

September 1, 2006



Financial Management

Providing Interim Payments to
Contractors in Accordance with the
Prompt Payment Act
(D-2006-108)

Department of Defense
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Acronyms

C.F.R.	Code of Federal Regulations
DCAA	Defense Contract Audit Agency
DFARS	Defense Financial Acquisition Regulation Supplement
DFAS	Defense Finance and Accounting Service
EDM	Electronic Data Management
FAR	Federal Acquisition Regulation
FMR	Financial Management Regulation
GAO	Government Accountability Office
MOCAS	Mechanization of Contract Administration Service
OIG	Office of Inspector General
OMB	Office of Management and Budget
U.S.C.	United States Code



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

September 1, 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY, AND LOGISTICS
UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE, HEADQUARTERS
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE, COLUMBUS
DIRECTOR, DEFENSE CONTRACT MANAGEMENT
AGENCY

SUBJECT: Report on Providing Interim Payments to Contractors in Compliance with the
Prompt Payment Act (Report No. D-2006-108)

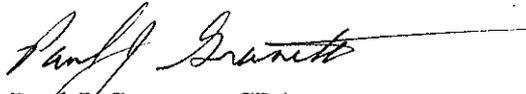
We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense for Acquisition, Technology, and Logistics and the Defense Finance Accounting Service Columbus comments were partially responsive. We request additional comments on Recommendation A.1. and A.3. by October 2, 2006. In addition, we request that the Defense Finance Accounting Service Columbus provide additional comments related to the management control weakness and the related potential monetary benefits.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Audcolu@ddodig.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to James L. Kornides at (614) 751-1400 ext. 211 or Mr. Mark Starinsky at (614) 751-1400 ext. 231. The team members are listed inside the back cover. See Appendix B for the report distribution.

By direction of the Deputy Inspector General for Auditing:


Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Department of Defense Office of Inspector General

Report No. D-2006-108

September 1, 2006

(Project No. D2006-D000FJ-0076.000)

Providing Interim Payments to Contractors in Accordance with the Prompt Payment Act

Executive Summary

Who Should Read This Report and Why? DoD personnel responsible for disbursing and processing interim payments on cost-reimbursement service contracts in accordance with the Prompt Payment Act should read this report. It discusses internal controls that ensure payments are made in a timely manner.

Background. Each year, DoD makes thousands of interim payments on the cost-reimbursement type contracts that it uses to obtain services. Interim payments on service contracts include payments for developing software, providing software support, developing and testing mechanical parts, and providing engineering services related to developing and maintaining weapons systems. The National Defense Authorization Act of 2001, Public Law 106-398, amended the Prompt Payment Act of 1998 and required that these interim payments comply with all requirements of the Prompt Payment Act. The Prompt Payment Act of 1998, section 3903, title 31, United States Code, requires that the payment date is the date payment is due under the contract for the item of property or service provided, or 30 days after a proper invoice for the amount due is received if a specific payment date is not established by contract. The Prompt Payment Act also requires an agency to make payments no more than 7 days prior to the payment due date, unless the agency head or designee has determined (on a case-by-case basis) that earlier payment is necessary. In FY 2005, the Defense Finance and Accounting Service Columbus made interim payments subject to the Prompt Payment Act totaling \$32.1 billion.

Results. During FY 2005, the Defense Finance and Accounting Service Columbus prematurely disbursed approximately \$28.4 billion of the \$32.1 billion of interim payments on cost-reimbursement service contracts. These early payments resulted in approximately \$9.4 million in lost Federal interest. Potential monetary benefits of \$56.4 million could be recognized through interest savings during the period FY 2006 through FY 2011 if the Defense Finance and Accounting Service Columbus improves the cash management of interim payments on cost-reimbursement service contracts. Specifically, DoD needs to establish a policy that requires a payment due date of 30 days for interim payments on cost-reimbursement service contracts (finding A).

The Defense Finance and Accounting Service Columbus did not identify either the proper invoice receipt date, payment due date, or interest payments due on 24 of the 100 interim payments on cost-reimbursement service contracts that we judgmentally tested. The Defense Finance and Accounting Service Columbus needed to improve controls over identifying invoice receipt dates and calculating payment due dates and interest payments owed on cost-reimbursement service contracts interim payments (finding B). See the Finding sections of the report for the detailed recommendations.

Management Comments and Audit Response. The Deputy Chief Financial Officer for the Under Secretary of Defense (Comptroller)/Chief Financial Officer concurred with our recommendation to remove interim payments for cost-reimbursement service contracts from the DoD Financial Management Regulation definition of contract financing. The Center Site Deputy Director, Defense Financial Accounting Service Columbus concurred with our recommendation to provide training to employees for entering invoice receipt date information.

The Director, Defense Procurement and Acquisition Policy; the Deputy Chief Financial Officer for the Under Secretary of Defense (Comptroller)/Chief Financial Officer; and the Center Site Deputy Director, Defense Financial Accounting Service Columbus nonconcurred that DoD policy for making interim payments on cost-reimbursement service contracts did not comply with the Prompt Payment Act and the National Defense Authorization Act of 2001. The Director and the Deputy asserted that Defense Federal Acquisition Regulation Supplement section 232.906, "Making Payment," properly establishes a 14-day due date for interim payments on cost-reimbursement service contracts and falls within Office of Management and Budget guidelines. The Director, Defense Procurement and Acquisition Policy disagreed that the payment due date for interim payments on cost-reimbursement service contracts should be changed to 30 days. The Center Site Deputy Director, Defense Financial Accounting Service Columbus disagreed that the Defense Finance and Accounting Service should discontinue its policy to pay interim payments on cost-reimbursement service contracts more than 7 days prior to the payment due date. He also stated that there was no management control weakness and; therefore, no potential monetary benefit. We disagree that Defense Federal Acquisition Regulation Supplement section 232.906 permits early payment and that Office of Management and Budget regulations permit DoD to change the payment due date. The National Defense Authorization Act of 2001 and Code of Federal Regulations are clear that interim payments on cost-reimbursement service contracts are subject to the Prompt Payment Act due date requirements for invoices.

We request that The Director, Defense Procurement and Acquisition Policy and the Center Site Deputy Director, Defense Financial Accounting Service Columbus provide additional comments on the final report by October 2, 2006. See the Finding sections of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

The President's Management Agenda focuses on areas where the Federal Government can improve its performance. Financial management is 1 of 14 focus areas. The Office of Management and Budget (OMB) noted that noncompliance with laws and regulations governing the financial management area is one factor preventing the Federal Government from achieving unqualified and timely audit opinions on its annual financial statements. OMB Circular A-123¹ augments the Chief Financial Officers Act of 1990 requiring that auditors report on compliance with laws and regulations related to financial reporting. This report discusses compliance with the Prompt Payment Act and the controls over payments to contractors who provide services to DoD through cost-reimbursement contracts.

Interim Payments on Cost-Reimbursement Service Contracts. DoD uses cost-reimbursement contracts when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract. Examples of services purchased through cost-reimbursement contracts are engineering and development of software, software support, developing and testing of mechanical parts, and engineering services related to weapons systems.

The Defense Finance and Accounting Service (DFAS) Columbus records indicated that its Contract Pay Product Line Division paid interim payments of about \$32.1 billion on cost-reimbursement service contracts during FY 2005. The National Defense Authorization Act of 2001 requires interim payments on cost-reimbursement service contracts to comply with the requirements of the Prompt Payment Act of 1998.

