for this objective cannot be projected and may not be representative of the experiences of all DOD small business contractors. We requested comments on a draft of this report from the Secretary of Defense or his designee. We received written comments from the Deputy Under Secretary of Defense (Business Transformation), which are reprinted in appendix I of this report. Our work was performed from November 2004 through January 2006 in accordance with U.S. generally accepted government auditing standards. Additional details on our scope and methodology are included in appendix II.

Results in Brief

In general, our analysis of DOD's fiscal year 2004 payment data for nine DOD vendor pay locations showed that to varying degrees, small business invoices were paid late more often than all invoices paid at each of the nine vendor payment locations. Overall, at these nine vendor pay locations, 10 percent of all invoices were paid late—compared with 14.5 percent of small business invoices. According to DOD vendor pay officials, the disparity between the payment of small business invoices and all invoices may exist because DOD's cash management practices place a lower priority on the payment of smaller, less-complex invoices—like those typically submitted by small business contractors. Further, these vendor payment sites lacked the demographic information needed to implement DOD's policy which allows for the payment of small-disadvantaged businesses early. Although many of the same prioritization practices were used by DOD's contract pay site, they did not result in a timing disparity because, for the most part, DOD's contract pay site pays its bills on time—paying only 2 percent of all invoices late. However, many of the efficiencies that are used in DOD's contract pay business line cannot be cost effectively applied to improve the timeliness of payments at DOD's vendor pay sites. For example, the receipt and acceptance process used by the contract pay business line is often performed by a government representative located at the contractor's facility. While this speeds the payment process, it is also more costly and, therefore, cannot be practically applied to DOD's vendor pay product line. Given that DOD's vendor pay business line presents the most significant challenge for DOD, with respect to paying invoices on time, we focused specifically on DOD's vendor payment processes and actions needed to improve the timeliness of payments made through these processes.

Systemic weaknesses in DOD's vendor payment processes result in late payments to contractors, including small business contractors. For

decades, we have reported that the leading cause of late payments at DOD stems from delays in receiving the payment documents needed to complete a payment transaction—including receiving and acceptance documents. The delayed processing of these payment documents is caused, in large part, by the paper-driven nature of DOD’s vendor payment process and DOD’s nonintegrated payment, accounting, and logistics systems. Although, DOD has reported significant improvements in its metrics related to late payments, these improvements have come through dedicating additional resources to the problem and not through addressing the underlying weaknesses that cause late payments. Recently, however, DOD invested in a Web-based tool known as Wide Area Work Flow (WAWF),⁶ which, if implemented and utilized effectively, could reduce the problems created by DOD’s nonintegrated financial systems by facilitating the electronic transmission of payment documents and data. According to DOD, WAWF is intended to (1) be a major component of the department’s compliance with the electronic invoicing requirements of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001⁷ and (2) contribute to the department’s goal of reducing interest charges for late payments to vendors. However, DOD’s WAWF program lacks the management information and strategic direction needed to be successful. Specifically, DOD lacks the metrics needed to know whether WAWF is being utilized and, if not, what the barriers are to more effective utilization. In addition, the program management of this initiative has changed hands numerous times, has not clearly defined the roles and responsibilities of the organizations that are integral to the program’s success, and does not have a written strategy for ensuring that WAWF will be effectively utilized. Finally, while the electronic invoicing provisions included in the National Defense Authorization Act for Fiscal Year 2001 require contractors to submit invoices electronically, there is no clear legal and regulatory requirement for the military services and defense agencies to process receiving and acceptance reports and other payment-related

⁶ DOD also uses Electronic Data Interchange and Web Invoicing applications to transmit payment documents and data electronically. However, because WAWF provides greater visibility over the status of payments and payment documents, it is DOD’s stated goal that all electronic invoicing be performed using WAWF.

⁷ Pub. L. No. 106-398, § 1008, 114 Stat. 1654, 1654A-249 (Oct. 30, 2000).

documentation electronically when contractors send their invoices directly to DOD vendor payment sites—which is often the case.⁸

Disruptions of cash flow caused by late payments—depending on the extent and duration—can impact the day-to-day operations of small businesses. To obtain a perspective on the effect late payments can have on small business contractors, we interviewed and, when available, obtained payment documentation from 17 small business contractors that were paid late multiple times during fiscal year 2004. According to 14 of the 17 contractors we spoke with, late payments from DOD created cash flow problems, which ultimately led them to seek and obtain a line of credit in order to finance their day-to-day operations. Further, although DOD is required by the Prompt Payment Act to pay interest penalty payments when certain bills are paid late, 10 of the contractors we spoke with said they often did not receive interest on payments they considered late. In an effort to substantiate the contractors' assertions, we requested payment documentation from DOD—including invoices, receiving reports, and other relevant payment documents—for the 3 small business contractors that provided us with information that they believed demonstrated that they were owed interest. However, DOD was unable to provide us with the requested documentation, and therefore, we were unable to confirm the contractors' assertions. Nonetheless, according to one of the small business owners, after we asked DOD to research the contractor's claims, DOD determined that the contractor was entitled to interest penalty payments of approximately \$1,000—which, according to the contractor, DOD later paid. Further, according to 11 of the small business contractors we spoke with, when interest is received, it is less than the small businesses' cost of capital. For example, using the prompt payment rate of 4.25 percent, which was in effect as of June 2005, DOD paid interest of \$199 to one small business contractor on an \$84,150 invoice paid 20 days past its due date. However, financing \$84,150—using the 7.250 percent interest rate available through the contractor's line of credit—would cost the small business owner \$340.

We are making five recommendations to improve the timeliness of DOD payments, including payments to small business contractors. Specifically,

⁸ Invoices related to certain types of contracts, such as construction contracts, must be certified by a DOD contracting official, who then forwards the certified invoice to the appropriate DOD vendor pay site for payment.

we are recommending that DOD (1) clarify its management structure for WAWF and provide strategic direction for DOD and the military services in their efforts to implement and effectively utilize WAWF; (2) establish a strategic plan that defines the roles and responsibilities of the various organizations that are integral to the program's success; (3) develop performance metrics to measure the success of the program; (4) consider incorporating, as part of the WAWF application, a data element that would flag invoices submitted by small disadvantaged business so that they could be paid early, in accordance with DOD policy; and (5) require the military services and defense agencies to process all DOD receiving and acceptance reports and other supporting payment documentation electronically.

In written comments, which are reprinted in appendix I, DOD concurred with our recommendations and affirmed its commitment to fully implementing and effectively utilizing WAWF. DOD noted its plans to provide clear direction and a strategic plan for WAWF, including evaluating and revising existing WAWF metrics and considering, as part of its next WAWF requirements review, a data element that would flag invoices submitted by small disadvantaged businesses. DOD also stated that, as part of its strategic plan, it would reemphasize the clear requirement for the military services and defense agencies to process all receiving and acceptance reports and other supporting payment documents electronically.

