GAO

United States General Accounting Office

Report to the Chairman, Committee on Government Operations, House of Representatives

September 1989

PROMPT PAYMENT

State and Federal Payment-Timing Practices Are Similar

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GAO United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-228722

September 26, 1989

The Honorable John Conyers, Jr.
Chairman, Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report provides the results of our review of state payment-timing practices in response to a July 1988 request by you and the former Committee Chairman. We have also described the major provisions of the federal Prompt Payment Act of 1982, as amended, as a point of reference with which to compare state policies. We responded to the first segment of your request, regarding the states' payment-timing laws, in a March 1989 report entitled, Prompt Payment: State Laws Are Similar to the Federal Act but Less Comprehensive (GAO/AFMD-89-33BR, March 10, 1989).

Overall, we found that states have developed payment-timing policies and procedures that are similar to those used by federal agencies. However, many states' requirements differ from federal criteria regarding (1) automatic payment of interest penalties and (2) the timing of payments to subcontractors. Most of the invoice payments we examined in 12 states were paid by their due dates.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of this letter. At that time, we will send copies of the report to the Chairman, Senate Committee on Governmental Affairs, and make copies available to others upon request. Please contact me at (202) 275-9454 if you or your staff have any questions concerning the report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Jeffrey C. Steinhoff

Jeffrey C. Steinhoff
Director, Financial Management
Systems Issues

Executive Summary

Purpose

The federal government provides billions of dollars annually for state purchases of goods and services provided in support of federally assisted programs. Due to concerns regarding the timeliness of federally funded state payments to vendors and contractors, the Chairman, House Committee on Government Operations, asked the General Accounting Office (GAO) to study the need for and potential impact of federal requirements in this area. This is the second of two reports designed to aid in any future deliberations on this matter. The first, issued in March 1989, summarized the provisions of state and District of Columbia prompt payment laws. This report provides information on these governments' payment-timing policies, procedures, and practices.

Background

The Prompt Payment Act of 1982 generally requires that federal agencies pay bills within 30 days after receiving an invoice or accepting goods or services, whichever is later, and that they pay interest when payments are late. Amendments enacted in 1988 provide specific criteria regarding payments on construction contracts, including payments to subcontractors.

State expenditures of federal dollars are not subject to the federal Prompt Payment Act, but are, instead, governed by varying provisions of state laws. In March 1989, GAO reported that, overall, state laws were similar to the federal act but that some contained significant variations and most were less comprehensive. GAO also reported that three states had not developed any payment-timing laws.

GAO based its findings in this report on information gathered from visits to 12 states and questionnaire responses received from another 31 states and the District of Columbia (44 governments). During visits to the 12 states, GAO analyzed administrative policies and procedures and randomly selected and examined 271 invoice payments, including 79 interim payments on construction contracts.

Seven states did not respond to GAO's questionnaire. However, GAO considered these states' laws, as outlined in its March 1989 report, in observations regarding the impact of possible federal requirements for the timing of federally funded state payments.

Results in Brief

Thirty-seven of the 44 governments had developed at least some basic criteria regarding the timing of payments to vendors and for paying interest penalties on late payments. Most states applied these criteria to their payments regardless of funding source. GAO determined that about three quarters of the payments it examined were paid by their due dates and that about half of these may have been paid too early.

Requiring every state and the District of Columbia to apply the same timing and interest criteria found in the Prompt Payment Act would require them to modify their payment systems and procedures. Stipulating that states adopt certain minimum criteria or allowing them to apply their existing criteria to federally funded payments would necessitate fewer modifications, especially in those states that have already addressed the key elements of payment timing.

Principal Findings

State and Federal Criteria Are Similar

Many of the 44 governments included in GAO's review had administratively supplemented the prompt pay requirements of their laws, resulting in even closer conformance with federal provisions than indicated by the laws alone. For example, several states had administratively added acceptance of goods and services as an element of due-date determination, which is consistent with federal provisions. States also tended to use a 30-day payment period, even when their laws provided no criteria or specified longer periods. However, six states had not developed timing criteria for many types of payments.

Laws and administrative policies for 37 of the 44 governments provided for interest on late payments for most types of goods and services. However, unlike the federal government, 20 of these states required that vendors request interest on late payments, rather than paying it automatically. (See chapter 2.)

GAO determined that 73 percent of the 271 payments it examined were paid on time and that 19 percent were paid after their due dates. GAO could not assess the timeliness of the remaining 8 percent, because needed dates or timing criteria were not available. Eleven of the 12 states GAO visited had paid some interest on late payments during 1988. However, GAO found no evidence that any interest was paid on the late payments it examined, primarily because vendors apparently had not requested it, as required by some state laws and policies. (See chapter 3.)

Construction Contract Payments

Most states applied timing and interest penalty criteria to interim payments on construction projects that were either the same or similar to those applied to payments for other goods and services. However, final payments on construction projects were often subject to different criteria, which usually allowed a longer period before payments were considered late. GAO determined that 92 percent of the interim payments on construction contracts it examined were paid by their due dates. (See chapters 2 and 3.)

At least 24 states had timing criteria for payments to subcontractors in their laws or policies. Ten of these states told us that they implemented these provisions through required or standard contract clauses. However, none of the governments included in our review said that they enforced or monitored contractor compliance with these provisions. (See chapter 2.)

Early Payments

Contrary to effective cash management procedures, most state agencies did not precisely control payment timing, but instead processed invoices as soon as supporting documents were received. Seven of the 12 states GAO visited had either developed systems, enacted laws, or issued administrative guidance discouraging early payments. However, these efforts were not effective in many of the agencies GAO visited, primarily because some payment processing personnel did not adhere to agency criteria or system features designed to precisely time payments on or shortly before their due dates. GAO determined that 41 percent of the 271 invoices it examined were paid more than 7 days before they were due. Such early payment can result in increased costs to both federal and state governments. (See chapter 3.)

Effect of Modifying State Payment-Timing Criteria

The impact of requiring states to apply federally imposed criteria when paying vendors with federal funds would vary depending on the level of detailed criteria in any such federal requirements.

- Requiring states to use the same provisions that federal agencies use would compel every state and the District of Columbia to alter their payment processing systems and procedures.
- Requiring states to develop certain minimum prescribed criteria would necessitate fewer changes to existing policies and systems in most states, especially those that already have basic timing and interest-payment criteria. GAO's analysis found that six states had already developed criteria that provided for determining due dates, automatically

paying late-payment interest penalties, and stipulating timing provisions for payments to subcontractors. However, about half of the states included in GAO's review did not require automatic payment of interest and a similar number had not developed timing criteria for payments to subcontractors.

- Allowing states to apply their existing timing and interest criteria to all payments regardless of funding source would require little or no change in state payment-timing practices. (See chapter 4.)

Recommendations

GAO is making no recommendations in this report.

Comments From States

In accordance with the requester's wishes, GAO did not solicit written comments from the states on a draft of this report. However, GAO discussed its findings and the potential impact of federal payment-timing requirements with responsible officials in the states visited and incorporated their comments, as well as those provided in questionnaire responses, throughout the report as appropriate.

Contents

Tables

Abbreviations

GAO	General Accounting Office
OMB	Office of Management and Budget

Introduction

During fiscal year 1988, the states and the District of Columbia disbursed billions of federal dollars to private vendors for goods and services in support of federally assisted programs. Some Members of the Congress have expressed concern regarding the timeliness of payments to vendors and have considered legislation that would impose basic payment-timing requirements on the states when they are disbursing federal funds. This report is designed to provide the Congress with information on state payment-timing practices to aid in future deliberations on this matter.

Many Federal Programs Involve Vendor Payments

A variety of federal programs, ranging from abandoned mine reclamation to educational services, are financed through federal grants to the states and the District of Columbia.[1] The states carry out many of these programs by contracting with private businesses to provide the goods and services, including construction services, required. For some programs, such as urban mass transit, a substantial percentage of federal program funds is "passed through" from the states to political subdivisions of states, such as cities, counties, and local transit authorities.