Prompt Payment Act. The Prompt Payment Act of 1998, section 3903, title 31, United States Code (31 U.S.C. 3903), was enacted by Congress to require Federal agencies to pay bills on a timely basis and to pay interest penalties when payments are made late.

DFAS Columbus and Mechanization of Contract Administration Service (MOCAS). The Contract Pay Product Line Division uses MOCAS, an electronic integrated system for contract administration. For interim payments, MOCAS automatically calculates the payment due date as 30 days after the proper invoice receipt date (adjusted for any additional days related to improper invoices). MOCAS releases the interim payments for disbursement as soon as possible, but if the date MOCAS disburses the payment occurs after the MOCAS due date, MOCAS should generate and send a report to the DFAS Columbus Prompt Payment Interest Branch for further review.

¹ Circular A-123, "Management's Responsibility for Internal Control."

Objective

The audit objective was to determine whether DFAS Columbus was making interim payments on cost-reimbursement contracts in accordance with the Prompt Payment Act. We also reviewed the management control program as it related to the overall objective. See Appendix A for a discussion of the scope and methodology and prior coverage related to the objective.

Review of Internal Control

DoD Instruction 5010.40, "Managers' Internal Control program Procedures," January 4, 2006, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of DFAS Columbus management controls over making interim payments in compliance with the Prompt Payment Act on cost-reimbursement service contracts. Specifically, we determined whether DFAS Columbus controls prevented noncompliance with the Prompt Payment Act. We also reviewed the adequacy of management's self-evaluation of those controls.

Adequacy of Management Controls. We identified material management control weaknesses for DFAS Columbus, as defined by DoD Instruction 5010.40. The DFAS Columbus management controls for complying with the Prompt Payment Act were not adequate. The recommendations in this report, if implemented, will correct the identified weaknesses and could result in \$56.4 million in interest savings during the period FY 2006 through FY 2011. A copy of the report will be provided to the senior officials responsible for management controls in DFAS Columbus.

Adequacy of Management's Self-Evaluation. DFAS officials identified compliance with the Prompt Payment Act as an assessable unit. However, DFAS did not identify any material control weaknesses related to the assessable unit because the scope of their review was not adequate.

A. Early Interim Payments Made on Cost-Reimbursement Service Contracts

In FY 2005, DFAS Columbus disbursed approximately \$28.4 billion in 291,618 interim payments on cost-reimbursement service contracts earlier than permitted by the Prompt Payment Act.² The early payment of these invoices resulted from DFAS implementation of Federal and DoD policies that were in conflict with the Act. These early payments contributed to a calculated \$9.4 million in lost Federal interest based on the Treasury Current Value of Funds rate. The U.S. Treasury could realize \$56.4 million in interest savings during the period FY 2006 through FY 2011 if DoD corrects its payment practices related to interim payments.

Noncompliance with the Prompt Payment Act

DFAS Columbus did not always make the \$32.1 billion of interim payments on cost-reimbursement service contracts in compliance with the cash management provisions of the Prompt Payment Act. MOCAS records showed that DFAS Columbus paid \$28.4 billion of those invoices earlier than allowed under the provisions of the Act.

The Prompt Payment Act requires the payment date for an invoice to be the date payment is due under the contract or 30 days after a proper invoice is received if a specific payment date is not established by the contract. The Act also states that an agency must make payments no more than 7 days prior to the payment due date unless the agency head or designee has determined (on a case-by-case basis) that earlier payment is necessary. Title X, subtitle A, section 1010 of the National Defense Authorization Act of 2001 applied the provisions of the Prompt Payment Act to interim payments on cost-reimbursement service contracts. Title 5, code of Federal Regulations (5 C.F.R.), section 1315.4 (2), 2006, provides the implementing guidance for the Prompt Payment Act. As such, 5 C.F.R. Section 1315.4 (2) requires that the payment due date for interim payments on cost-reimbursement service contracts be 30 days after the date a proper invoice is received.

Based on the above requirements of the Prompt Payment Act and amendments, DFAS was required to make interim payments on cost-reimbursement service contracts between the 23rd and 30th day after receipt of a proper invoice. However, DFAS Columbus records showed that most of these interim payments on cost-reimbursement service contracts disbursed in FY 2005 through MOCAS were paid earlier than 7 days prior to the due date MOCAS calculated. Table 1 shows that DFAS Columbus paid 90 percent of the invoices and 88 percent of the

² This information is based on data DFAS provided. See Appendix A for the scope and methodology used to determine the number and amount of interim payments.

disbursement amounts earlier than 7 days prior to the due date. Neither the Offices of the Under Secretaries of Defense³ nor DFAS Columbus documented a need to make these payments early, but DFAS personnel stated that making interim payments as soon as possible was a long-standing practice.

<u>Category</u>	<u>Number of Invoices</u>	<u>Dollar Value (in billions)</u>
Early	291,618	\$28.4
On Time	22,327	2.4
Late	6,410	1.1
Unclassified*	<u>2,199</u>	<u>0.2</u>
Total	322,554	\$32.1

*Note: We were unable to classify these invoices as early, on time, or late because there was no MOCAS due date provided in the MCOAS data obtained from DFAS Columbus. We were unable to determine why the due date was not calculated.

On average, DFAS Columbus made the payment on the sixteenth day after it received the invoice, which is 7 days sooner than allowable by the Prompt Payment Act.

DFAS Payment Policy Implementation

DFAS Columbus followed policy that was published in Federal and DoD regulations instead of complying with the Prompt Payment Act. Specifically, parts of the implementing Code of Federal Regulations (C.F.R.), Federal Acquisition Regulation (FAR), Defense Federal Acquisition Regulation Supplement (DFARS), DoD Financial Management Regulation (FMR), and DFAS desk policies contained guidance related to the payment due dates of invoices and the cash management of interim payments on cost-reimbursement service contracts that differed from requirements set forth in the Prompt Payment Act.

Establishing the Payment Due Date. The FAR and DFARS clauses that establish the payment due date are in conflict with the Prompt Payment Act, the National Defense Authorization Act, and the OMB implementing regulation in 5 C.F.R. Section 1315.

Specifically, 31 U.S.C. 3902 (b) states that interest penalty shall be paid from the period beginning on the day after the required payment date. Further, 31 U.S.C. 3903 states that the required payment date for invoices is the date payment is due

³ (Comptroller)/Chief Financial Officer and Acquisition, Technology, and Logistics.

under the contract for the item of property or service provided or 30 days after the date a proper invoice is received. The National Defense Authorization Act of 2001, which amends the Prompt Payment Act, states that when DoD acquires services from a business under a cost-reimbursement contract requiring interim payments, DoD must pay interest to the contractor on payments made more than 30 days after the date of the receipt of a proper invoice. Furthermore, 5 C.F.R. section 1315.4 (2) states that the payment due date for interim payments on cost-reimbursement service contracts is 30 days after the date of receipt of a proper invoice.

FAR 32.9(e), "Prompt Payment," states that for purposes of computing late payment interest penalties that may apply, the due date for making interim payments on cost-reimbursement contracts for services is 30 days after the date of receipt of a proper invoice. However, FAR 32.908(c)(2) allows agency policies and procedures to amend the standard 30 days payment due date clause and insert a period less than 30 days. In contrast to FAR 32.908(c)(2), the FAR lists an "Alternate I" clause at the end of FAR 52.232-25, which states that for the purpose of computing late payment interest penalties that may apply to interim payments on the cost-reimbursement service contract, the due date for payment is the 30th day after the designated billing office receives a proper invoice.