Background

The Small Business Act defines a small business concern as “one that is independently owned and operated and which is not dominant in its field of operation.”⁹ The law also states that in determining what constitutes a small business, with respect to size standards, the definition will vary from industry to industry to reflect industry differences accurately.¹⁰ Over the years, SBA has established and revised numerical definitions for all for-profit industries—which are matched to North American Industry Classification System industries and referred to as SBA’s size standards table. Size standards in the table are almost always stated either as the number of employees or average annual receipts of a business concern. In addition to establishing eligibility for SBA programs, all federal agencies

⁹ 15. U.S.C. § 632 (a) (1).

¹⁰ Id. at § 632 (a) (3).

must use SBA's size standards as criteria when awarding small business contracts.

DOD plays a key role in the success of the federal government's small business programs because it accounts for about two-thirds of all federal procurements. The DOD Office of Small Business Programs (OSBP) is responsible for DOD-wide small business policy and oversight to ensure compliance by all military departments and defense agencies. OSBP is not itself a procurement office but, instead, serves as a liaison between the small business community and the DOD procurement offices. OSBP is responsible for, among other things, advocating the use of small, small disadvantaged, HUBZone, veteran owned, service-disabled veteran-owned, and women-owned small businesses, and small business participation in SBA's 8(a) business development set aside program. This involves promoting small business prime and subcontracting opportunities in accordance with federal laws, regulations, and policies in an effort to meet statutory goals. OSBP is not responsible for assisting small businesses in receiving timely payments from DOD.

Prompt Payment Act Requirements

The Prompt Payment Act requires federal agencies to pay interest on overdue invoices¹¹ and take discounts only when payments are made within the allowed discount period.¹² The Prompt Payment Act implementing regulations also generally prohibit paying invoices too early—specifying that agencies may not make payments more than 7 days prior to the payment due date, except under certain conditions. Agencies may use accelerated payment methods under certain circumstances, including paying small business invoices as quickly as possible once all required documentation is received at the designated payment office.¹³ The Prompt Payment Act does not apply to contract financing payments—or the authorized payment of monies prior to the acceptance of goods and services—including advance payments, progress payments, payments on performance-based contracts, or interim payments.

¹¹ 31 U.S.C. § 3902.

¹² *Id.* at § 3904.

¹³ 5 C.F.R. § 1315.5 (b).

In general, payments covered by the Prompt Payment Act are due, unless otherwise specified, (1) on the date specified in the contract, (2) in accordance with the discount terms that are offered and taken, (3) in accordance with accelerated payment methods, or (4) 30 days after the start of the payment period.¹⁴ If payments are not made according to the above criteria, the government must pay interest penalty payments, and if the interest penalty is not made, the contractor may demand an additional penalty amount. These payments are calculated from the day after payment was due until the day payment is made.¹⁵ The rate used to calculate interest penalties is established by the Secretary of the Treasury under the Contract Disputes Act, 41 U.S.C. § 611. As of January 1, 2006, the rate was 5.125 percent.¹⁶ The rate is calculated quarterly based on a 12-month rolling average of the Treasury Tax and Loan rate.

DOD's Commercial Payment Process

DOD's Defense Finance and Accounting Service (DFAS) has overall responsibility for the payment of invoices related to goods and services supplied by commercial vendors. These payments are made on behalf of the military services and other defense agencies and are referred to as commercial payments. As part of a reorganization effort in April 2001, DFAS separated its commercial payment services into two business lines—contract pay and vendor pay.

- DOD's contract pay business line is managed and operated out of DFAS-Columbus. The contract pay business line processes invoices for formal, long-term contract instruments that are typically administered by the Defense Contract Management Agency (DCMA). These contracts tend to cover complex, multiyear purchases with high dollar values, such as major weapon systems. Payments for contracts administered by DCMA are made from a single DFAS system—Mechanization of Contract Administration Services.

¹⁴ 5 C.F.R. § 1315.4 (g). The start of the payment period is the later of (1) the receipt of the proper invoice by the designated billing office or (2) the government's acceptance of supplies delivered or services performed by the contractor.

¹⁵ 31 U.S.C. § 3902 (b).

¹⁶ 70 Fed. Reg. 76497, December 27, 2005. (See www.publicdebt.treas.gov/opd/opdrmt2.htm.)

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- DOD's vendor pay business line is managed and operated by 20 separate DFAS sites located throughout the world. The vendor pay product line processes invoices for contracts not administered by DCMA, plus miscellaneous non-contractual payments, such as for utilities, uniforms/clothing, fuels, and food. Payments processed through the DOD vendor pay business line are made from any one of 13 systems at the 20 vendor pay locations.

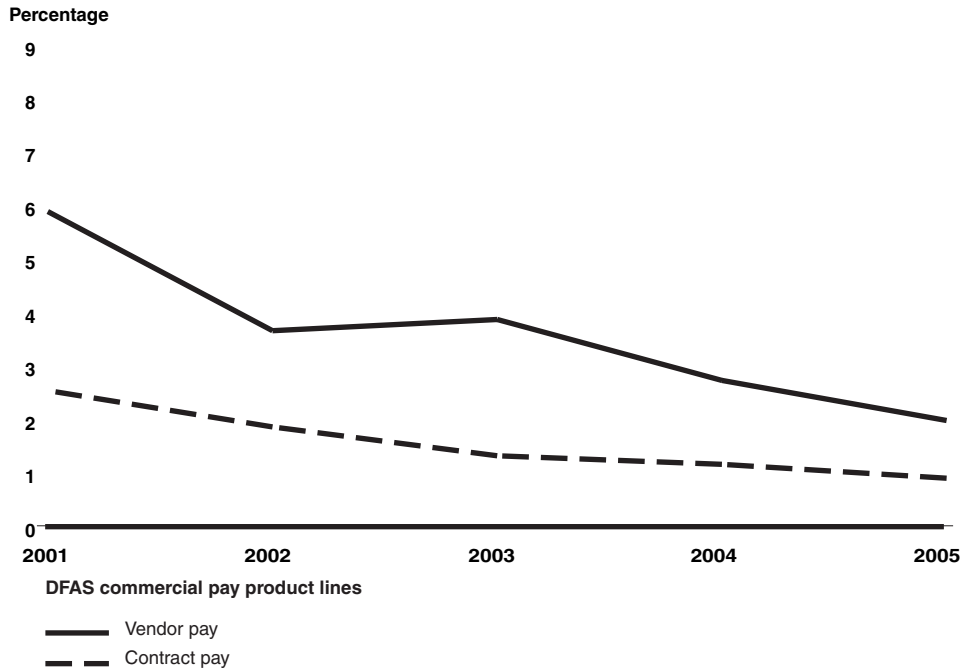
In general, DFAS makes both vendor and contract payments only after matching the request for payment, or invoice, with (1) a signed contract, purchase order, or other contractual document—to ensure that the purchase of goods or services was authorized; (2) a receiving/acceptance report—to ensure that the goods or services ordered have been received and/or accepted;¹⁷ and (3) the official accounting records—to ensure that funds have been obligated and are available for use. Because of DOD's numerous nonintegrated automated and manual systems, much of the data generated by these systems cannot be electronically transferred from one system to another in order to complete a payment transaction. Therefore, various data must be read, interpreted, and manually entered from hard copy documents—or manually verified and entered from electronic documents.