Statewide summary figures are not readily available on the total dollar value or number of invoices paid by the states and their political subdivisions with federal funds. However, according to figures developed by the Census Bureau,[2] federal agencies provided $110 billion in grants to states and localities during fiscal year 1988. This included about $12 billion for highway construction, a program which, according to state officials, is carried out largely through construction contracts with private vendors. Based on our knowledge of how major federal programs operate, we estimate that during fiscal year 1988, a significant segment of the federal funds provided for other programs was also disbursed by states and localities to contractors and vendors. Such programs include public housing, construction of wastewater works, and compensatory education for the disadvantaged. Our review did not include the Medicaid program, which accounted for $30 billion of the $110 billion in federal grants to states, because Medicaid payments are for services provided to individuals, rather than directly to the states.

[1] Federal grants are also provided to the U.S. territories of Puerto Rico, the Virgin Islands, American Samoa, Guam, and the Northern Marianas. These governments were not included in our review.

[2] Federal Expenditures by State for Fiscal Year 1988, U.S. Department of Commerce, Bureau of the Census.

Overview of Prompt Payment Issues

Since the late 1970s, the Congress has taken an active interest in the timing of payments by federal agencies to vendors and enacted the Prompt Payment Act in 1982 (Public Law 97-177; 31 U.S.C. Chapter 39) and related amendments in October 1988. Generally, areas of concern have centered on

- how quickly vendors are paid after delivering goods or completing services and submitting an invoice;
- whether compensation, in the form of interest, is paid to vendors when payments are late; and
- the timeliness of payments on construction contracts, including those made to subcontractors associated with federally financed projects.

In recent years, some Members have also been concerned about the responsibility of the federal government to ensure the timeliness of federally funded vendor payments made by the states.

This report addresses these prompt payment issues as they relate to federally funded payments made by the states and the District of Columbia.

We reported in March 1989[3] that 47 states and the District of Columbia had enacted laws that governed the timing of at least some types of state payments to private vendors and contractors. The three remaining states (Georgia, New Hampshire, and Vermont) had not enacted prompt payment laws. Although there were significant variations among state laws, many states had included provisions that paralleled federal prompt pay legislation. For example, about three quarters of the states had laws requiring that, in the absence of contractual payment-timing provisions, invoices for goods and services be paid within a period of either 30 or 45 days, and most provided for interest penalties when payments were late. However, the laws in most states were not as comprehensive as the federal law because they did not have as broad an application and did not specifically address as many types of payments and payment-timing issues. For example, laws in four states pertained only to payments on construction contracts, and laws in six states specifically did not apply to at least some federally funded state payments.

[3] Prompt Payment: State Laws Are Similar to the Federal Act but Less Comprehensive (GAO/AFMD-89-33BR, March 10, 1989).

Objectives, Scope, and Methodology

In July 1988, the Chairman of the House Committee on Government Operations requested that we study the need for and possible impact of prospective legislation to extend coverage of federal or state prompt payment laws to federally assisted contracts and grants. Specifically, we were asked to (1) survey state prompt payment laws and (2) assess state payment-timing practices. We reported on prompt payment laws in March 1989. This report addresses the second segment of the request. The principal objectives of this report were to

- provide an overview of the payment-timing practices followed by states and the District of Columbia, with emphasis on the issues discussed in the previous section;
- determine if the states are complying with the payment-timing criteria they have established; and
- determine how state practices differ from those prescribed by the federal Prompt Payment Act and how the enactment of federal requirements would affect state operations.

To accomplish these objectives, we gathered information through observations, discussions, and invoice audits in 12 states and through use of questionnaires that were sent to all states and the District of Columbia.

Twelve States Visited

In each of the 12 states visited, we talked with personnel involved in (1) the development and monitoring of official policies and procedures related to the timing of vendor payments and (2) payment processing. This usually included officials in the offices of the comptroller, treasurer, and auditor. In addition, because much of the payment processing and scheduling was done at the agency level, we observed these operations in two or three major departments or agencies in each state. We visited each state's department responsible for highway construction, since that program involves the largest amount of federally funded state payments to contractors, except for Medicaid.

We selected these states for detailed audit work because they receive relatively large amounts of federal funds and, as a whole, their laws cover a wide range of payment-timing provisions. For example, one state we visited, Georgia, had not enacted any payment-timing laws, while others, such as California and New York, had enacted very specific criteria applicable to virtually all vendor payments, including provisions that entitle vendors to interest when payments are late. We also visited Pennsylvania, Virginia, Maryland, Illinois, North Carolina, Texas, Florida, Ohio, and Michigan. According to Census Bureau statistics, these 12 states received 56 percent of the federal dollars provided to the 50 states and the District of Columbia during fiscal year 1988.

To assess state compliance with laws, policies, and procedures, we audited 271 invoices paid between September 7, 1988, and February 10, 1989, by the 12 states we visited. These payments totaled about $19.7 million and included payments for construction and other types of goods and services.

For each invoice selected, we obtained supporting documentation, which usually included a copy of the invoice, the related contract or purchase order, evidence of receipt and acceptance of the items or services purchased, and a listing indicating the check date or check-mailing date. From this documentation, we extracted contract terms and dates needed to determine the invoice due date. Based on this evidence, we determined if the states had

- paid invoices by their due dates,
- paid any interest due on late payments,
- taken vendor-offered discounts within established terms, and
- prudently managed cash by not paying too early.

Although we selected an average of 23 invoices in each state related to a variety of federally assisted programs, the results of our invoice tests are not projectable either to individual states or to the 12 states collectively. We did not attempt to select a statistically representative sample of invoices because most agency systems could not readily identify federally funded payments to vendors in order to develop a universe of such payments. In addition, significant amounts of federal funds are "passed through" to localities, and data were not readily available regarding the number and dollar value of invoices paid by these entities.

Questionnaire Data

We sent questionnaires to the District of Columbia and the 38 states that we did not visit asking for basic data on payment timing, late-payment interest, provisions regarding the timing of payments to subcontractors, and the potential impact of imposing federal requirements. Through follow-up phone calls, we supplemented and clarified the data provided in the 32 responses we received.

We sent a shorter questionnaire on the impact of imposing federal requirements to the 12 states we visited. Eleven of these states responded, and the information they provided supplemented data gathered during our visits. Appendix I provides a list of the states that responded to our questionnaire and those that we visited.

In accordance with the requester's wishes, we did not solicit written comments from the states on a draft of this report. However, during our review, we discussed pertinent facts, findings, and the potential impact of federal payment-timing requirements with responsible state officials. In addition, many provided written comments as part of their questionnaire responses. We have incorporated these comments, where appropriate, throughout the report. We performed our work in accordance with generally accepted auditing standards from November 1988 to May 1989.

Administrative Policies Supplement State Laws

With some exceptions, states have implemented payment-timing criteria that include the critical elements needed to calculate due dates and, thus, allow vendors to know when payments can be expected. Most states' criteria are similar to those developed by the federal government regarding the number of days within which an invoice should be paid and when this period should begin. States generally treat payments involving federal funds the same as payments funded from other sources. Like the federal act, most states' laws and policies provide for the payment of interest to vendors when payments are late. However, at the time of our review, at least 22 states required that vendors request late-payment interest, rather than paying it automatically, as is required of federal agencies by the federal act.

This chapter describes state due-date criteria and interest-payment policies. We have also included a section on state payments to construction contractors and subcontractors, because laws and administrative policies and procedures for these types of payments often differ from those governing payments for other types of goods and services. Also, this has been a specific area of congressional interest in recent years.