Further, DFARS 232.906, "Prompt Payment Act," states that generally the contracting officer shall insert the standard due date of 14 days for interim payments on cost-reimbursement contracts for services in the clause at FAR 52.232-25, "Prompt Payment," when using the clause with its Alternate.⁴

Therefore, if the contracting officer follows the guidance in DFARS 232.906, then the contract will not be paid in compliance with the Prompt Payment Act, which states that interest shall begin to accrue on the day after the required payment date (in this case, 14 days) and the National Defense Authorization Act of 2001, which states that interest will begin to accrue on interim payments for cost-reimbursement service contracts after the 30th day, regardless of the Alternate I FAR clause. However, the National Defense Authorization Act and 5 C.F.R. section 1315 are both clear that the payment due date for interim payments on cost-reimbursement service contracts is 30 days after an invoice is received, and that is when the interest should start to accrue.

The FAR and DFARS policies that allow these payments to be paid earlier than other contracts provides preferential treatment for this type of billing, despite specific exclusion by 5 C.F.R. section 1315.4 (2) and categorization as standard invoices by the National Defense Authorization Act of 2001. Since almost all contractors can argue that they have cash flow concerns that warrant early payment, the DoD policy of paying these invoices early goes too far in favor of some contractors. DoD makes other types of invoice payments that are not nearly so favorable. For example, contractors bill for service payments on fixed-price

⁴ This regulation changed during the course of the audit on December 20, 2005. The DFARS 232.906 (originally titled "Contract Financing Payments"), in effect at the time the sample invoices were paid, stated that "generally the contract officer shall insert the standard due dates of . . . 14 days for interim payments on cost type contracts in paragraph (b)(1) of the Prompt Payment clauses at FAR 52.232-25." The policy related to a 14 day payment due date did not change.

contracts that DoD does not routinely pay until the 23rd day after receipt. Contractors who provide goods must also wait until the 23rd day for payment. These contractors have the same payroll and expenses that contractors working under a cost-reimbursement contract have. Therefore, DoD must work to treat its contractors the same.

We performed a judgmental sample on 30 service contracts with interim payments to determine if the DFARS provisions were enacted in the contract and the contract provided for a shorter payment timeframe than 30 days. While none of the contracts amended the standard 30-day payment due date, the DFARS should be revised to state that the standard due date of 30 days is required to ensure compliance with the Prompt Payment Act and 5 C.F.R. Section 1315.4 (2).

Cash Management Requirements. Section 1315 of 5 C.F.R, the FAR, the DFARS, the FMR, and DFAS desk procedures are in conflict with either the Prompt Payment Act or the National Defense Authorization Act of 2001 as it relates to cash management of interim payments on cost-reimbursement service contracts.

Specifically, the Prompt Payment Act permits an agency to make payment up to 7 days prior to the required payment date, or earlier as determined necessary on an individual basis by an agency. The National Defense Authorization Act states that the provisions of the Prompt Payment Act apply to interim payments on cost-reimbursement service contracts as if the interim payments were originally subject to the Prompt Payment Act.

5 C.F.R. Section 1315. The Prompt Payment Act required OMB to issue implementing guidance of the Act. OMB issued 5 C.F.R. section 1315 to fulfill this requirement. However, OMB only partially implements the requirements of the Prompt Payment Act and the National Defense Authorization Act of 2001. Specifically, 5 C.F.R. section 1315.4(j) states that the authority to make an early payment must be used cautiously, weighing the benefits of making a payment early against the good stewardship inherent in effective cash management practice.

However, OMB allows an agency to use “accelerated payment methods” when it determines that earlier payment is necessary. One of the accelerated payment methods allows agency heads to make interim payments on cost-reimbursement service contracts earlier than 7 days prior to the payment due date in keeping with agency regulations or policies. This provision appears to go beyond the purview of the Prompt Payment Act which granted OMB the authority to prescribe regulations to permit agencies to make expedited payments based on case-by-case determinations.

FAR and DFARS. The FAR also permits the use of accelerated payment methods. At the time the universe of invoices was paid in FY 2005, the DFARS compounded the issue, stating that it is DoD policy to make contract financing payments as quickly as possible. DFARS also stated that interim payments on cost type contracts are contract financing. Both of these policies were in conflict with the Prompt Payment Act and the National Defense Authorization Act of

2001. In addition, DFARS did not follow OMB guidance to require DoD to state why making early payment is necessary.

Since those invoices were paid, DoD has revised DFARS 232.906 by removing interim payments on cost-reimbursement service contracts from contracting financing and removing the statement that it is DoD policy to pay those invoices as quickly as possible. However, the FMR and DFAS regulations remained the same.

FMR and DFAS Procedures. The DoD Financial Management Regulation, DoD 7000.14-R, volume 10, chapter 7, paragraph 070205, B10, “Prompt Payment Act,” reiterates the DFARS concept that departmental policy is to make contract financing payments as expeditiously as possible and that contract financing payments include interim payments on cost type contracts. It also states that in accordance with DFARS, the standard due date for interim payments on cost type contracts is 14 days after the date an invoice is received and that no interest penalty will be paid as a result of delayed contract financing payments.

On the other hand, DFAS Desk Procedure 101 states that cash management policy requires that all contractor invoices be paid no sooner than 7 days prior to the due date. It says all requests for early releases should be in writing, well documented, and signed by the Commander of the requesting activity or their designee.

DFAS Desk Procedure 800 states that the DoD cash management objective is to pay bills on time. Late payments result in interest penalties, which cause prices of goods and services used within DoD to rise. Early payments cause cash to be withdrawn from the U.S. Treasury prematurely, which results in unnecessary service costs on the national debt. It also states that interim cost or bureau vouchers must be paid within the standard due date of 14 days (per DFARS 232.906). Desk Procedure 904 states that DFAS pays late payment interest penalties on late payments of public vouchers for contracts issued for services.

While both OMB (through 5 C.F.R. section 1315) and the Prompt Payment Act place the burden on the agency to determine whether early payments should be made, the Prompt Payment Act intends that the early payments be made only as an exception – when determined necessary on a case-by-case basis – rather than through a broad agency policy that permits early payments with little justification. This general agency policy allows more early payments to occur because the agencies do not have to document case-by-case determinations that early payment is appropriate. DFAS Columbus paid close to 300,000 invoices early, totaling \$28.4 billion.

Because DoD revised the DFARS policy related to accelerated payments for interim payment on cost-reimbursement service contracts, the FMR, and DFAS Desk policy, which use the expedited methods should be changed and DFAS should immediately cease making interim payments on cost-reimbursement service contracts as quickly as possible, and only make the payments 7 days earlier than required by the individual contract. Early payments do not comply

with the Prompt Payment Act. Policies allowing early payments need to be revised as quickly as possible. In addition, DoD needs to update the FMR to distinguish the difference between interim payments on cost-reimbursement service contracts and contract financing payments. DFAS also should update its desk procedures to change the standard due date of interim cost or bureau vouchers for service contracts to 30 days after receipt of an invoice, as required by the Prompt Payment Act.