As we have reported in the past,¹⁸ DFAS management has focused on reducing commercial payment backlogs since fiscal year 2000 and has reported significant improvements in these payment metrics in recent years. However, many of these improvements have come from dedicating additional resources to the problem and not from addressing the underlying weaknesses or inefficiencies that cause late payments. In addition, as shown in figure 1, DOD's vendor pay payment backlog metrics continue to lag behind its contract pay metrics.

¹⁷ The fast pay procedure allows payment under limited conditions to a contractor prior to the government's verification that supplies have been received and accepted. (48 C.F.R. subpt. 13.4). Among other conditions, deliveries of supplies are to occur at locations where there is both a geographical separation and a lack of adequate communications facilities between government receiving and disbursing activities that will make it impractical to make timely payment based on evidence of government acceptance.

¹⁸ [GAO-03-457](#).

Figure 1: Overdue Invoices on Hand as a Percentage of Total Invoices Processed for DOD's Vendor Pay and Contract Pay Business Lines for Fiscal Years 2001 through 2005



Source: GAO analysis of DFAS data.

As we have previously reported,¹⁹ for the most part, both DOD's vendor payment and contract payment processes are paper driven—spanning numerous DOD and contractor organizations with nonintegrated procurement, logistics, and accounting systems. However, inherent differences in the type of payments made through DOD's vendor pay and contract pay processes result in significant differences in the timeliness of payments made through each of these processes.

Although the payment processes for DOD's vendor pay and contract pay product lines require DOD to match key payment documents before an invoice can be paid, there is one major difference in the processes that allows DOD to pay invoices submitted through its contract pay process in

¹⁹ [GAO/AIMD-98-40](#).

a more timely fashion. Specifically, as part of DOD's contract pay process, the receipt and acceptance of goods and services is often performed by a government representative located at the contractor's facility—which is referred to as source acceptance. In contrast, under the vendor pay process, receipt and acceptance is usually performed after goods are received at their destination—which is referred to as destination acceptance. Consequently, the vendor pay process is more time consuming than DOD's contract pay process. It is important to note that source acceptance, while more efficient, is also more costly, and therefore it would not be practical to expand the use of this practice to the vendor pay product line.

Small Business Invoices Paid Late More Often Than All Invoices Paid at Vendor Pay Locations

Our analysis of DOD's fiscal year 2004 payment data for nine DOD vendor pay locations showed that to varying degrees, small business invoices were paid late more often than all invoices paid at each of the nine vendor payment locations. However, this disparity was not evident at DOD's contract pay site, because efficiencies utilized by DOD's contract pay business line result in more timely payments to contractors—including small business contractors. As noted above, these same efficiencies cannot be cost effectively applied to DOD vendor pay business line. Table 1 shows the payment timing differences for the nine vendor pay locations and for contract payments.

Table 1: Percentage of Invoices Paid Late by DFAS Location and Small versus All Business for Fiscal Year 2004

| DFAS payment locations | Percentage of small business invoices paid late | Percentage of all invoices paid late | Percentage difference |
|---------------------------|---|--------------------------------------|-----------------------|
| Vendor pay | | | |
| Pensacola ^a | 63.69 | 24.97 | 38.72 |
| Dayton | 17.63 | 12.87 | 4.76 |
| San Diego | 10.11 | 9.62 | 0.49 |
| Norfolk | 14.43 | 9.04 | 5.39 |
| Rock Island | 9.24 | 8.92 | 0.32 |
| Charleston | 15.19 | 7.98 | 7.21 |
| Limestone | 10.83 | 7.24 | 3.59 |
| Orlando | 10.06 | 5.35 | 4.71 |
| Pacific | 9.00 | 4.69 | 4.31 |
| Overall vendor pay | 14.43 | 9.94 | 4.49 |
| Contract pay | | | |
| Columbus | 1.72 | 1.78 | (.06) |

Source: GAO analysis of DOD payment data.

^aAccording to DFAS officials, the high percentage of invoices paid late by the Pensacola vendor pay site was because of disruptions caused by hurricanes that affected the region in 2004.

As discussed later, resolving this disparity will require the department to improve the overall timeliness of payments made through DOD’s vendor pay business line. Further, given that DOD’s vendor pay business line presents the most significant challenge for DOD, with respect to paying invoices on time, we focused specifically on the systemic weaknesses in DOD’s vendor payment processes and actions needed to improve the timeliness of payments made through these processes.

Long-standing Weaknesses in DOD's Vendor Payment Processes Result in Late Payments to Contractors, Including Small Business Contractors

Long-standing weaknesses in DOD's vendor payment processes—including DOD's lack of automated systems—result in late payments to contractors, including small business contractors. For decades, we have reported that the leading cause of DOD late payments stems from delays caused by the receiving and acceptance process. The delayed processing of these payment documents is caused, in large part, by the paper-driven nature of DOD's vendor payment process and DOD's nonintegrated payment, accounting, and logistics systems. As discussed previously, small business invoices are paid late more often than all invoices paid at selected vendor payment locations, which according to DOD officials, may occur because of DOD's cash management and prioritization practices. Resolving this disparity will require the department to improve the overall timeliness of payments made through DOD's vendor pay business line. To its credit, DOD has invested in Web-based business tools that facilitate the electronic transmission of payment documents and data. If implemented and used effectively, these tools could improve the timeliness of DOD's vendor payments; however, DOD has been slow to implement and use these tools.

DOD's Cash Management Practices May Disadvantage Small Businesses

DOD vendor pay officials told us that they were unaware that small business invoices were paid late more often than all invoices and were uncertain as to the cause of the disparity. However, some officials suggested that the difference may occur because DOD's cash management practices inadvertently disadvantage small businesses by placing a lower priority on the payment of smaller, less-complex invoices, like those typically submitted by small business contractors. In addition, none of the vendor pay sites we visited were following DOD's written policy to assist small disadvantaged businesses²⁰ by paying them as quickly as possible after invoices are received and before normal payment due dates established in the contract.