Basic Criteria Are Essential to Determine Payment Timeliness

Well-defined payment-timing criteria that are clearly and consistently communicated to agency personnel can improve payment operations by imposing structure and discipline on the payment process, thereby standardizing the timing of payments. Effectively communicating these policies to vendors allows them to more accurately predict when to expect payment. Such an environment can generate benefits to the states and the federal government. States can save money by avoiding late-payment penalties and by paying invoices as close to their due dates as is practical, thus earning interest on larger balances of state funds and avoiding earlier than necessary drawdowns of federal funds. Further, a history of prompt payment may increase vendor competition for state business, which in turn can result in procurement savings.

The two primary elements of payment-timing criteria are (1) the payment period, which is the number of days within which a payment is to be made and (2) the start date, which is the date from which the payment period is measured. State and federal prompt payment laws generally require that payments be timed in accordance with terms provided in contracts or other purchase agreements and provide default criteria to be applied in the absence of such contract terms. However, because many contracts do not contain adequate payment-timing criteria, default criteria provided in laws, policies, and procedures must clearly specify a payment period, a start date, and any interest penalties that apply when payment is late. Only 17 percent of the contractual agreements associated with the 271 invoices we audited either stated a specific due date or provided adequate criteria for determining a due date. Only 10 percent contained terms regarding late-payment interest penalties.

The federal government's timing criteria applicable to payments made to vendors by federal agencies clearly define payment periods and start dates. The Prompt Payment Act of 1982, as amended, and implementing procedures developed by the Office of Management and Budget (OMB) prescribe that, unless otherwise stated in the related contract, payments are to be made within 30 days, and that this 30-day period is to begin with the later of (1) receipt of a proper invoice or (2) acceptance of goods or services. These criteria were recently supplemented by a requirement that, for the purpose of calculating interest penalties, acceptance be deemed to have occurred no later than 7 calendar days after delivery of the goods or completion of the services, unless a longer acceptance period is specified in the related contract. The federal requirements also provide that partial payments on construction contracts are to be paid within 14 days of receipt of a request for payment, unless otherwise stipulated in the contract.

State and Federal Due-Date Criteria Are Similar

In our March 1989 report, we noted that the payment-timing criteria provided in state laws were similar to those provided by the federal act. About three quarters of the states had laws requiring that, in the absence of contractual payment-timing provisions, invoices were to be paid within 30 or 45 days of a date usually based on either receipt of an invoice or receipt and/or acceptance of goods or services.

Based on our examination of written policies and procedures and questionnaire responses and on discussions with state officials, we determined that many states had administratively supplemented the provisions of their laws, resulting in even closer conformance to the basic federal provisions. New Hampshire has no laws or written procedures on prompt payment, but the state's questionnaire respondent told us that state agencies are expected to make payment within 30 days after the later of the date that the invoice is received or the goods or services are accepted. Six states (Arkansas, Georgia, North Carolina, New Mexico, Nevada, and Vermont) had not developed statewide timing criteria for many payments.

In addition, we found that federally funded payments were covered by the same timing criteria applicable to payments that were funded exclusively with state money. None of the agencies we visited in 12 states differentiated between state-funded and federally funded payments for timing purposes. Also, none of the additional 32 governments (31 states and the District of Columbia) that responded to our questionnaire, including 5 whose laws specifically exempted federally funded payments from state timing criteria, said that they timed such payments any differently than payments funded by other sources.

Most States Require Payment Within 30 to 45 Days

Most states had developed policies and procedures requiring payment of bills within a 30- to 45-day period, as specified in their respective state laws. (The federal act generally requires that bills be paid within 30 days.)

Of the 12 states we visited, 9 had either laws or statewide administrative policies that specified a 30-day payment period. (Georgia's prompt pay requirements, which were directed by executive order rather than by law, specified a 30-day payment period, but did not apply to payments on construction contracts.) One other state had a 45-day period, and another had a 50-day period. The prompt payment laws of the remaining state, North Carolina, specified a 45-day payment period applicable only to final payments on construction contracts.

In practice, payments in the two states that had payment periods exceeding 30 days and in the one state that had not developed statewide timing criteria were often subject to a 30-day period.

- In Michigan, whose laws specified a 45-day payment period, 18 of the 32 payments we audited were governed by contracts stipulating 30-day payment periods.
- North Carolina had not developed payment-timing criteria for most types of payments; however, 10 of the 21 invoices we audited were subject to contracts specifying payment periods of 30 days or less, and one North Carolina agency that we visited had implemented a 30-day payment period as part of a new system development effort.
- In California, whose laws specified a 50-day payment period for most types of payments, 12 of the 21 payments we audited were governed by agreements stipulating a payment period of 30 days or less.

Of the 32 governments that we did not visit but that responded to our questionnaire, 14 told us that they applied a payment period of 30 calendar days or less.

- Seven indicated a payment period of 30 days or less, as specified in their laws.
- Wisconsin and Hawaii officials told us that recent legislation reduced their payment periods from 45 to 30 days. Wisconsin's payment-timing laws and administrative policies directed agencies to begin using a 30-day period as of February 1, 1989. Hawaii's respondent told us that, although the 30-day period will not officially become effective until January 1990, the Governor directed state agencies to begin using the 30-day period in January 1989.
- A New Hampshire official responding to our questionnaire stated that, although his state had not enacted any payment-timing laws, state agencies were to use a 30-day payment period.
- Massachusetts, South Dakota, and Nebraska officials told us that their states attempted to pay within 30 days. Under Massachusetts law, interest accrued from the 45th day. Under South Dakota and Nebraska law, interest accrued from the 30th and 31st day, respectively, when payments were made after 45 days.
- As we reported in March 1989, Arkansas law provided two sets of payment-timing provisions, both of which applied to construction contracts only. One allowed a total of 17 days for payment processing, while another required payment within 90 days. In response to our questionnaire, Arkansas told us that state agencies were allowed 17 working days to pay invoices.

Fifteen of the governments that we did not visit but that responded to our questionnaire told us that they applied a payment period of more than 30 calendar days.

- Thirteen indicated a payment period of more than 30 days, as specified in their laws. Included in this thirteen were three states that applied a payment period of 30 working days, as specified in their laws.
- The respondent from Kansas told us that although agencies tried to make payments sooner, the state did not consider payments late if made within 45 days. Both the state's law and policy specified that payments were to be made within 30 days, but an interest penalty was not due the vendor if full payment was made on or before the 45th day.
- Louisiana's questionnaire response indicated that state agencies were to pay invoices within 60 days after the later of receipt of an invoice or receipt of goods or services. However, according to a 1988 law, interest

is not due unless payment is made more than 90 days after contractual due dates. Prior to the 1988 law, interest was due when invoices were paid more than 30 days after the due date.

Respondents from the remaining three states that we did not visit, New Mexico, Nevada, and Vermont, told us that their states had not developed timing criteria applicable to most state payments. Vermont had not enacted any prompt payment laws and the other two states had laws whose applicability was limited or not clearly defined.

States Administratively Supplement Start-Date Criteria

To compare state payment-timing practices, it is important to consider the "start date," the day on which the payment period begins. Even when payment periods are similar, different ways of determining start dates can lead to significantly different payment due dates.

As we reported in March 1989, most states' laws specified a start date based on one or more of the following:

- the date an invoice is received,
- the date goods are received or services are completed, or
- the date goods or services are accepted.

We found that, in practice, many states had supplemented the start-date criteria specified in their laws. For example, Ohio law stated that the payment period was to be measured from the date an invoice was received, while Ohio's administrative policies and procedures defined invoice receipt as the date the state had received both the invoice and the goods or services. Further, seven of the states that we either visited or that responded to our questionnaire had supplemented their start-date criteria to include acceptance of goods and services. Generally, the supplemental administrative requirements provided state personnel with criteria for handling payment-processing situations that were not specifically addressed by their laws alone.

Table 2.1 compares the start-date criteria provided in state laws and reported by us in March 1989 with the start-date criteria provided in written state-level administrative policies and procedures, when available, or by state officials' responses to our questionnaire. This data shows that, when administrative policies and procedures are considered, more states used start-date definitions that were identical or similar to the federal criteria than is indicated by start-date definitions provided in state laws alone.