Effects of Noncompliance

As a result of DFAS Columbus noncompliance with the Prompt Payment Act, we calculate that DFAS Columbus caused the U.S. Treasury to lose about \$9.4 million in interest because of the early payment of 291,618 invoices in FY 2005.⁵

We calculated the interest lost on early payments by dividing the applicable Treasury Current Value of Funds rate for each invoice by 360 days, multiplying by the number of days the invoice was paid early, and then multiplying by the invoice amount as required by the Department of Treasury guidance.⁶

The noncompliance and resulting interest lost primarily resulted from DFAS following Federal and DoD policies that effectively do not comply with the Prompt Payment Act. DFAS allowed agencies to issue regulations to make interim payments on cost-reimbursement service contracts earlier than 7 days prior to the payment due date. If controls governing compliance with the Prompt Payment Act are not corrected, DFAS Columbus could continue to pay a significant number of interim payments early and violate the provisions of the Prompt Payment Act. Specifically, in FY 2005 we determined that \$9.4 million could have been saved by making payments on time instead of early. Changing the DoD practice of paying these invoices early could save the Government \$56.4 million during the period FY 2006 through FY 2011 in interest savings.

Management Comments on the Finding and Audit Response

Management Comments on DFAS Compliance with the Prompt Payment Act. The Deputy Chief Financial Officer for the Under Secretary of Defense (Comptroller)/Chief Financial Office disagreed with our assertion that DFAS Columbus was disbursing a significant number of interim payments on cost-reimbursement service contracts earlier than allowable by the Prompt Payment Act.

⁵ This information is based on U.S. Treasury information and data DFAS provided. See Appendix A for the scope and methodology used to determine the number and amount of DFAS Columbus interim payments.

⁶ U.S. Treasury guidance can be found at <http://www.fms.treas.gov/prompt/index.html>.

She stated that the Prompt Payment Act provides that the required payment date, which is used as a baseline to assess any interest penalty due to the contractor, is the date payment is due under the contract terms and conditions, or 30 days after a proper invoice is received, if a specific payment date is not established by the contract. The Deputy then stated:

In practice, the DFAS makes payments under cost-reimbursement contracts for services in accordance with the date payment is due under the contract. The Defense Federal Acquisition Regulation Supplement (DFARS) 232.906 contract clause entitled "Making payment," inserted in cost-reimbursement contracts for services, states that, generally, "the contracting officer shall insert the standard due date of 14 days for interim payments on cost-reimbursement contracts for services in the contract." As reported in Section A of the OIG's [Office of Inspector General] draft audit report, DFAS paid these invoices, on average, within 16 days of receipt of a proper payment. . . In our opinion, the OIG misconstrued the purpose of establishing the required payment date in the PPA, which is to establish the baseline for calculating the interest penalties due to the contractor, not to fix the date on which an Agency must make payment. . . Many factors influence an Agency's decision as to when contract payments should be made. Cash management practices, good financial stewardship, fostering competition for Government contracts, and lowering overall contract prices are some of the elements that must be considered when determining those practices that best service the Department's interest. The Departments' business decision to make payments on cost-reimbursement contracts for services within 14 days falls well within the Department's discretion, Prompt Payment Act provisions, and Office of Management and Budget (OMB) guidelines. In the Background Information section of the Federal Register publication of the final rule...OMB specifically addressed an Agency's prerogative to make these policy decision.

Audit Response. We disagree with the Deputy Chief Financial Officer's comments. DFAS did not make interim payments on cost-reimbursement contracts in accordance with the terms of the contract. None of the contracts in our sample included the 14-day due date in the FAR 52.232-25. All used the standard 30-day due date. Therefore, the contractual due date for the Prompt Payment Act interest and cash management is 30 days from receipt of a proper invoice. DFAS policy to pay these invoices, irrespective of the contractual payment terms, as soon as possible is not in accordance with the terms of the contracts and violates the Prompt Payment Act.

The National Defense Authorization Act of 2001 and 5 C.F.R. 1315 state that interim payments for cost-reimbursement service contracts *must* have a payment due date of 30 days. The Prompt Payment Act states that interest will start to accrue the day after the contractual payment due date. DoD cannot change the payment due date for interim payments on cost-reimbursement services and comply with the Act. OMB does not give Agencies the authority to change the payment due date for interim payments on cost-reimbursement service contracts. If a contracting officer inserts payment due date terms of 14 days in the contract (and none of the contracting officers in our sample did) then, according to the

Prompt Payment Act, interest would start to accrue on the 15th day, which would violate the National Defense Authorization Act of 2001.

We disagree with the Deputy Chief Financial Officer's conclusion that because the "average" number of days to make interim payments was 16, DFAS was making the payments in accordance with the Prompt Payment Act. There were 1,907 interim payments on cost-reimbursement service contracts paid in FY 2005 from our 30 sample contracts, and those payments were made from 2 to 72 days after receipt of invoice. The sample also showed that 89 percent⁷ (\$2.4 billion) were paid earlier than 7 days prior to the stated due date specified in the 30 contracts, in accordance with section 52.232-25.

We agree with the Deputy Chief Financial Officer that many factors influence an agency's decision as to when contract payments should be made. Cash management, financial stewardship, and competition are valid factors for payment decisions but must not take precedence over the law.

Management Comments on the Adequacy of Management Controls and Potential Monetary Benefits.

Management Comments. The Center Site Deputy Director for Defense Finance and Accounting Service Columbus stated that the DFAS Office of Counsel has reviewed the proposed material weakness and stated that the OMB regulations codified at 5 C.F.R. Part 1315 state, in part, that interim payments may be made more than 7 days prior to their due date. As a result, DFAS Columbus does not believe a material weakness or any associated interest savings exist.

Audit Response. We disagree with the Center Site Deputy Director's comments. The OMB regulations state that interim payments may be made more than 7 days prior to their due date if agencies determine it is necessary to make early payment, and there are agency regulation and policy that permits early payment. There is no DoD policy that permits payment to be made earlier than 7 days prior to the due date. We request the Center Site Deputy Director reconsider his position and provide additional comments on the final report.

Recommendations, Management Comments, and Audit Response

Deleted Recommendations. Based on the updated DFARS 232.906 clause and the Director, Defense Procurement and Acquisition Policy comments, we deleted part of Recommendation A.1.

A.1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics revise the Defense Federal Acquisition Regulation

⁷ Judgment sample percentage does not generalize to the universe.

Supplement to require contracting officers to establish a payment due date of 30 days for interim payments on cost-reimbursement service contracts.

Management Comments. The Director, Defense Procurement and Acquisition Policy nonconcurred with the recommendation. He stated that the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplement specifically authorize payments on cost-reimbursement contracts for services within 14 days. He stated that the Prompt Payment Act and all subsequent implementing regulations establish the payment due date for the purpose of determining if the payment is late and to assess late payment penalties, and is not intended to prohibit Agencies from paying a contractor earlier than 30 days. The DoD policy has been well vetted through the regulatory process since the beginning of the Prompt Payment Act implementation.

He quotes the OMB final rule in the Federal Register 70, 516 (December 30, 2002), which states that “section 1010 (of the 2001 National Defense Authorization Act) is not intended to modify current agency practices or policies. . . For example, it is the policy of the Department of Defense to generally pay contractors in 14 days or less. . .” He also quotes a Government Accountability Office (GAO) report that indicated late payments caused small business contractors to obtain more expensive financing. The DoD practice of making payments under cost-reimbursement contracts for services within 14 days serves to decrease the contractor’s overall costs, which also ensures that small businesses are better able to compete for DoD service contracts. As of July 12, 2006, approximately 52 percent of cost-reimbursable service contracts being paid by DFAS were contracts awarded to small and small, disadvantaged businesses.