DOD's vendor pay sites prioritize the payment of invoices based on the amount of the invoice, the payment due date, and whether the contractor

²⁰ Defense Federal Acquisition Regulation Supplement, 48 C.F.R. § 232.903. Small disadvantaged businesses are a subset of the larger population of small business contractors. The payment data provided by DOD did not allow us to isolate and analyze payments made to small disadvantaged businesses.

has offered an early payment discount.²¹ While these priorities are based on sound cash management practices, they tend to favor the payment of non-small business invoices first. In addition, DOD's vendor pay sites prioritize their workload based on the overall complexity of an invoice and the anticipated time it will take to process the invoice. For example, large multimillion-dollar invoices may contain over 100 lines of accounting—or separate funding sources for each billable item. Each line of accounting must be matched with the receiving report, contract terms, and accounting records to ensure proper payment of the invoice—making it time-consuming to process these invoices. These complex invoices are not typically associated with small businesses. It is important to note that these same practices are also used at DOD's contract pay site but did not result in a timing disparity between the payment of small business and all invoices.

Finally, it is DOD's written policy to assist small disadvantaged businesses by paying them as quickly as possible after invoices are received and before normal payment due dates established in the contract. However, at the vendor pay sites we visited, the automated systems used to process payments did not contain the demographic information needed to identify small disadvantaged businesses and prioritize the payment of their invoices. According to DOD vendor pay officials, it was too costly to change the vendor payment system requirements to accommodate the needed information. As a result, none of the vendor pay sites we visited had implemented DOD's policy to pay small disadvantaged businesses as quickly as possible after their invoices are received.

Electronic Commerce Tools Could Improve the Timeliness of Payments Made through DOD's Vendor Payment Process

To its credit, DOD has invested in the Web-based tool know as WAWF, which, if implemented and used effectively, could improve the overall timeliness of payments made through DOD's vendor pay business line by facilitating the electronic transmission of payment documents and data. However, DOD's WAWF program lacks the management information and strategic direction needed to be successful. Specifically, DOD lacks the metrics needed to know whether WAWF is being utilized and, if not, what

²¹ Agencies may pay early if the discount terms result in an annual interest rate equal to, or higher than, the Current Value of Funds Rate (CVFR). Department of the Treasury, *Treasury Financial Manual*, vol. I, pt. 6, § 8040.40. The CVFR is published quarterly by the Secretary of the Treasury.

the barriers are to more effective utilization. In addition, the program management of this initiative has changed hands numerous times, lacks the organizational authority to effect change across DOD, and does not have a written strategy for ensuring that WAWF will be effectively utilized. As a result, DOD's vendor payment sites continue to process mostly paper payment documents, which can often result in redundant data entry; misplaced documents; and ultimately, payment delays.

Until recently, the computer-to-computer exchange of routine business information, known as Electronic Data Interchange (EDI), was the predominant electronic commerce technology available to both government and industry. Using EDI technology, invoices and other payment documents—traditionally conveyed in paper form—can be transmitted electronically between computers without human intervention. However, to implement EDI technology, data must be converted into a standard data format before it is transmitted to the receiving system. Because the cost of converting and transmitting business data was prohibitively expensive for small and midsized companies, most small businesses continued to convey paper documents by mail or facsimile (fax).

With the arrival of Web-based business tools, the electronic exchange of data has become more cost-effective for many smaller businesses. Accordingly, the Congress included a requirement in the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001²² that the Secretary of Defense shall require any claims for payment (e.g., invoices) under DOD contracts be submitted in electronic form.²³ In January 2004, DOD updated the Defense Federal Acquisition Regulation Supplement (DFARS) to reflect the new electronic invoicing requirement.²⁴ The January 2004 DFARS update outlines the electronic submission options²⁵

²² Pub. L. No. 106-398, § 1008, 114 Stat. 1654, 1654A-249 (Oct. 30, 2000).

²³ Subsection 1008(c) authorized the Secretary to exempt any category of invoices from this requirement if he determines that adherence to the requirement would be “unduly burdensome.” Through DOD’s implementing regulations, the Secretary has exempted invoices where vendors are unable to submit invoices electronically, among other categories. DFARS 232.7002(a).

²⁴ DFARS 252.232-7003.

²⁵ Although DFARS 252.232-7003 provides several electronic submission options, DOD has designated WAWF as the preferred electronic invoicing tool because it provides greater visibility over the status of payments and payment documents.

and provides for exceptions to the regulation when (1) the contractor is unable to submit a payment request in electronic form or (2) DOD is unable to receive a payment request in electronic form.

DOD deployed the first version of WAWF in fiscal year 1999 with the goal of eliminating paper from the payment process by enabling authorized defense contractors and DOD personnel to create and transmit electronic invoices and receiving reports and access contract-related documents online. According to DOD officials, WAWF is intended to be a major component of the department's compliance with the electronic invoicing requirements of the fiscal year 2001 National Defense Authorization Act and contribute to the department's goal of reducing interest charges for late payments to vendors. Specifically, WAWF provides DOD with the capability to automatically update its payment systems to complete the payment transaction without human intervention—which could significantly improve the timeliness of payments. Under DOD's current vendor payment process, these paper documents may arrive at the DFAS payment office separately—typically by mail or by fax. DFAS vendor payment technicians then process each document as it arrives by manually keying it into the payment system.

WAWF, if fully implemented and utilized as planned, can eliminate paper and redundant data entry; improve data accuracy; reduce the number of lost or misplaced documents; and ultimately, result in more timely payments to contractors. Further, this tool is available to all of DOD's contractors at no cost and provides electronic confirmation that the payment office has received payment documents and allows contractors to track the status of their payments. WAWF, according to DOD, also provides direct financial savings to the military services. Because processing electronic invoices is less costly for DFAS than processing paper invoices, the military service activities that use WAWF will pay a reduced payment processing service fee. For example, according to DOD, processing an electronic invoice for the U.S. Navy Bureau of Medicine and Surgery (BUMED) costs \$3.66 per line of accounting²⁶ whereas a paper invoice costs \$19.08. By using WAWF, BUMED estimated that it could reduce the amount it pays DFAS to process its invoices and save about

²⁶ Invoices may contain multiple lines of accounting, or funding sources. DFAS must match each line of accounting with the official accounting records to ensure that funds are available.

\$2.78 million per year. Other direct savings may be realized because of reductions in the amount of prompt payment interest paid. According to DOD, when the Air Force Air Education and Training Command implemented WAWF it realized a 45 percent decrease in the amount of interest penalties paid resulting from late payments.