Table 2.1: Start-Date Criteria Provided in State Laws and in Administrative Policies and Procedures

Start-date criteria	State laws	State administrative policies and procedures
	(Number of states)	
Receipt of invoice or receipt of goods or services, whichever is later	13	18
Receipt of invoice or receipt and acceptance of goods or services, whichever is later	10	17
Receipt of invoice	8[a]	3[a]
Other criteria	6	1
No start-date criteria provided	3	1
Total	**40**	**40**

Note: This table does not include Arkansas, New Mexico, Nevada, and North Carolina because these states' criteria applied only to payments on construction projects. In addition, it does not include the seven states that did not respond to our questionnaire.

[a]Includes California, whose criteria specified that the invoice postmark be used as the start date.

Criteria Not Consistently Defined

Start-date criteria in some states were ambiguous as to whether both the dates of receipt and of acceptance of goods and services were to be used in determining a start date or whether only the date of receipt of goods or services should be considered. Such ambiguities increase the subjectivity of timing decisions made by agency personnel.

During our visits to Maryland, Texas, and Georgia, we identified inconsistencies in written policies and procedures, data entered on processing documents, or verbal explanations provided by state officials. Such inconsistencies indicate that a uniform policy regarding the use of the acceptance date as an element of due date calculation had not been clearly defined or consistently communicated to agency personnel. For example,

- Maryland's statewide policies, as well as standard contract clauses used by the state's highway administration, defined the start date as the later of receipt of an invoice or receipt and acceptance of goods and services. However, written instructions for filling out an "Invoice Payment Authorization Form" at Maryland's Department of Natural Resources defined the start date as the date the invoice was received or goods and services were received, whichever was later. The instructions did not mention acceptance as an element in start-date determination.

- Officials in both Georgia and Texas stated that payment periods should not start until goods and services have been accepted. However, centrally developed written policies in both states, as well as those available in the agencies we visited, did not mention acceptance as an element in start-date determination.

We also identified inconsistencies among the start-date criteria specified in the laws, administrative policies, and questionnaire responses of four states that we did not visit.

- The laws and administrative policies in New Jersey stated that the start date was the later of receipt of an invoice or receipt of goods and services, while the questionnaire response indicated that the start date should be the later of receipt of an invoice or acceptance of goods and services.
- Alaska's laws and administrative policies stipulated that the payment period was to begin on the date an invoice was received. However, the questionnaire response indicated that Alaska used the later of the date an invoice was received or goods or services were accepted.
- South Carolina law defined the start date as the date the agency "certifies its satisfaction with the received goods or services," and the state's questionnaire respondent agreed that acceptance was an element of South Carolina's start date. However, South Carolina's written policies directed agencies to begin the payment period on the date an invoice was received or goods or services were received, whichever was later.
- Massachusetts administrative policies referred to both receipt and acceptance of goods and services, but did not clearly state how acceptance affects due-date determination. The state's questionnaire respondent told us that the start date was the date the invoice was received or the date goods or services were accepted, whichever was later.

The choice of whether to use the date of receipt of goods or services or of acceptance as an element in start-date determination can have a significant impact on payment timing when there is a substantial time gap between the two. In our audit of 271 invoice payments, we identified 31 instances where documented dates indicated that more than 30 days had elapsed between receipt of goods or completion of services and acceptance.[1]

[1]Available documentation generally did not allow us to determine the cause of delays between receipt and acceptance or whether these delays were warranted. In addition, such delays were not always the sole factor in delaying the start of the prescribed payment period. In several cases, vendors had not submitted invoices until well after providing services or delivering goods.

Few Limits on Time Allowed to Accept Purchases

Although laws in eight of the states we visited specified time limits within which vendors were to be notified when their invoices or goods and services were defective, we identified provisions in only two states we visited that limited the time within which goods and services had to be accepted for purposes of establishing due dates.

- Illinois' law and administrative policies required that invoices be approved for payment within 30 days after their receipt or receipt of the goods and services, whichever was later. State officials told us that, generally, invoices could not be approved for payment until the related goods and services had been accepted as satisfactory. If an agency exceeded this 30-day period, then the additional 30-day period allowed for paying the invoice was reduced, and interest was due if payment was not made by the 45th day after receipt of the invoice or receipt of the goods and services, whichever was later.
- Florida's centrally developed administrative policies stated that goods and services were to be inspected and accepted within 5 working days of their delivery or completion, unless otherwise stated in the related bid specification or purchase order.

In addition, the District of Columbia's written procedures required that contracts contain a "stated inspection period, where necessary, for acceptance of property or services."

Start-Date Criteria in Two States Visited Extended Payment Period

Two of the 12 states we visited had implemented start-date criteria, provided by their respective laws, that extended the period allowed for paying vendor invoices. However, according to officials in these two states, many invoices are paid in far less than the maximum time allowed.

Illinois laws and administrative procedures required that agencies pay invoices within 30 days of their "approval." However, approval, defined as "final approval of the agency head," was not required until 30 days after receipt of the invoice or receipt of the goods or services, whichever was later. As a result, payment could have been made up to 60 days after the date that was used as a start date in many other states and still have been considered on time according to Illinois criteria.

However, an Illinois state official told us that, in practice, most invoices were paid well before the 60-day period had elapsed. We found that the Illinois invoices we audited were approved within an average of 11 days after the later of receipt of an invoice or receipt of goods or services and paid within an average of 16 days after their "approval."

A second state, California, had implemented start-date criteria that, in effect, allowed the state up to 60 days to pay some invoices submitted by small and nonprofit businesses. This was 10 days more than the 50-day period allowed for payments to other types of businesses. Specifically, California law provided that, unless otherwise specified in the contract, small businesses were to be paid within 30 days of the "required payment date," which was defined as (1) 30 days after receipt of a proper invoice or (2) the date the invoice was received, if the invoice specified that payment was due upon receipt. Payments to other businesses had to be made within 50 days of the postmark date of the invoice.

During our audit of invoices, we found that these criteria led to disparities in payment-timeliness determinations. One California agency official told us that her agency tried to pay all small businesses within 30 days of invoice receipt regardless of whether the words "due upon receipt" were printed on the invoice. However, an official in California's Small Business Administration told us that interest determinations were based on the criteria provided by law.

Most States Have a Policy of Paying Interest on Late Payments

Of the 12 states we visited, 10 had laws and administrative policies providing for interest on most types of late payments. However, 2 of these 10 had administrative policies that significantly limited the applicability of interest payments. Also, officials in one agency in a third state told us that the agency paid no interest because all of its funds were federally provided, and related federal guidance precludes the use of these funds for interest payments.

Of the 32 governments that we did not visit but that responded to our questionnaire, 27 had laws and administrative policies providing for interest on most types of late payments, while 5 did not. Officials from three states with interest penalty provisions told us that these provisions were not applied to payments that were federally funded.

The greatest difference between state and federal interest provisions was that many states required vendors to request late-payment interest penalties, while the federal law requires federal agencies to automatically pay any interest due. Total interest paid to vendors during fiscal year 1988 by nine of the states we visited ranged from $6,741 to

$821,192. Of the other three states we visited, Georgia paid no interest, and California and North Carolina could not provide us with the amount of interest paid statewide during fiscal year 1988. None of the states could identify the amount of interest paid only on federally funded payments. During the period of our review, interest rates for those states that paid interest were, on average, higher than the rate used by federal agencies.

The laws of four states (Georgia, New Hampshire, New Mexico, and Vermont) did not require those states to pay interest on any late payments. Three other states had interest penalty requirements that applied only to a segment of their payments. Arkansas and North Carolina laws provided for interest only on construction contracts; Nevada law provided for interest only on payments to construction subcontractors.