He stated that, “OMB and DoD are consistent with Section 3903(a)(1)(B) of Title 31 of the United States Code which states: ‘...The regulations shall (1) provide that the required payment date is... (B) 30 days after a proper invoice for the amounts due is received if a specific payment date is not established by contract. . .’” DFARS 232.906(a)(i) requires a specific 14-day due date be established in the contract for cost-reimbursable contracts for services.

Audit Response. We disagree with the Director of Defense Procurement and Acquisition Policy’s comments. The FAR and the DFARS policies that permit a change to the due date of interim payments on cost-reimbursement services do not meet the intent of the Prompt Payment Act, the National Defense Authorization Act of 2001, and the OMB implementing regulations of the Prompt Payment Act. Those laws and regulations specifically state that interest will begin to accrue on the day after the required payment date in the contract, which is 30 days for interim payments on cost-reimbursement service contracts.

We agree with the Director’s discussion of the GAO report that concluded that small businesses should not be paid late. We do not agree that setting the payment due date at 14 days for interim payments on cost-reimbursement service contracts will help this problem. The GAO report discussed all invoices paid, not just the interim payments. The GAO report also identified that one of the reasons the small businesses were paid late was because DoD cash management practices place lower priority on the payment of smaller, less-complex invoices—like those

typically submitted by small business contractors. Changing the payment due date would not stop this practice.

We also agree with the DoD position that timely payments can reduce contract costs. We are not advocating that DoD make the interim payment after the due date. We are advocating compliance with sound cash management principles and established payment practices rooted in the Prompt Payment Act. The National Defense Authorization Act of 2001 requires the same treatment of interim payments on cost-reimbursement service contracts as all other standard invoices. As written, the current DoD policy provides particular guidance on interim payments for cost-reimbursement service contracts but not thousands of other invoices, some of which are also from small businesses.

We disagree with the Director's implication that the majority of interim payments for cost-reimbursement service contracts are paid to small businesses. We did not audit the percentage of contracts awarded based on contractor size. However, of those invoices included in the \$32.1 billion that we reviewed, according to DFAS records, DFAS paid 74 percent of the dollar value (\$23.7 billion) to the top 100 DoD contractors and their subsidiaries. The Prompt Payment Act, 31 U.S.C. § 3903(a)(8), permits an agency to make payment up to 7 days prior to the required payment date, or earlier, as determined by the agency to be necessary on a case-by-case basis. In lieu of its current noncompliant practices, DoD can use this provision to assist contractors when necessary. We request that the Director reconsider his position and provide additional comments on the final report.

A.2. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer revise the Financial Management Regulation to remove interim payments on cost-reimbursement service contracts from the definition of contract financing.

Management Comments. The Deputy Chief Financial Officer concurred with the recommendations. They will revise the DoD Financial Management Regulation, volume 10, chapter 7, "Prompt Payment Act," July 2002 to reflect the updated list of types of contract financing payments, which will specifically exclude interim payments under cost-reimbursement service contracts.

A.3. We recommend that the Director, Defense Finance and Accounting Service Columbus direct Defense Finance and Accounting Service Columbus personnel to discontinue paying interim payments on cost-reimbursement service contracts earlier than 7 days prior to the payment due date.

Management Comments. The Center Site Deputy Director for Defense Finance and Accounting Service Columbus nonconcurred with the recommendation. Specifically, he stated that OMB guidance is clear that for interim payments under cost-reimbursement contracts for services, agency heads may make payments earlier than 7 days prior to the payment due date in accordance with agency regulations or policies. Furthermore, the DoD regulation in the Defense Federal Acquisition Regulation Supplement 232.906(a)(i) states, "the contract office shall insert a standard due date of 14 days for interim payments on cost-reimbursement service contracts." Therefore, payments under cost-reimbursement contracts for services should not be held until 7 days prior to the

payment due date. DFAS Columbus will continue to make payment for interim vouchers on cost-reimbursement service contracts earlier than 7 days prior to the payment due date unless the underlying regulations are changed or unless directed otherwise.

Audit Response. We disagree with the Deputy Site Director's comments. Although DFARS section 232.906 states that, "generally the contracting officer shall insert the standard due date of 14 days for interim payments on cost-reimbursement contracts for service in the clause at FAR 52.232-25, Prompt Payment, when using the clause with its Alternate I," it does not permit interim payments earlier than 7 days prior to the due date. OMB guidance permits an agency to make payments earlier than the 7 days prior to the payment due date only if the agency policies permit early payment. The Site Director makes an assumption that contracting officers are inserting the DFARS section 232.906 in the FAR clause 52.232-25. For the 30 contracts we judgmentally sampled, the contracting officer did not change the standard 30-day due date for any contract. DFAS should use the payment due date in the contract, and not a standard DFARS clause. In addition, since there is no DoD policy to support payment earlier than 7 days prior to the payment due date, payment should be only within 7 days prior to the payment due date. We request that the Center Site Deputy Director reconsider his position and provide additional comments on the final report.

B. Identifying Invoice Receipt Dates, Payment Due Dates, and Interest Payments Due

DFAS Columbus did not always follow the Prompt Payment Act requirements for identifying the proper invoice receipt date, payment due date, and associated interest payments due related to late interim payments on cost-reimbursement service contracts. The noncompliance occurred because of human input error. As a result, there is a risk that DFAS Columbus will not identify interim payment invoices paid late and calculate interest due to the contractor.

Sample of Interim Payments

For contracts that allow interim payments on cost-reimbursement service contracts, the contracting officer (at the appropriate Defense Contract Audit Agency [DCAA]) determines whether the contractor should submit the interim payment request through DCAA for approval, or directly to DFAS Columbus. DFAS considers interim payments to be “direct submit” if the contractor is permitted to submit the invoice directly to DFAS, either electronically or as a hard-copy invoice annotated, “direct submission authorized.” However, if the contractor is required to submit the invoice to DCAA for review prior to submission to DFAS, it is not considered direct submit.

If the interim payments on cost-reimbursement service contracts are not direct submit, then, to comply with the Prompt Payment Act requirements, DFAS Columbus inputs two invoice dates into MOCAS. Specifically, when an invoice that is not directly submitted to DFAS Columbus is received, it is scanned into the Electronic Data Management (EDM) system, which automatically assigns the MOCAS receipt date. The scanned copy is then forwarded to other personnel at DFAS Columbus for further review.

As required by DFAS policy, DFAS personnel then review the invoice for a date stamp indicating when DCAA received the invoice. If there is a DCAA date stamp, DFAS Columbus needs to enter this date in the MOCAS field, “DCAA/ACO [Administrative Contracting Officer] Receipt Date.” If there is no DCAA date stamp, the field is to be left blank. In addition, DFAS Columbus looks for the Invoice Preparation Date provided by the contractor and enters it into the “Invoice Prep Date” field in MOCAS as well as the Invoice Receipt Date field. The Prompt Payment Act requires that the “Invoice Prep Date” be considered the proper invoice receipt date if DCAA did not date stamp the invoice.

We judgmentally selected and analyzed 100 sample payments from DFAS data on interim payments on cost-reimbursement service contracts to determine whether

DFAS Columbus complied with selected requirements of the Prompt Payment Act. Specifically, we determined whether DFAS Columbus properly:

- entered the correct invoice receipt date in the required fields,
- calculated the due date, and
- paid interest to the contractor when required.