According to DOD, WAWF has produced promising results when it is effectively utilized. However, the program lacks the strategic direction and management information needed to ensure its success. DOD's WAWF program has been managed by the Defense Information Systems Agency (DISA) since it was placed in operation in fiscal year 1999 but according to the current program manager, this position has changed hands three times since fiscal year 2003—at times, with no one filling the position. In October 2005, with the establishment of the Defense Business Transformation Agency (BTA)—which is intended to advance DOD-wide business transformation—ownership of the WAWF initiative was transferred to BTA. However, as of the date of this report, although ownership has been officially transferred to BTA, DISA, in effect, continues to manage WAWF. Moreover, DISA's primary focus has been on addressing technical issues that affect WAWF functionality—not on ensuring that the application is effectively utilized by contractors or the military services.

Although other DOD organizations, such as DFAS and DCMA, and the military services have established implementation points of contact who have initiated efforts to market WAWF and provide training, their focus has been almost entirely on implementing WAWF in the contract pay arena. Less emphasis has been placed on implementing WAWF in the vendor pay business line. Further, DOD does not have a comprehensive written strategy for how it intends to ensure that contractors routinely submit their invoices electronically or that the military services submit receiving and acceptance reports electronically. Because DOD's vendor pay process relies almost exclusively on destination acceptance, it is important that military service and defense agency receiving units designate and train WAWF focal points who will be responsible for receiving and accepting goods and services electronically. However, military service and defense agency receiving units have been slow to embrace WAWF as a means of performing receipt and acceptance activities. As such, a comprehensive strategy for addressing this and other challenges that may adversely affect WAWF utilization is essential.

Although DOD has equipped 14 of its 20 vendor payment locations with WAWF, DOD does not collect the management information needed to

effectively measure the success of this initiative. For example, the WAWF program manager did not know the percentage of vendor pay invoices received electronically or the percentage of vendor pay receiving/acceptance documents received electronically, or to what extent the military services had equipped and trained their receiving units to use WAWF. DFAS officials at the vendor pay sites we visited also did not keep track of these metrics but estimated that they receive, at most, 20 percent of their invoices electronically and even fewer receiving/acceptance reports. Even with the small number of payment documents processed through WAWF, vendor pay officials complained of the application's slow processing speed—stating that they were not sure if the application could handle a larger workload. As a result, these officials said that they were reluctant to encourage the use of WAWF. According to the WAWF program manager, the problems experienced by these vendor pay locations have been resolved and were likely caused by the latest application upgrade.

Finally, the legal and regulatory requirement for the military services and defense agencies to process receiving and acceptance reports and other supporting documentation electronically may not apply to the majority of invoices submitted through DOD's vendor payment process. Specifically, the electronic invoicing provisions included in the National Defense Authorization Act for Fiscal Year 2001 states that DOD officers or employees who receive an electronic invoice from a DOD vendor, and who also must transmit the invoice to another DOD officer or employee for payment processing, must transmit the claim and any supporting documentation electronically (e.g., receiving reports). However, most vendor pay contractors submit their invoices directly to DFAS for payment²⁷ and rely on the military service or defense agency receiving unit to send receiving and acceptance documents to DFAS. Thus, when a vendor pay contractor submits an electronic invoice to DFAS, DOD does not require military service or defense agency receiving units to acknowledge receipt and acceptance electronically.

Although DOD policies encourage the electronic transmission of receiving reports and other supporting documentation, DOD's implementing

²⁷ Invoices related to certain types of contracts, such as construction contracts, must be certified by a DOD contracting official, who then forwards the certified invoice to the appropriate DOD vendor pay site for payment.

regulations and policies do not clearly extend this requirement to receiving and acceptance officials.²⁸ While requiring contractors to submit invoices electronically is a good first step toward improving DOD's payment process, electronic invoicing alone does not address DOD's biggest obstacle to paying its bills on time—the timely submission of receipt and acceptance documents. As a result, according to DOD vendor pay officials, they continue to receive most of these documents by mail or fax, which can often result in redundant data entry, misplaced documents, and ultimately, payment delays.

Late Payments May Create Financial Hardship for Some Small Business Contractors

Although DOD is required by the Prompt Payment Act to pay interest penalties when certain bills are paid late,²⁹ the amount of interest received is less than small businesses' cost of capital and may also affect cash flow. As a result, the disruption of cash flow caused by late payments can have a significant impact on the day-to-day operations of small businesses. Further, many of the small business contractors we interviewed said that they often did not receive interest on invoices that in their view, were paid late. In an effort to substantiate the contractors' assertions, we requested documentation from DFAS for late payments for the three small business contractors that provided us with information they believed demonstrated that they were owed interest. However, DFAS was unable to provide us with the requested documentation, and therefore, we were unable to confirm the contractors' assertions.

To obtain a perspective on the effect late payments have on small business contractors, we interviewed 17 small business owners who, according to DOD's records, were paid late multiple times during fiscal year 2004. At these interviews, 14 of the 17 small business owners said that because DOD pays its bills late, they have had to obtain lines of credit or use their personal resources to finance day-to-day operations. In three cases, contractors told us that their cash flow problems became so significant that they were concerned about their ability to continue in operation. Although DOD is required by the Prompt Payment Act to pay interest

²⁸ DFARS 232.7002(b). While subsection 1008(c) of the National Defense Authorization Act also authorized the Secretary to exempt categories of transactions from the electronic transmission requirement, DOD's implementing regulations currently allow for no such exemptions.

²⁹ 31 U.S.C. § 3902.

penalty payments when certain bills are paid late, the amount of interest received is less than these small businesses' cost of capital. Eleven of the 14 small business owners who had obtained a line of credit said that a line of credit cost them 2 to 4 percentage points more than the interest rate DOD uses to calculate late payment penalties. For example, using the prompt payment rate of 4.25 percent, which was in effect as of June 2005, DFAS paid interest of \$199 to 1 small business contractor on an \$84,150 invoice paid 20 days past its due date. However, financing \$84,150—using the 7.250 percent interest rate available through the contractor's line of credit—would cost the small business owner \$340.

The difference between the prompt payment interest rate and interest rates obtained by the small business owners we spoke with is consistent with government statistics on lending rates. Over the 10-year period between 1995 and 2004, the prompt payment interest rate was on average 5.8 percent, whereas the average prime lending rate—the interest rate charged by major banks to their best or most creditworthy customers—was 7.1 percent. Cash flow problems experienced by these DOD small business contractors are also consistent with the findings of a survey of small-business owners conducted by the Federal Reserve and the National Federation of Independent Businesses (NFIB).³⁰ The results of the NFIB survey showed that outstanding receivables are the primary reason small businesses experienced cash flow problems.

Table 2 provides an overview of the types of pay problems described by 8 of the 17 small business owners we interviewed. As discussed previously, the problems described by these 8 small business contractors may not be representative of all DOD small business contractors. As shown in table 2, DOD records showed that 5 of the 8 were paid late more than 15 times and, according to 6 of the 8 small business owners, they had outstanding invoice amounts totaling at least \$400,000 as of the date we interviewed them.