Of the 10 states we visited whose laws provided for interest on most types of late payments, 2 had instituted administrative policies that significantly restricted interest payments, and one agency we visited in a third state did not pay interest on federally funded payments. In addition, in an effort to eliminate the administrative burden of making very small interest payments, four of the states we visited did not pay interest unless the penalties exceeded specific minimum amounts ranging from $1 to $10.

Pennsylvania law allowed agency officials discretion in deciding whether to pay interest on many types of late payments. This flexibility existed because the state's prompt pay law stipulated that the state <u>shall</u> pay interest on late payments to small businesses and <u>may</u> pay interest on late payments to other types of businesses. Also, the state had interpreted its law to require interest payments on all final construction payments from the date of a project's final acceptance by the state. Officials in the state comptroller's office told us that, except for interest on final construction payments, decisions regarding interest payments to other than small businesses were left up to individual state agencies and that they had not issued any guidance on this topic.

Michigan officials told us that their state did not pay interest until 45 days after the payment-period start date, regardless of contract terms specifying earlier payment due dates. This practice may be at odds with Michigan's law, which provided that interest be paid when payments were "past due." The law defined "past due" as 45 days after receipt of an invoice, receipt of goods or services, or completion of a contract, whichever is later, <u>unless otherwise agreed in writing</u>. However, state officials told us that they did not consider interest due on the six Michigan invoices we audited that were paid after the 30-day payment period specified in their purchase orders or contracts had expired, because they were paid before the 45th day.

Ohio's Bureau of Employment Services did not pay interest on federally funded payments. Although this may not be consistent with the state's law and administrative policy, which directed agencies to automatically pay interest on late payments, Bureau officials told us that they implemented a no-interest policy because the Bureau was funded solely by federal money. They noted that OMB Circular A-87, "Cost Principles for State and Local Governments," precludes the use of federal funds for paying fines, penalties, interest, or other financial costs.

OMB Circular A-125, which implements the Prompt Payment Act, also prohibits the use of federal funds to pay late-payment interest charges incurred by the states or other grantees. However, these prohibitions do not preclude the states' paying interest penalties with state-provided funds when their administration of federally assisted programs results in late payments to vendors.

Grace Periods

As we reported in March 1989, in most of the states and the District of Columbia, payments made after the payment period expired were subject to interest penalties starting the next day. However, the laws for five governments with 30-day payment periods also provided that interest penalties were not to be assessed, unless payment was made after the expiration of a grace period. Four of the governments had a 15-day grace period, and the fifth one had a 7-day grace period. Thus, grace periods for these states allowed payments to be made from 37 to 45 days after the start date, before an interest penalty was incurred. The laws of seven additional states can be viewed as including "built-in" grace periods, because they stipulated that payments not made within 45 days accrue interest retroactively from an earlier point in time, usually the 30th or 31st day after the start date. (Prior to April 1989, federal agencies were allowed a 15-day grace period in addition to the 30-day payment period before interest penalties were due. However, the October 1988 amendments eliminated this provision.)

Interest Rates Vary

Annual interest rates assessed on late payments during the last 6 months of 1988 ranged from 6 to 24 percent and averaged 12.8 percent. During the same period, federal agencies applied a 9.75 percent annual rate. As we reported in March 1989, laws in 46 states and the District of Columbia provided for late-payment interest penalties on at least some payments to vendors. Of these 47 governments, 31 applied interest rates that were specified by law and 16 applied rates that were tied to other rates, such as the commercial prime rate published in The Wall Street Journal.

Many States Require Vendors to Request Interest Due

Of the 37 governments included in our review that had interest penalty provisions applicable to most types of payments, 20 did not pay interest unless vendors submitted requests. This requirement was imposed by law in 8 of these states and by administrative policy in 12.[2] (The federal Prompt Payment Act requires automatic payment of interest by federal agencies and imposes an additional penalty when vendors must request interest they are due.)

Officials in states that required vendors to request interest strongly supported this policy. Generally, they told us that automatic payment of interest would be too expensive because it would require careful calculations and reviews by state personnel and would result in compensation to vendors who were not dissatisfied with state payment timing.

Payments on Construction Contracts

Timing criteria applicable to partial or progress payments[3] on construction contracts frequently varied from those applicable to final payments on completed projects. With some exceptions, state officials told us that state agencies were to apply the same timing and interest criteria to interim payments on construction contracts that they used for other types of payments. However, we observed that most of the states we visited routinely expedited interim payments. Five of the 12 states we

[2]Of the seven states that we did not visit and that did not respond to our questionnaire, laws in two specified that vendors were to request interest on late payments, laws in four provided for interest but were silent on whether such penalties were to be paid automatically, and laws in one required states to pay interest penalties automatically.

[3]Some state laws, as well as recent amendments to the federal law, refer to partial payments as "progress payments." In an attempt to eliminate confusion at the federal level with regard to the terms "partial" and "progress" payments, OMB has defined partial payments as payments made for partial execution or delivery of accepted goods or services, including those made under construction contracts. Progress payments, on the other hand, are defined as payments made prior to receipt or acceptance of the goods or services solely for the purpose of assisting the contractor in financing the project. According to OMB's definitions, which are contained in OMB Circular A-125, partial payments are subject to interest penalties if paid late, while progress payments for financing purposes are not. However, we found no evidence that states have made a similar distinction between these two types of payments. Accordingly, in this report we generally refer to any type of partial or progress payment as an "interim" payment.

visited allowed a longer period within which to pay final payments on construction than was allowed for other types of payments, presumably so that state personnel would have time to ensure that all contract requirements had been met. In addition, due dates for final payments were usually based on final inspections, occupancy, or other indications of final acceptance.

Interim Payments

Officials in 30 of the 44 governments in our review told us that interim construction payments were subject to the same payment period as other types of payments. Officials in 10 of the other 14 governments told us that they either applied a different payment period to interim payments on construction than they applied to other types of payments or that they had not developed timing criteria for one of these two types of payments.

- Massachusetts law specified that payments for goods and services were to be made within 45 days and that interim payments on construction contracts were to be made within 24 days.
- Although most payments in California were subject to a 50-day payment period, that state's law stipulated a 60-day payment period for public works construction, including interim payments. However, the interim payments on highway construction that we audited in California were paid according to a predetermined schedule that required payment about 15 days after the end of the related work period.
- Michigan applied a 30-day payment period to interim payments on construction, while using a 45-day period for payments on other types of purchases.
- As provided by law, Mississippi told us that the state applied a 60-day payment period to interim payments on construction, while applying a 45-day period to other payments.
- Nebraska told us that interim payments on construction were usually paid within 15 days, while a payment period of 45 days was allowed for other types of payments.
- Georgia and Oklahoma excluded interim construction payments from their general payment-timing provisions, and no other criteria were provided for such payments when related contracts were silent on payment timing.
- Kansas' questionnaire respondent stated that the state had not developed specific payment-timing criteria for interim payments on construction, but that such payments were "expedited." Kansas was to pay for most purchases within 30 days.

- Arkansas' respondent told us that the state's timing criteria applied only to construction contracts and that no criteria had been developed for other types of payments.
- West Virginia's respondent told us that the state had developed criteria applicable to payments on completed contracts, but not on interim payments.

Questionnaire respondents in the four remaining states (North Carolina, New Mexico, Nevada, and Vermont) told us that they had not developed timing criteria for either interim payments or most other types of payments.

In addition to the varying payment periods described above, 12 states had designated a different start date for at least some interim construction payments, often because vendors were not required to submit an invoice, as was usually the case with other types of payments.

- Four states, including three that we visited, started the payment period for at least some interim construction payments with the date the related segment of work was completed, often referred to as the "cut-off date."
- Eight states, including five that we visited, started the payment period for at least some interim construction payments with the date the state inspector or engineer approved or certified a completed segment of work and related cost estimates. One of these, Texas, specified that the start date for interim construction payments by the Department of Highways was the date the engineer's approval was entered into an automated system.