Entering the Correct Invoice Receipt Dates

DFAS Columbus did not always select and enter the correct receipt date on hard-copy invoices that it subsequently scanned for further processing, and DFAS Columbus entered dates in the wrong fields.

Selecting the Correct Receipt Date. Out of the 100 sample items, 29 invoices submitted in hard-copy format required manual input. For 15 of the 29 scanned invoices, DFAS did not enter the correct date into either the “DCAA/ACO Receipt Date” or the “invoice prep date” fields. In a prior audit report (Report No. D-2006-076, “DoD Compliance with the Prompt Payment Act on Payments to Contractors,” April 19, 2006), the Office of the Inspector General recommended that DFAS Columbus ensure that Entitlement and Tier II personnel are adequately trained in determining the correct receipt dates to enter into MOCAS. DFAS agreed to the recommendation to provide additional and refresher training related to selecting correct receipt dates to both Tier II and Entitlement personnel. Therefore, we will not recommend additional corrections at this time.

Entering Dates in MOCAS Fields. The Prompt Payment Act requires that the invoice preparation date be used as the proper invoice receipt date if the designated agency office does not annotate or date stamp the invoice. The MOCAS system is designed to use the earlier of the “Invoice Receipt Date” or “DCAA/ACO Receipt Date” field in calculating the due date for interim payments on cost-reimbursement contracts. Further, DFAS Columbus procedures require that DFAS Columbus enter the invoice prepared date in the invoice receipt date field if DCAA did not date stamp the invoice.

Out of the 100 sample items that we reviewed, there were 26 invoices that were not directly submitted to DFAS Columbus and did not have a date entered in the “DCAA/ACO Receipt Date” field in MOCAS. Of those 26 invoices, 24 did not have the invoice preparation date in the invoice receipt date field, as DFAS Columbus procedures require. MOCAS calculated the payment due date based on the date that DFAS Columbus received the invoice instead of the proper invoice receipt date (which should have been the invoice preparation date). The two invoices that correctly used the invoice preparation date occurred because the MOCAS receipt date and the invoice preparation date were the same. Additional training would help ensure that the proper dates were entered.

Risk Associated With Incorrect Receipt Dates

DFAS Columbus did not always enter the correct invoice receipt date or enter the receipt date in the proper field, which created a risk that late invoices would not be identified and that appropriate interest would not be paid on them. For example, of the 24 invoices in our sample that either had the receipt date incorrectly entered or an improperly calculated payment due date, two were not identified as late by DFAS. As a result, DFAS did not pay \$15,413.66 of interest the Government owed to the contractors.

To put the issue in perspective, for the 283,530 interim payments DFAS made on cost-reimbursement service contracts in FY 2005 that did not have a date entered in the “DCAA/ACO Receipt Date” field in MOCAS, 189,778 potentially would have been considered late if the invoice preparation date was used instead of the MOCAS receipt date. We recognize that some of these invoices were direct submit, and that the MOCAS receipt date was correctly chosen. However, there is a risk that the invoices that were not directly submitted did not get identified by MOCAS as late and, therefore, were not sent to the Prompt Payment Branch for further review.

Recommendations and Management Comments

B.1. We recommend that Defense Finance and Accounting Service Columbus provide additional training to ensure that the invoice preparation date is entered into the Mechanization of Contract Administration Service invoice receipt date field for invoices that should be Defense Contract Audit Agency/Administrative Contracting Officer date stamped but are not.

Management Comments. The Center Site Deputy Director for Defense Finance and Accounting Service Columbus concurred with our recommendation. Specifically, he stated that the Director, Defense Finance and Accounting Service Columbus provided training to the Tier II technicians on how to enter the invoice preparation date in the invoice receipt date field in MOCAS when vouchers are not date stamped by the Defense Contract Audit Agency.

Appendix A. Scope and Methodology

We reviewed requirements of the Prompt Payment Act and National Defense Authorization Act of 2001 related to the allowable payment timeframe for interim payments on cost-reimbursement service contracts. Specifically, we determined that interim payments on cost-reimbursement service contracts are required to be paid between the 23rd and 30th day after receipt of a proper invoice. We then examined the DFAS process to pay those invoices to determine if DFAS was in compliance with the Prompt Payment Act and National Defense Authorization Act of 2001.

We requested all interim payments on cost-reimbursement contracts made through MOCAS during FY 2005. We obtained information from DFAS Columbus on the disbursement amount. We divided the invoices into two categories, those paid on service contracts and those paid on all other types of contracts, based on the contract type.

To determine the number of early payments, we used the MOCAS due date and the MOCAS processed (paid) date. Specifically, any invoice that was paid earlier than 7 days prior to the due date was early, any invoice that was paid 7 days early through the due date was on time, and any invoice paid after the due date was late. We performed this analysis only on payments on service contracts (Kind 6). We focused our testing on the invoices that appeared to be paid early. For the entire early universe, we calculated the number of days the invoices were paid early based on the MOCAS due date and the MOCAS payment date. We then calculated the interest lost by dividing the appropriate daily interest rate by 360, multiplying by the number of days the invoice was paid early, and then multiplying by the disbursement amount.

To determine whether invoice data had been entered correctly, we selected a judgmental sample of 100 invoices paid on service contracts that had no DCAA *received* date in MOCAS. For each sample invoice, we determined, through MOCAS data, whether the invoice was paid in accordance with the Prompt Payment Act. Specifically, we determined whether the invoice required approval before submission to DFAS Columbus (*not direct submit*) or whether the invoice could be submitted directly to DFAS (*direct submit*). If the invoice was *not direct submit*, we looked for the hard copy invoice in EDM to verify that the *invoice prep date* in MOCAS was correct, that the *invoice prep date* was entered as the MOCAS *received date*, and that there was no DCAA *received date* stamp. We determined whether the MOCAS due date was calculated correctly. For direct submit invoices, the MOCAS received date is the correct receipt date. For invoices that are not direct submitted, the DCAA-stamped *received date* is the correct receipt date, or the *invoice prep date* when there is no DCAA date. We also verified that the MOCAS due date was 30 days after the correct receipt date, as adjusted for any additional days related to improper invoices. We used the MOCAS due date and payment date to identify the invoices that were paid early, on time, and late. We calculated the interest due or interest lost by dividing the appropriate daily interest rate by 360, multiplying by the number of days the invoice was paid early or late, and then multiplying by the disbursement amount.

For the invoices that were paid late, we verified through EDM records whether the correct amount of interest was paid to the contractor by DFAS.

We also selected a sample of 30 contracts from our judgmental sample to determine if the DFARS policy to use a 14 day due date was implemented.

We performed this audit from November 2005 through May 2006 in accordance with generally accepted government auditing standards.

We did not verify that the MOCAS system data, such as kind of contract, DCAA *received date*, and *invoice prep date*, were accurate. Although these data fields are manually input and are subject to human error, we relied on the data without formal testing. Therefore, there may be some invoices in our early payments universe that were not paid early or as early as we have calculated and our amount of incurred lost Federal interest can only be viewed as an estimate.

Use of Computer-Processed Data. We used computer-processed data obtained from the MOCAS system to determine the amount of disbursement, the type of contract, the kind of payment, and the universe of interim payments for cost-reimbursement contracts, the due dates, and the payment dates. We did not perform a formal reliability assessment of the computer-processed data. Our results were not negatively affected by not performing a formal reliability assessment of MOCAS because the information was used to develop an estimate and was not intended to be used as an audited number.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the financial management high-risk area.