³⁰ National Federation of Independent Businesses, *National Small Business Poll: The Cash Flow Problem*, vol. 1, no. 3 (2001).

Table 2: Case Study Examples of Small Business Invoices Paid Late by DFAS

| Small business | Number of late payments in fiscal year 2004 | Receivables > 30 days as of the date of our fieldwork^a | Payment problems identified by small businesses | Consistently received interest payments on overdue receivables |
|---|--|---|--|---|
| Case study 1: 8(a), small disadvantaged business providing promotional and recruiting items for the Army | 5 | \$491,782 | Invoices lost by DFAS, resulting in continual follow-up to receive payments | Yes |
| Case study 2: 8(a), small disadvantaged business providing environmental remediation services for the Navy | 17 | \$755,951 | Cumbersome, inefficient process; no current contractual documents not available in payment office | No |
| Case study 3: 8(a), small disadvantaged business providing construction services for the Air Force and the Navy | 63 | \$431,920 | Invoices lost by DFAS, resulting in continual follow-up to receive payments | Yes |
| Case study 4: 8(a), small disadvantaged business providing environmental engineering services for the Army and the Navy | 22 | \$570,899 | Invoices lost by DFAS, resulting in continual follow-up to receive payments; poor customer support when trying to resolve issues | No |
| Case study 5: 8(a), small disadvantaged business providing general maintenance and construction services for the Army and the Navy | 23 | \$743,000 | Invoices lost by DFAS, resulting in continual follow-up to receive payments | Yes |
| Case study 6: minority owned small business providing moving and storage services for the Army | 361 | \$286,760 | Invoices lost by DFAS, resulting in continual follow-up to receive payments | No |
| Case study 7: small business providing computer software and equipment for the Army | 1 | \$600,000 | Receiving unit failed to submit receiving report in a timely manner | No |
| Case study 8: minority owned, 8(a), small disadvantaged business providing facilities management services for the Army and the Navy | 2 | \$140,000 | Invoices lost by DFAS, resulting in continual follow-up to receive payments; cumbersome, inefficient process. | No |

Source: GAO analysis of DOD and vendor data.

^aWe interviewed small business owners from June 2005 through September 2005 and obtained outstanding balance information as of the date of our interview.

Although DOD is required by the Prompt Payment Act to pay interest penalty payments when certain bills are paid late, 10 of the 17 small business owners we spoke with said that they did not receive interest payments when they were paid late. For example, 1 contractor provided us with information on 10 invoices totaling \$755,951 that were submitted during a 5-month period in 2005. Although, based on the contractor's

records, each invoice was paid from 7 to 125 days late, according to the contractor, no interest was ever received. In an effort to substantiate these assertions, we requested documentation from DFAS for late payments that according to these contractors, should have resulted in interest penalty payments. Specifically, we requested a copy of the invoice and receiving and acceptance documents for 20 examples of late payments provided by 3 small business contractors for which, according to the contractors, no interest was received. DFAS, however, was unable to provide us with the documentation we requested. Nonetheless, according to 1 of the small business owners, after we asked DOD to research the contractor's assertions, DOD determined that the contractor was entitled to interest penalty payments of approximately \$1,000—which, according to the contractor, DOD later paid. According to DFAS officials, interest was not paid on these invoices previously because DFAS entered the wrong invoice dates into the payment system. As discussed later, the invoice date entered into the payment system is used to establish payment due dates.

As shown in table 2, from the small business contractors' perspective, the biggest challenge they face in getting paid is ensuring that DFAS receives and acknowledges receipt of the invoices they submit. Nine of the 17 small business owners we interviewed told us that they had to submit their invoices to DFAS multiple times before DFAS acknowledged receipt of the invoice. According to most of the contractors we spoke with, they submitted their invoices by fax—often transmitting the same invoice to DFAS multiple times before DFAS acknowledged receipt of the invoice by date stamping it and subsequently processing it for payment. This is significant in that DFAS establishes payment due dates based on the date a proper invoice is received by the payment office.³¹ If days and weeks go by—as it was described to us—before contractors' invoices are successfully received by the payment office, it would explain why, from the contractors' perspective, they believed that they were entitled to interest payments that they did not receive. According to DFAS officials,

³¹ The Prompt Payment Act provides that an invoice is deemed to be received on the later of (1) the date a proper invoice is received by an agency if the agency annotates the invoice with the date of receipt or (2) the seventh day after the date on which goods are delivered or services completed, unless acceptance occurs earlier or if a longer acceptance period is specified in the contract. 5 C.F.R. § 1315.4 (b) (1). If the agency fails to annotate an invoice with the date of receipt of the invoice, the date placed on the invoice by the contractor is used to determine the start date for the payment period. *Id.* at § 1315.4 (b) (2). Further, agencies are required to return improper invoices to the contractor within 7 days of receipt to identify deficiencies in the invoice. 5 C.F.R. § 1315.4 (c).

because DFAS has no visibility over hard copy invoices until they are entered into the payment system, the time lag between the receipt of a hard copy invoice and its entry into the payment system could lead contractors to believe that DFAS had lost their invoice.

As discussed previously, WAWF, if implemented and used effectively, would eliminate the problem of lost invoices and provide a mechanism by which small business contractors could track the status of their invoices online and possibly be paid earlier. However, most of the small business owners we interviewed said that they had never heard of WAWF, and only 4 of the 17 contractors we interviewed were using WAWF. According to these 4 small business owners, using WAWF did resolve payment delays related to lost invoices but did not resolve the problem of late payments. Because DOD also requires acknowledgment of the receipt and acceptance of goods and services—over which contractors have little control—and the military service and defense agency receiving units responsible for receipt and acceptance do not routinely utilize WAWF, these contractors will likely continue to experience payment delays.

Conclusion

DOD has made significant progress in recent years in reducing its reported backlog of overdue invoices and improving its overall metrics related to late vendor payments. However, many of these improvements have come from focusing additional resources on the problem and not from addressing the underlying weaknesses that cause late payment. Although DOD has embarked on a series of efforts over the last decade to modernize its business systems—in an effort to address the underlying weaknesses in its vendor payment processes that we identified in our report—these efforts have been largely unsuccessful. With advances in Web based technology, DOD now has the opportunity to address some of these weaknesses and improve its ability to pay its contractors on time—including small business contractors. However, fully implementing and effectively utilizing WAWF will require sustained leadership and a focused strategy aimed at ensuring the successful implementation and utilization of available electronic commerce tools.