Regarding interest penalties, questionnaire respondents in five states told us that late interim construction payments were subject to requirements that differed from those applied to other types of payments. Alaska and Mississippi used lower interest rates for interim construction payments: 10.5 percent and 12 percent, respectively, versus 18 percent for other types of payments. Nebraska's respondent told us that, although the state paid interest on other types of payments, it did not pay interest on late interim construction payments. Similarly, Connecticut's respondent told us that interim payments on highway construction were exempt from late-payment interest penalties. Conversely, Arkansas paid interest on at least some interim construction payments but did not pay interest on payments for other types of purchases.

Final Payments

Laws or administrative requirements in 5 of the 12 states we visited stipulated a longer payment period for final payments on at least some types of construction than was provided for payments on most other types of purchases. Additionally, the requirements in two other states provided for shorter periods, and the laws in an eighth state visited applied only to final payments on construction.

- The laws of Florida and New York specified 30-day payment periods for most types of vendor payments, but allowed 75 days for final payments on certain types of construction.
- Pennsylvania law, which also specified a 30-day payment period, allowed 45 days for certain types of final construction payments. In addition, Pennsylvania had interpreted its law as requiring payment of interest on all final construction payments from the date of final acceptance, regardless of when payment is made. For other types of invoices subject to late-payment penalties, interest was only due after the 30-day payment period and a 15-day grace period had expired.
- Michigan and California laws stipulated 45-day and 50-day payment periods, respectively, for most types of payments. However, Michigan law and California's Department of Transportation specifications, which were to be included in that department's contracts, allowed only 30 days for final payments on certain types of construction.
- Standard contract specifications developed by the departments responsible for highway construction in both Maryland and Virginia stated that final construction payments were to be made within 90 days of project acceptance. Both states' laws specified 30-day payment periods for other types of purchases.
- North Carolina law, which did not provide any timing criteria for payments on most types of goods and services, specified that final payments on construction, other than highway construction, be made within 45 days. In addition, the North Carolina Department of Transportation's "Road and Structures Specifications" provided that final payments be made within 120 days of a project's final acceptance.

Overall, as we reported in March 1989, 16 states had enacted separate payment-period provisions for final payments on at least some types of construction contracts. These provisions generally allowed longer payment periods than those applicable to most other state purchases.

Timing of Payments to Subcontractors

In recent years, the timing of payments to subcontractors working on federally assisted projects has been of particular interest to the Congress. The federal Prompt Payment Act was amended in 1988 to require that all federal agency contracts entered into or amended after April 1, 1989, include a clause requiring that contractors pay their subcontractors within 7 days after receiving payment from the federal agency.

At least 24 states had developed criteria regarding when contractors were to pay their subcontractors in at least some situations. These provisions were included in the laws of 22 states (including 3 that we did not visit and that did not respond to our questionnaire), and questionnaire respondents in an additional 2 states told us that they had developed administrative policies that specified timing criteria for payments to subcontractors.

However, many of these states had not developed techniques for either implementing or monitoring such provisions. Officials in 10 states responding to our questionnaire said that their states had developed a standard or required contract clause outlining subcontractor provisions. None of the states we visited had developed such a required contract clause, and only 4, or 5 percent, of the contracts for the 83 construction contract payments we examined contained terms specifying a number of days within which contractors were to pay subcontractors.

All of the officials participating in our review from those states that had subcontractor provisions told us that they did not actively monitor or enforce such provisions, whether required by contracts or not. Some of those we visited said that, other than responding to subcontractor complaints, there was little they could do to ensure that subcontractors were being paid in a timely manner.

As for the states that had not developed timing criteria for payments to subcontractors either in their laws or in their administrative policies, officials generally objected to such provisions because, in their opinion, they would be

- an inappropriate government intrusion into contractor-subcontractor relations and
- costly and difficult to monitor and enforce.

Compliance With Criteria Varied in Twelve States Visited

Almost three quarters of the invoices we audited were paid by their due dates, with construction contract payments generally paid closer to their due dates than payments for other types of purchases. About 19 percent of the state payments we audited were made after their due dates, but states paid no interest on these invoices, primarily because vendors did not request it. We could not determine the timeliness of the remaining invoice payments audited because data essential to due-date determination were missing.[1]

About 40 percent of the payments we examined were paid more than 7 days before their due dates, a practice that is not consistent with good cash management. The abilities of the state agencies we visited to precisely time payments varied according to the systems and procedures they had developed. Many did not determine precise due dates, but instead scheduled invoices for payment as soon as they received needed documentation.

Most Audited Invoices Paid by Their Due Dates

Of the 271 invoices we audited for compliance with state criteria, 73 percent were paid by their due dates. This represented 90 percent of the dollar value of the audited invoices. Forty-one percent of the invoices examined were paid more than 7 days early. Nineteen percent of the invoices we audited were paid after their due dates.

We could not determine whether the remaining 8 percent (22 invoices) were paid when due. The primary reason was that documentation essential for making this determination, such as delivery dates and invoice receipt dates, was not available. Also, in some cases, timing criteria applicable to the payment in question were not provided either in state laws, policies, and procedures, or in the related contract. Table 3.1 summarizes the timeliness of the payments we audited.

[1]In 1986, based on our review of over 1,500 randomly selected invoices, we estimated that federal agencies paid 76 percent of invoices by their due dates. See Prompt Payment Act: Agencies Have Not Fully Achieved Available Benefits (GAO/AFMD-86-69, August 28, 1986).

Table 3.1: Timeliness of Audited Invoice Payments According to Each State's Due-Date Criteria

	Invoices		Amount	
	Number	Percent	Dollars	Percent
Paid more than 7 days before due date	110	40.6	$4,850,551	24.7
Paid between 0 and 7 days before due date	89	32.8	12,923,402	65.7
Total Paid by Due Date	**199**	**73.4**	**17,773,953**	**90.4**
Within 15 days after due date	38	14.0	1,076,424	5.5
More than 15 days after due date	12	4.5	19,893	0.1
Total Paid After Due Date	**50**	**18.5**	**1,096,317**	**5.6**
Undeterminable due to missing data	17	6.3	760,968	3.8
Undeterminable due to a lack of timing criteria	5	1.8	45,867	0.2
Total Invoices Audited	**271**	**100.0**	**$19,677,105**	**100.0**

Note: For states in which due-date criteria provided in laws differed from criteria provided in administrative policies, we based our analysis on written administrative policies.

Vendors offered discounts on seven invoices in our sample. State agencies took two of these—one within the established discount period and one after the period had elapsed.

Interim payments on construction contracts were more likely to be paid on time and closer to their due dates than other types of payments. Of the 79 interim payments on construction in our sample, 92 percent were paid by their due dates. Interim construction payments that were paid on time were paid an average of 9 days before their due dates, while on-time payments for other goods and services were made an average of 11 days before their due dates. Late interim construction payments were paid an average of 3 days after their due dates versus an average of 16 days late for other goods and services.

Our sample also included four final payments on construction contracts. Of these, two were paid by their due dates. We could not determine whether the other two were on time or not because, for one, the final acceptance date had not been documented and, for the other, no timing criteria were available in either the related contract or state laws and administrative policies.

Missing Dates and Criteria Precluded Determination of Timeliness

Determining the timeliness of an invoice payment requires (1) payment-timing criteria provided either in the related contract or in laws or administrative procedures and (2) reliable documentation of key dates, such as the date an invoice is received or the date goods and services are received or accepted.

Although criteria and key dates were available for most of the invoices we audited, we could not determine a precise due date for 52 sample invoices because such data were not available. For 38 of these invoices, information needed to calculate due dates, such as the date an invoice was received or the date goods or services were received or accepted, had not been documented by state agency personnel. For the other 14 invoices, either no payment-timing criteria were available or the criteria were incomplete. These 14 were from North Carolina and Georgia, states which had not developed timing criteria for many types of payments.