Prior Coverage

During the past 5 years, the Department of Defense Inspector General (DoD IG) has issued one report related to compliance with the Prompt Payment Act. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

DoD IG

DoD IG Report No. D-2006-076, "DoD Compliance with the Prompt Payment Act on Payments to Contractors," April 19, 2006

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Defense Contract Management Agency
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Under Secretary of Defense Acquisition, Technology, and Logistics Comments



ACQUISITION
TECHNOLOGY
AND LOGISTICS

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

JUL 19 2006

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCE AUDITING
SERVICE, DODIG

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *7/12/06*

SUBJECT: Response to DoDIG Draft Report D2006-D000FJ-0076.000, "Providing
Interim Payments to Contractors in Accordance with the Prompt Payment Act"

As requested, I am providing responses to the general content and
recommendations contained in the subject report.

DoDIG Recommendation A.1. We recommend that the Under Secretary of Defense for
Acquisition, Technology, and Logistics revise the Defense Federal Acquisition
Regulation Supplement to require contracting officers to establish a payment due date of
30 days for interim payments on cost-reimbursement service contracts. In addition,
Defense Federal Acquisition Regulation Supplement should distinguish between interim
payments on cost-reimbursement service contracts and contract financing.

DPAP Response:

- 1 ***Establish a payment due date of 30 days for interim payments on cost-reimbursement service contracts. Non-concur.*** The Federal Acquisition Regulations (FAR) and Defense Federal Acquisition Regulation Supplement (DFARS) specifically authorize payments on cost-reimbursement contracts for services within 14 days. The FAR and DFARS are consistent with the National Defense Authorization Act for Fiscal Year 2001, Section 1010, and the Code of Federal Regulation, 5 CFR Part 1315.5.

Timely payment acts as incentive to attract new suppliers in the Federal marketplace to foster competition and provides incentive for contractors to use the more efficient and cost effective electronic billing and payment systems instead of less efficient U.S. mail or facsimile.

The Prompt Payment Act and all subsequent implementation regulations establish the payment due date for the purpose of determining if the payment is late and to assess late payment penalties, and is not intended to prohibit Agencies from paying a contractor earlier than 30 days. The DoD policy has been well vetted through the regulatory process since the beginning of the Prompt Payment Act



implementation.

When the Office of Management and Budget (OMB) published in the Federal Register its final rules implementing the changes required by Section 1010, 67 Fed. Reg. 70,516 (December 30 2002), the DoD policy was specifically addressed. In the Supplemental Information Background accompanying the change to the Prompt Payment Act implementing regulations, OMB commented: *“Neither section 1010 nor this final rule is intended to modify current agency practices or policies...other than to require...interest penalties be paid on interim payments that are made more than 30 days after the agency receives a proper invoice.... For example, it is the policy of the Department of Defense to generally pay contractors in 14 days or less....”*

In contrast to the findings in this draft report, the General Accountability Office (GAO) in a May 2006 report “DOD Payments to Small Businesses” GAO-06-358, reported that late payments caused small business contractors to obtain more expensive financing (7.25%). This lack of cash flow was so significant that, in some cases, companies were concerned about their ability to stay in business. This finding is consistent with DoD’s previous finding that timely payment reduces contractor costs. The DoD’s practice of making payments under cost reimbursement contracts for services within 14 days serves to decrease the contractor’s overall costs, which also ensures that small businesses are better able to compete for DoD services contracts. As of July 12, 2006, approximately 52 percent of cost reimbursable service contracts being paid by DFAS were contracts awarded to small and small disadvantaged businesses.

We do not concur with the DoDIG position that OMB’s implementation of the Prompt Payment Act (CFR 1315.5) goes beyond the purview of the Prompt Payment Act. OMB and DoD are consistent with Section 3903(a)(1)(B) of Title 31 of the United States Code which states: *“...The regulations shall (1) provide that the required payment date is... (B) 30 days after a proper invoice for the amounts due is received if a specific payment date is not established by contract....”* DFARS 232.906(a)(i) requires a specific date be established in the contract for cost reimbursable contracts for services. The DFARS states: *“Generally, the contracting officer shall insert the standard due date of 14 days for interim payments on cost-reimbursement contracts for services in the clause at FAR 52.232-25, Prompt Payment, when using the clause with its Alternate 1”.*

2. In addition, Defense Federal Acquisition Regulation Supplement should distinguish between interim payments on cost-reimbursement service contracts and contract financing. Non-concur. The Defense Federal Acquisition Regulation Supplement (DFARS) supplements the respective sections of the

Deleted

Federal Acquisition Regulation (FAR) where additional guidance is needed. FAR 32.001, Definitions, already clearly defines contract finance payments, and DFARS 232.906 provides appropriate guidance for payments under cost reimbursable services contracts.

If you have any questions regarding this memorandum, please contact my point of contact Mr. John McPherson, at 703-614 -4840 or at john.mcpherson@osd.mil.



Shay D. Assad
Director, Defense Procurement
and Acquisition Policy

Under Secretary of Defense (Comptroller)/ Chief Financial Officer Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JUL 14 2006

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL
AUDITING SERVICE, OFFICE OF THE
INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

SUBJECT: Response to Draft Audit Report, "Providing Interim Payments to
Contractors in Accordance with the Prompt Payment Act,"
Office of the Inspector General (OIG), Department of Defense (DoD)

This memo is written in response to the subject May 22, 2006, draft audit report, which addresses the Department's practices regarding the timing of payments made to contractors under cost-reimbursement contracts for services.

OIG Recommendation A.1.a. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer revise the Financial Management Regulation to remove interim payments on cost-reimbursement service contracts from the definition of contract financing.

Office of the Under Secretary of Defense Comptroller) response. Concur. The DoD Financial Management Regulation, Volume 10, Chapter 7, entitled "Prompt Payment Act" (July 2002), will be revised to reflect the list of contract financing payments identified in the Federal Acquisition Regulations (FAR), Part 32.001:

Contract financing payments are authorized Government disbursements of monies to a contractor prior to acceptance of supplies or services by the Government. Contract financing payments include advance payments, performance-based payments, commercial advance and interim payments, progress payments based on cost, a percentage or stage of completion (except those payments made under fixed-price construction contracts or fixed-price architect-engineer contracts), and interim payments under cost reimbursement contracts (except for cost reimbursement contracts for services).

We plan to issue the revised chapter no later than September 30, 2006.

General Comments

We strongly disagree with OIG's assertion that the Defense Finance and Accounting Service (DFAS), Columbus, prematurely disbursed approximately \$28.4 billion out of \$32.1 billion of interim payments on cost-reimbursement contracts for services in fiscal year (FY) 2005, resulting in \$9.4 million in annual lost Federal interest. In our opinion, OIG's conclusion is based on an invalid interpretation of the Prompt Payment Act (PPA).