Recommendations for Executive Action

We recommend that the Secretary of Defense direct the Director of the Defense Business Transformation Agency to take the following four actions to clarify the management structure and policies over WAWF:

- Provide strategic direction for DFAS, DCMA, DISA, the military services, and defense agencies in their efforts to fully implement and effectively utilize WAWF.
- Establish a strategic plan that defines the roles and responsibilities of the various organizations that are integral to the success of the program and outlines a strategy for improving the utilization of WAWF—including correcting WAWF functionality or processing issues that may hamper effective utilization.
- Develop performance metrics that enable the department to measure the success of the program—including comprehensive metrics on the volume of invoices and receiving documents transmitted electronically.
- Consider incorporating, as part of the WAWF application, a data element that would flag invoices submitted by small disadvantaged business so that they may be paid more expeditiously, in accordance with DOD policy.

To help ensure that the military services and defense agencies effectively utilize WAWF we also recommend that the Secretary of Defense take the following action:

- Establish a clear requirement that the military services and defense agencies process all receiving and acceptance reports and other supporting payment documentation electronically.

Agency Comments and Our Evaluation

In written comments, which are reprinted in appendix I, DOD concurred with our recommendations and noted that the recent transition of WAWF to BTF will provide a renewed opportunity to address the strategic direction and planning to ensure that this program is fully implemented and effectively utilized. According to DOD, it plans to evaluate and revisit existing WAWF metrics and consider including, as part of its next WAWF requirements review, a data element that would flag invoices submitted by small disadvantaged businesses. DOD also stated that, as part of its strategic plan, it would reemphasize the clear requirement for the military services and defense agencies to process all receiving and acceptance reports and other supporting payment documents electronically.

We are sending copies of this report to the Secretary of Defense, interested congressional committees, and other interested parties. We will make copies of the report available to others upon request. In addition, the report is available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-9095 or williamsm1@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report were Diane Handley, Assistant Director; Francine DeVecchio; and Jamie Haynes.

A handwritten signature in black ink that reads "McCoy Williams". The signature is written in a cursive, flowing style.

McCoy Williams
Director, Financial Management and Assurance

List of Congressional Committees

The Honorable John Warner
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Duncan L. Hunter
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

The Honorable C.W. Bill Young
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

Appendix I: Comments from the Department of Defense



ACQUISITION
TECHNOLOGY
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

07 OCT 2005

Mr. McCoy Williams
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Williams:

This is the Department of Defense (DoD) response to the GAO Draft Report 06-358, 'DOD PAYMENTS TO SMALL BUSINESSES: Implementation and Effective Utilization of Electronic Invoicing Could Further Reduce Late Payments,' dated April 12, 2006 (GAO Code 192144). The Department concurs with the two recommendations for executive action and our responses are enclosed.

As noted in your report, Wide Area Workflow (WAWF) for electronic transmission of receiving and acceptance reports and other related payment documentation is currently used at various levels by the military services and defense agencies with resulting cost avoidance. WAWF customer representation is active through participation in the Joint Requirements Board.

The Department has issued several memorandums directing WAWF usage. The latest direction, dated August 18, 2004, was released as a joint memorandum from the Offices of the Under Secretaries of Defense (Comptroller) and (Acquisition Technology and Logistics). The recent transition of this program to the Business Transformation Agency (BTA) provides a renewed opportunity to address the strategic direction and planning to fully implement and effectively utilize WAWF. This tool, along with other related enterprise systems, will be assessed in the context of an integrated approach designed to achieve the overall capabilities required by DoD. Existing metrics for the identification of problems and/or issues, as well as for the measurement of success of the program, will be validated and expanded where necessary.

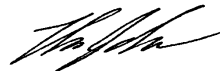
Your recommendation regarding the incorporation of a data element that would flag invoices submitted by small disadvantaged business so that they may be paid more expeditiously in accordance with DoD policy will be taken into consideration as part of the next requirements review.



**Appendix I: Comments from the Department
of Defense**

My point of contact for this matter is Ms. Cynthia Beck and she may be contacted by email: cynthia.beck@bta.mil or by telephone at (703) 607-1296.

Sincerely,



for Paul A. Brinkley
Deputy Under Secretary of Defense
(Business Transformation)

Attachments:
As stated

(GAO-06-358)/Code 192144
DoD Payments to Small Business Contractors

Recommendation A.1: The Secretary of Defense directs the Director of the Defense Business Transformation Agency to clarify the management structure and policies over WAWF that at a minimum:

- Provides strategic direction for DFAS, DCMA, DISA, the military services, and defense agencies in their efforts to fully implement and effectively utilize WAWF,
- Establishes a strategic plan that defines the roles and responsibilities of the various organizations that are integral to the success of the program and outlines a strategy for improving the utilization of WAWF – including correcting WAWF functionality or processing issues that may hamper effective utilization,
- Develops performance metrics that enable the Department to measure the success of the program – including comprehensive metrics on the volume of invoices and receiving documents transmitted electronically, and
- Considers incorporating, as part of the WAWF application, a data element that would flag invoices submitted by small disadvantaged business so that they may be paid more expeditiously in accordance with DoD policy.

DoD Response: Concur. The Business Transformation Agency (BTA) recently took over responsibility for the WAWF program and plans to address the need to reestablish a clear direction and a strategic plan that will focus the program. WAWF, along with other related enterprise systems, will be assessed in the context of an integrated approach designed to achieve the overall capabilities required by the Department.

A variety of metrics have captured historical WAWF usage. BTA will validate the accuracy, completeness and utility of existing metrics and revise as necessary to meet program direction. An additional data element can be added to the WAWF application to identify small business invoices. WAWF already receives Central Contractor Registry information and could use a Cage/Vendor comparison for setting such a flag. This will be considered as part of the next requirements review.

Recommendation A.2: The Secretary of Defense establishes a clear requirement that the military services and defense agencies process all receiving and acceptance reports and other supporting payment documentation electronically.

DoD Response: Concur. As an integral part of the strategic plan, the Department of Defense will reemphasize the clear requirement for the military services and defense agencies to process all receiving and acceptance reports and other supporting payment documentation electronically.

Appendix II: Objectives, Scope, and Methodology

To determine whether small businesses were more likely to be paid late than all businesses, we requested transaction-level detail for all DOD commercial payments subject to the Prompt Payment Act and all interest penalties paid in fiscal year 2004. For fiscal year 2004, DOD reported total payments subject to the Prompt Payment Act of \$206 billion—of which \$119 billion were paid through DOD’s contract pay business line and \$87 billion were paid through its vendor pay product line. We received all the payment data requested for DOD’s contract payment business line. However, DOD was able to provide payment data for only 9 of its 20 vendor payment locations. The payments generated from these 9 locations represent \$24 billion, or approximately 28 percent, of the total \$87 billion in vendor payments that were subject to the Prompt Payment Act.