However, we were able to conclude whether or not 30 of these 52 invoices had been paid on time based on other available data, such as vendors' invoice dates and various dates documented during payment processing, and on available criteria, such as payment periods included in contracts. Available data for the remaining 22 invoices were not sufficient for us to determine whether or not they were paid on time.

To ensure that key dates were available, some state agencies had developed standardized documentation mechanisms that prompted personnel to record needed dates and facilitated their subsequent identification. The following are examples of controls we found in the agencies we visited.

- Most of the agencies we visited dated invoices when they were received with a stamp identifying the receiving office.
- Pennsylvania's Department of Transportation used computer input screens that prompted the user for pertinent dates.
- Florida had developed a three-line stamp which was used by two of the three agencies we visited to record the invoice receipt date, the goods/services receipt date, and the goods/services acceptance date on the invoice. The purchase orders used by the third Florida agency we visited had preprinted spaces for recording these dates.
- New York, Virginia, Ohio, and Maryland used standard forms to record start dates or due dates, which were subsequently keyed into automated systems.

Some Payments Delayed During Processing

Some payments that we determined were on time according to state laws and administrative criteria were actually held up by delays in either submitting or receiving the invoice or in accepting delivered goods or completed services. In most cases, available documentation was not sufficient to determine whether the delays were the fault of the vendor or the state. Thirty of the invoice payments we examined, while technically paid by their due dates, were delayed from 10 to 96 days before the events necessary for a start date occurred. The following are examples of hidden delays that we discovered during our invoice audit.

- Date stamps indicating invoice receipt by various state agencies showed that 14 invoices were not received until between 15 and 66 days after the vendors' invoice dates. (We were not able to determine whether vendors sent the invoices in a timely manner or whether agencies promptly acknowledged receipt.)
- Four interim payments on highway construction projects in Maryland, which were on time according to state laws and policies, were paid between 52 and 85 days after the related work had been completed, in part because approvals by state auditors took from 10 to 28 days. According to state officials, when such approvals are required, they serve as the start date for measuring the state's 30-day payment period. An auditor responsible for examining these invoices told us that, although his office's review can be completed within one day, due to a heavy workload, the invoices in question had probably been delayed so that they could be examined with other invoices on the same contracts. He also said that it is sometimes more cost-effective to accumulate related invoices so that they can be reviewed as a group.

Timeliness According to Standard Criteria

The preceding analyses assess the success of the 12 states we visited in complying with their respective state laws and administrative policies regarding payment timing. However, because timing criteria varies from state to state, a payment that is considered on time in one state could be considered late if assessed according to another state's criteria. To offset these variations and provide an overall assessment of how quickly vendors are paid, we performed two additional analyses of the timeliness of the sample payments. The two criteria we used were the periods that elapsed between (1) delivery of goods or completion of services and payment and (2) the vendor's invoice date and payment. We used delivery of goods, completion of services, and vendors' invoice dates as "start dates" in these analyses because these dates generally are not subject to varying state criteria.

For these analyses, we deleted the four final payments on construction contracts from our sample because, as discussed in chapter 2, such payments are often subject to criteria that are significantly different from those applied to other types of payments. Our analysis of the remaining 267 invoices audited showed that payments were made an average of 37 days after the related goods had been delivered or services had been completed and an average of 40 days after the vendor's invoice date.

No Evidence of Interest Paid on Audited Invoices

According to state criteria, 26 of the 50 invoices that were paid after their due dates, including one improperly taken discount, were not subject to interest penalties. We could not find any indication that interest or other late payment penalties were paid to vendors on the remaining 24. The reasons interest was not paid, based on our discussions with state officials, are summarized in Table 3.2.

Table 3.2: Reasons Interest Was Not Paid on Payments Made After Their Due Dates

Reason	Number of invoices	
Payments subject to interest penalties:		
No evidence that vendor requested interest as required by state law or policy	14	
Oversight, administrative error, or no reason could be determined	10	
Total		24
Payments <u>not</u> subject to interest penalties:		
Payment was made during grace period	8	
Interest did not exceed $5 or $10 threshold specified in state laws or policies	3	
No requirement to pay interest existed either in state law or in contract	3	
Although contract specified a 30-day payment period, state policy precluded payment of interest until after 45 days (Michigan)	6	
Agency was not provided state funds to pay interest on federally funded payments (Ohio Bureau of Employment Services)	6	
Total		26
Total		**50**

We found no evidence that some of the states we visited were attempting to make vendors aware that they may be entitled to interest on late payments, and interest-penalty provisions were usually not disclosed in contracts. Only 26 of the 271 invoices we audited were supported by contracts that included specific interest-payment provisions. Officials in two states noted that it was in their states' interest to refrain from advertising interest penalty provisions because it would prompt vendors to request interest, resulting in additional administrative expenses to verify such claims. This reluctance to inform vendors of late-payment interest penalty provisions may account for the fact that vendors apparently did not request interest on the late payments we reviewed. However, three states had developed routine methods for notifying vendors of their rights to interest on late payments.

- Virginia published a booklet describing procurement and payment practices, including how vendors should go about requesting late-payment interest. Virginia officials told us this booklet was distributed to all vendors doing business with the state.
- Illinois planned to include a preprinted notice with payment checks to vendors informing them that they may be entitled to interest when payments were not timed in compliance with state law. Until the new remittance forms were available, agencies were to type this information on the remittance advice that accompanied checks sent to vendors.
- Florida's purchase order forms and bid instructions contained preprinted citations of the state's prompt payment statute and stated that payments were subject to interest penalties when not paid within prescribed time limits, thus ensuring that vendors were provided with this information.

Limited Cash Management Efforts Resulted in Many Early Payments

Timely payments not only fulfill a state's responsibility to its vendors, but also protect the interests of the public. However, if states pay bills involving federal funds well in advance of when payment is actually due, states may draw down federal cash balances sooner than necessary. This could cause the federal government to either lose opportunities to earn interest on cash balances or incur additional borrowing costs. To the extent that state funds are also used earlier than necessary, states will incur similar costs.

Avoiding Early Payment Could Save Federal and State Funds

Using the federal criteria that payments should not be made more than 7 days before they are due, we determined that 110 of the 271 payments we analyzed were made earlier than necessary. These 110, or 41 percent of the invoices tested, accounted for 25 percent of the dollar outlays associated with the sample payments.

Such early payments can result in hidden expenses for the governments whose funds are being used. For example, one state could have saved \$522 on a \$325,866 payment made 13 days before the due date if that payment had been made on the 7th day before the due date. This determination is based on the assumption that the state could have earned interest at an annual rate of 9.75 percent[2] by retaining the funds for an additional 6 days. While it may not be reasonable to expect payments to be made exactly on their due dates, the more precisely a payment can be timed, the greater the potential savings. If the payment in our example had been made precisely on the due date, the potential savings associated with this payment would increase by $608 to a total of about $1,130.

We analyzed sample invoices to determine the amount of savings available if invoices had not been paid early. For 103[3] invoices valued at $4.1 million that were paid more than 7 days before their due dates, we estimated that $7,500 could have been saved if payment had been made on the seventh day before these invoices were due. Our analyses were based on the assumption that, during the period within which our sample invoices were paid, states or the federal government could have earned 9.75 percent interest, stated as an annual rate, or avoided borrowing at the same rate. We did not attempt to ascertain how such savings would have accrued to federal versus state entities. This would depend on precisely when the state drew down the federal funds associated with the payments we reviewed.

Cash Management Efforts Were Often Not Effective

Payments were early because, in many of the agencies we visited, payment center personnel did not formally apply payment periods or determine precise due dates. Instead, they frequently paid invoices as quickly as possible after needed documentation was received, often on a first-in, first-out basis.

Seven of the states we visited had (1) written laws or administrative policies, (2) automated system features, or (3) a combination of these, to promote payment close to invoice due dates. However, in each of these states, the effectiveness of cash management policies was limited because they had not been successfully communicated to agency personnel, they were not compatible with other state policies, or agency systems were not capable of precisely scheduling payments.