As stated in the draft audit report, the Prompt Payment Act (PPA) provides that the required payment date, which is used as a baseline to assess any interest penalty due to the contractor, is the date payment is due under the contract terms and conditions, or 30 days after a proper invoice is received, if a specific payment date is not established by the contract. In practice, the DFAS makes payments under cost-reimbursement contracts for services in accordance with the date payment is due under the contract. The Defense Federal Acquisition Regulation Supplement (DFARS) 232.906 contract clause entitled "Making Payments," inserted in cost-reimbursement contracts for services, states that, generally, "the contracting officer shall insert the standard due date of 14 days for interim payments on cost-reimbursement contracts for services in the contract." As reported in Section A of OIG's draft audit report, DFAS paid these invoices, on average, within 16 days of receipt of a proper invoice.

In contrast, OIG's position is that the PPA requires an Agency to make payments under cost-reimbursement contracts for services on the 30th day after receipt of a proper invoice, with a provision that would allow an Agency to make payment up to seven days earlier, or on the 23rd day. Based on this interpretation, OIG reported that the Department's practice has resulted in \$9.4 million in lost annual interest. In our opinion, OIG misconstrued the purpose of establishing the required payment date in the PPA, which is to establish the baseline for calculating the interest penalties due to the contractor, not to fix the date on which an Agency must make payment.

Many factors influence an Agency's decision as to when contract payments should be made. Cash management practices, good financial stewardship, fostering competition for Government contracts, and lowering overall contract prices are some of the elements that must be considered when determining those practices that best serve the Department's interests. The Department's business decision to make payments on cost-reimbursement contracts for services within 14 days falls well within the Department's discretion, Prompt Payment Act

provisions, and Office of Management and Budget (OMB) guidelines. In the Background Information section of the Federal Register publication of the final rule [67 Fed. Reg. 79,515 (Dec. 30, 2002)], implementing Section 1010 of the National Defense Authorization Act for Fiscal Year 2001¹, the OMB specifically addressed an Agency's prerogative to make these policy decisions:

"Neither Section 1010 nor this interim final rule is intended to modify current agency practices or policies regarding dates for payment for interim payments on cost-reimbursement service contracts, other than to require – in accordance with Section 1010(a) – that PPA interest penalties be paid on interim payments that are made more than 30 days after the agency receives a proper invoice. In particular, Section 1010 leaves unaffected existing agency policies that call for these interim payments to be made well in advance of 30 days. For example, it is the policy of the Department of Defense to generally pay contractors 14 days or less after being billed for reimbursement on cost-reimbursement contracts.

We appreciate the opportunity to respond to your draft audit report. My point of contact is Ms. Carol Phillips, who can be contacted by telephone at 703-693-6503 or e-mail at carol.phillips@osd.mil.


Teresa McKay
Deputy Chief Financial Officer

¹ The National Defense Authorization Act for Fiscal Year 2001, Section 1010, amended the Prompt Payment Act to pay the contractor an interest penalty, under cost-reimbursement contracts for services, when invoices are not paid within 30 days after the date of receipt of a proper invoice.

Defense Financial Auditing Service, Columbus Comments



DEFENSE FINANCE AND ACCOUNTING SERVICE
P.O. BOX 182317
COLUMBUS, OHIO 43218-2317

DFAS-CS/CO

JUL 11 2006

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL AUDITING
SERVICE, DEPARTMENT OF DEFENSE INSPECTOR
GENERAL

SUBJECT: Management Comments to the DoDIG Draft Audit "Providing Interim
Payments to Contractors in Accordance with the Prompt Payment Act,"
Project No. D2006-D000FJ-0076.000, dated May 22, 2006

In accordance with subject audit, management comments are provided for
Recommendations A.3 and B.1, as well as the material weakness identified in the report. The
recommendations are considered closed.

My point of contact for additional information is Mr. Benjamin Allen Davis,
DFAS-CSQA/CO, at 614-693-9008 or DSN 869-9008.

A handwritten signature in black ink, appearing to read "Carlton E. Francis".

Carlton E. Francis
Center Site Deputy Director

Attachment:
As stated

www.dfas.mil
Your Financial Partner @ Work

**Management Comments to the DoDIG Draft Audit “Providing Interim Payments to
Contractors in Accordance with the Prompt Payment Act,”
Project No. D2006-D000FJ-0076.000, dated May 22, 2006**

Recommendation A.3: We recommend that the Director, Defense Finance and Accounting Service Columbus, direct Defense Finance and Accounting Service Columbus personnel to discontinue paying interim payments on cost-reimbursement service contracts earlier than 7 days prior to the payment due date.

Management Comments: Non-concur. The DFAS Office of Counsel states that the draft audit report contends that the Prompt Payment Act and amendments require invoices be paid between the 23rd and 30th day after receipt of a proper invoice. This contention is based on the requirement in the Defense Authorization Act of 2001, which makes interim payments under cost-reimbursement contracts for services subject to the Prompt Payment Act. However, the Prompt Payment Act states the Office of Management and Budget (OMB) shall prescribe regulations that provide payment is due either 30 days after receipt of a proper invoice or the date payment is due under the contract (31 U.S.C. Section 3903(a)(1)(A) and (B)). The requirement to hold invoices until 7 days prior to the due date is imposed by a regulation promulgated by OMB, 5 Code of Federal Regulations (C.F.R.) 1315.4(j). The exemption from this requirement for cost-reimbursement payments for services is contained in 5 C.F.R. 1315.5(d), which states “For interim payments under cost-reimbursement contracts for services, agency heads may make payments earlier than seven days prior to the payment due date in accordance with agency regulations or policies.” The OMB guidance is clear, and the DoD regulation in the Defense Federal Acquisition Regulation Supplement (DFARS) 232.906(a) (i) states “the contract office shall insert a standard due date of 14 days for interim payments on cost-reimbursement service contracts.” Therefore, payments under cost reimbursement contracts for services should not be held until 7 days prior to the payment due date. DFAS Columbus will continue to make payment for interim vouchers on cost-reimbursement service contracts earlier than 7 days prior to the payment due date unless the underlying regulations are changed or unless directed otherwise.

Estimated Completion Date: This recommendation is considered closed.

Recommendation B.1: We recommend that Defense Finance and Accounting Service Columbus provide additional training to ensure that the invoice preparation date is entered into the Mechanization of Contract Administration Service invoice receipt date field for invoices that should be Defense Contract Audit Agency/Administrative Contracting Officer date stamped but are not.

Management Comments: Concur. The Director, Defense Finance and Accounting Service Columbus, provided training to the Tier 2 technicians on how to enter the invoice preparation date in the invoice receipt date field in the Mechanization of Contract Administration Service (MOCAS) system when vouchers are not date stamped by the Defense Contract Audit Agency. The training was completed June 26, 2006.

Estimated Completion Date: This recommendation was considered closed June 26, 2006.

Additional Management Comments: The Adequacy of Management Controls section of the draft audit report states, "The DFAS Columbus management controls for complying with the Prompt Payment Act were not adequate. The recommendations in this report, if implemented, will correct the identified weaknesses and could result in \$56.4 million in interest savings during the period FY 2006 through FY 2011." The auditors identified a specific material weakness stating that DFAS Columbus makes interim payments on cost-reimbursement service contracts in violation of the Prompt Payment Act by making payments earlier than 7 days prior to their due date. The DFAS Office of Counsel has reviewed the proposed material weakness and stated that the OMB regulations codified at 5 C.F.R. Part 1315 state, in part, that interim payments may be made more than 7 days prior to their due date. As a result, DFAS Columbus does not believe a material weakness or any associated interest savings exist.

Team Members

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

Paul J. Granetto
Patricia A. Marsh
James L. Kornides
Mark Starinsky
Lisa S. Sherck
Amber M. B. White