Using the payment data from the nine vendor pay locations and one contract pay location, combined with data we obtained from the Central Contractor Registration (CCR) database—which contains the most comprehensive listing of small business contractors—we calculated the extent to which small businesses are paid late as compared with the payment of all invoices. Specifically, we used the data from CCR to identify invoice and interest payments associated with small business contractors. However, payment data for the nine sites did not always contain complete identifier data, which would allow us to determine whether the transaction involved a small business; some sites contained fairly complete data and others were missing identifiers for a large percentage of transactions. Because we were not able to identify all small businesses, our calculations compare invoices from known small businesses to invoices from all companies. To determine the percentages of invoices paid late, we divided the number of invoices paid late by the total number of invoices paid during the same period.

To examine the potential impact of the missing identifier data on our analyses, we calculated and compared late payment rates in a number of ways: comparing invoices from known small businesses with invoices from all businesses, comparing invoices from known small businesses with the remaining invoices (excluding known small businesses), comparing invoices from known small businesses with the remaining invoices after designating the transactions with missing identifiers to be in equivalent proportion to the known small and known non-small businesses, and comparing invoices from known small businesses to the known non-small businesses—after all transactions with missing identifiers were removed. In all cases, the overall finding that small business invoices were more likely to be paid late remained consistent. This finding also remained relatively consistent between sites that had

more complete data and sites that did not. We also discussed with DFAS officials the reasons why identifier information was missing. The reasons included removal during the archive process and lack of a requirement for that field in particular systems. We found no evidence that the missing identifiers were caused by systematic differences in how data on transactions from small versus non-small businesses are maintained.

To ensure that the DOD data were sufficiently reliable for our analyses, we conducted detailed reliability assessments of the data sets that we used. We restricted these assessments, however, to the specific variables that were pertinent to our analyses. We assessed the reliability of the payment data obtained from DOD's payment systems by ensuring that the transaction detail provided was consistent with summary totals reported as part DOD's prompt payment metrics. We also assessed the reliability of these data by performing nonstatistical sampling. To accomplish this, individual transactions were selected on a judgmental basis. Attributes from these transactions were compared to the original, supporting documentation held at the respective DFAS service center that processed the transaction. We reviewed attributes such as dates, contract numbers, amounts, and ensured policies related to the payment process were met prior to disbursement of funds. As part of our data reliability assessment we also considered the risk that contractors are misclassified (large versus small business) in the CCR database. We believe the risk is small for two reasons. First, the Small Business Administration (SBA) verifies the small business status of contractors that are part of SBA's set aside program—which is the primary means by which DOD meets its annual small business procurement goals. Second, according to SBA, small business self-certification is policed by other small business contractors—who have a vested interest in the accuracy of the small business designation. We found that all the data sets used for this report were sufficiently reliable for use in our analyses.

To determine the cause of late payments, we performed audit work at six DFAS vendor payment locations and the DFAS contract pay site, which collectively represent \$169 billion, or 82 percent of all payments subject to the Prompt Payment Act. The payments generated from the six vendor pay locations represent \$50 billion, or approximately 58 percent, of the total vendor payments that were subject to the Prompt Payment Act. At each of the DFAS service sites visited, we interviewed officials who were responsible for processing vendor invoices for payment; officials who prepared and submitted metrics related to the overall timeliness of payments made; and officials who were responsible for handling both large and small business contractor complaints and inquiries. Additionally,

we obtained documentation on and performed walk-throughs of the vendor payment and contract payment processes.

We selected DFAS vendor pay sites for review based on the percentage of interest penalty payments made compared to the total amount of payments made subject to the Prompt Payment Act. Once this percentage was determined, we chose DFAS vendor pay sites with both disproportionately high and low percentages compared to the average percentage for all sites. Sites with low percentages were selected because of their relative proficiency in paying vendors in a timely manner and to identify possible best practices used by these sites. Sites with high percentages were chosen so that we could understand and document problems associated with the payment process. Further, the site selection criteria ensured that service-unique processes and locations were included. The DFAS vendor pay sites we visited are as follows: Columbus, Ohio; Dayton, Ohio; Norfolk, Virginia; Rock Island, Illinois; San Diego, California; and Indianapolis, Indiana.

To gain an understanding of how DFAS and DISA coordinated, managed, and implemented the WAWF program, we interviewed the DFAS WAWF focal point, officials responsible for collecting electronic commerce metrics at DFAS, and the WAWF program manager. We obtained and analyzed memorandums, directives, briefings, and other documents related to the WAWF program—including system requirements documentation describing the functionality of the current version of WAWF, version 3.0.9.

To document the criteria governing payments to small business contractors, we obtained and reviewed applicable policies, procedures, and program guidance, including the Small Business Act,¹ the Prompt Payment Act and regulations,² the Defense Federal Acquisition Regulations,³ the Federal Acquisition Regulation,⁴ and DFAS desk policies.

¹ 15 U.S.C. §§ 631-657g.

² 31 U.S.C. ch. 39; 5 C.F.R. pt. 1315.

³ 48 C.F.R. pt. 219 and subpt. 232.9.

⁴ Id. at pt. 32.

In conducting our work, we also referred to the internal control standards provided in *Standards for Internal Control in the Federal Government*.⁵

To assess the impact that late payments have on small business contractors, we relied on a case study approach, principally because DOD was unable to provide us with a complete universe of small business contractors that were paid late, which would be needed to perform sampling techniques that would allow us to comment on the experiences of small business contractors as a whole. Therefore, using DOD payment and other data, we identified small business contractors that were paid late multiple times during fiscal year 2004 and documented the difficulties experienced by 17 of these contractors. We selected our case study examples from the DOD payment data provided by identifying small business contractors that DOD paid late most frequently. Of those small business contractors that were paid late most frequently, 17 expressed a willingness to share information on late payments with us. Our findings for this objective cannot be projected and may not be representative of the experiences of DOD small business contractors as a whole. We interviewed each of these contractors from June 2005 through September 2005 and, when possible, obtained documentation related to late payments, including accounts receivable aging reports and copies of unpaid invoices. In addition, we attempted to corroborate contractors' claims that they had not received interest payments to which they believed they were entitled by requesting from DFAS invoices, receiving reports, and any other payment documentation related to these claims.

We briefed DFAS and DOD officials from the selected payment locations on the details of our audit, including findings and their implications. We conducted our fieldwork from November 2004 through January 2006 in accordance with U.S. generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of Defense or his designee. We received written comments from the Deputy Under Secretary of Defense (Business Transformation). These comments are evaluated in the "Agency Comments and Our Evaluation" section of this report and are reprinted in appendix I.

⁵ GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999). These standards provide the overall framework for establishing and maintaining effective internal control and for identifying and addressing areas of greatest risk of fraud, waste, abuse, and mismanagement.

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