[2]This is the rate for determining federal late-payment penalties that was in effect during the period of our review.

[3]Our analysis included only the 103 early payments for which we could determine a precise due date.

Three of the states we visited had program guidance clearly urging that payments not be made too early. Some of the cash management criteria in these three states were based on laws while others had an administrative basis. In contrast with federal criteria allowing payment to be made as early as 7 days before the due date, state guidance did not provide any specific instructions regarding how many days would be considered too early.

- A Pennsylvania management directive called for taking discounts, avoiding interest penalties, and paying nondiscounted invoices close to the due date. However, in the agencies we visited, only highway construction payments, which tend to be high-dollar, low-volume payments, were precisely timed to be paid on their due dates. The other Pennsylvania agency we visited had not developed written procedures for either formally determining due dates or precisely scheduling payments.
- North Carolina law called for state payments to be paid neither early nor late, but on the due date to the extent practical. Also, the state's cash management handbook called for maximizing investments of interest-bearing cash. However, North Carolina did not have statewide payment-timing criteria for most types of payments, and only one of the state's agencies we visited had independently developed criteria. As a result, unless timing criteria were provided in the purchase agreement, the state had no basis for determining due dates.
- California's administrative manual discouraged early payments because they reduce the amount of money the state can invest to earn interest. However, criteria provided in the manual, which stipulated payment within 30 days, had not been revised since 1975 and did not conform with more recent California laws, which required payment within 50 days. The payment processing personnel whom we talked with were generally not following any cash management guidance. Two of the California agencies we visited paid invoices as they were received, while all seven of the highway construction payments we examined were made precisely on their due dates.

Four states we visited, Virginia, New York, Maryland, and Michigan, had automated systems capable of precisely releasing payments by scheduled due dates on a routine basis. The systems required agency personnel to either calculate due dates or determine start dates so that an automated system could calculate the due dates. Payment data were then stored in the system until on or close to the due date. These systems appeared to work well when agency personnel entered correct dates. However, in each of these states, we talked with payment processing personnel who either did not calculate due dates or specified accelerated due dates which caused payments to be made early. For example, according to Michigan's Director of Accounting, that state's central payment system stored payments until 3 days before the agency-specified due date. However, two of the three Michigan agencies we visited did not routinely establish due dates, which resulted in their payments being processed immediately by the central system. About half of the Michigan invoices we examined were paid more than 9 days before their due dates.

The other five states we visited generally paid invoices as soon as they could. The overall view expressed by officials in these states was that, because of various approvals and manual processing steps involved in the payment process, they were much more concerned about avoiding late payments than early payments and, as a result, placed little emphasis on this aspect of cash management. A Florida official told us that his state's philosophy was to pay vendors as quickly as possible and that early payments were not discouraged. We determined that 9 of the 20 Florida payments we examined were paid more than 7 days before their due dates.

Informed Staff Essential to Compliance

Regardless of the automated and procedural control techniques that have been developed in many states to ensure proper payment timing, compliance ultimately depends on how well payment-center staff understand the criteria they are to apply. Although most of the invoices we examined at the 12 states visited were paid by their due dates, we identified instances where personnel (1) did not apply payment-timing criteria and, as a result, scheduled payments to be paid too early or too late, (2) did not pay interest penalties due, or (3) did not document key dates.

Routine monitoring of agency payment operations can help ensure that personnel understand procedures and that payments are being timed consistently and in accordance with state criteria. Of the 12 states visited, Florida, Georgia, New York, Pennsylvania, Maryland, and Virginia routinely gathered statewide information regarding the number, amount, and causes of late payments. Their reports also summarized payment activities by agency, thus further identifying those agencies which were not complying with prompt payment policies. In addition, reports by state auditors in Virginia, Florida, Ohio, and North Carolina included assessments of compliance with payment-timing provisions. Four states that we visited (California, Illinois, Michigan, and Texas) told us that they did not actively oversee agency compliance with payment-timing provisions.

Observations on the Impact of Federal Requirements

During congressional consideration of federal Prompt Payment Act amendments, which were enacted in October 1988, the need for legislation designed to ensure that states pay vendors in a timely manner when they are using federal funds was also discussed. Proposals ranged from (1) having states apply the same criteria to federally funded payments as those used by federal agencies to (2) allowing states to use the same criteria for federally funded payments that they apply to payments involving only state funds. A third alternative, which combines elements from both of the first two proposals, involves requiring states to develop minimum payment-timing criteria that would apply to federally funded state payments.

While it is ultimately up to the Congress to determine what course of action, if any, is needed to improve the timeliness of federally funded state payments to vendors, we offer the following observations based on our visits to 12 states, the information and comments we received in questionnaire responses, and our analysis of the laws of the 7 states that did not respond to our questionnaire.

Impact Would Vary Depending on Requirements

Establishing payment-timing criteria that states would have to apply when using federal funds would require changes in state payment systems and procedures. The amount of modification needed would increase according to the level of detailed criteria in any such federal requirements. The overall effects of each of the three alternatives we considered are discussed below.

Requiring that states time federally funded payments according to provisions that govern federal agencies would require some system and procedural changes in every state and the District of Columbia. Such changes would be needed because none of the states included in our review had developed criteria that were identical to those provided by the federal Prompt Payment Act. In addition, as reported in our March 1989 report, the criteria provided by the laws of the seven states that did not respond to our questionnaire differed in some aspects from the federal criteria.

Most states have developed basic due-date criteria that they apply to both state and federally funded payments. States whose laws and administrative requirements differ significantly from federal requirements would have to either apply federal requirements to all payments, including those funded by the state, or modify their systems to accommodate two streams of payments—one involving federal assistance and one for solely state-funded payments. Either option would require the states to make corresponding changes to written policies and procedures and to automated payment-timing features. Similarly, states whose systems cannot readily identify payments involving federal funds would have to either develop coding systems to distinguish between funding sources or use the same payment-timing criteria for both federally funded and state-funded payments.

Requiring states to develop and apply minimum payment-timing criteria to federally funded payments would result in fewer procedural and system changes. Such a requirement would allow states that have already addressed key aspects of payment timing to continue applying the criteria they have developed, even though these criteria may differ somewhat from the federal rules. States that have not developed criteria related to the minimum requirements would have to do so.

To assess the potential impact of this alternative, we determined the number of states with criteria that included

- a specified payment period and start date,
- automatic payment of interest on late payments, and
- a requirement that contractors pay subcontractors within a specified time frame.

Of the 44 governments included in our review, 38 governments had payment periods and start-date criteria applicable to most types of payments. Seven additional states, which we did not visit and which did not respond to our questionnaire, had prompt payment laws that appeared to provide these criteria. Thus, under this "minimum criteria" option, 45 of the 51 governments would not have to significantly alter the timing aspects of their systems. However, about half of the 44 governments included in our review did not pay interest automatically and a similar number had not developed timing criteria for payments to subcontractors. Thus, many governments would have to change at least some of their current practices, if the federal government required states to develop and apply criteria in these two areas. Six states (California, Florida, Hawaii, Mississippi, New York, and South Dakota) had established criteria for all of the payment-timing factors listed above and, therefore, would not need to supplement or revise their criteria.

Requiring that states apply their existing prompt payment laws to federally funded payments would have little or no impact on existing systems and procedures in most states. As we noted previously, states generally do not differentiate between federal and state funds for payment-timing purposes. Only the few states that currently exempt federally funded payments from late-payment interest penalty provisions or other criteria would be affected and need to revise their existing practices.

Cost Considerations

An additional issue that could arise from any federal direction to alter state payment policies is the resulting cost. States would incur costs to modify their respective payment systems to comply with federal requirements, and the payment of interest penalties may increase if all states are required to pay such penalties automatically. Several state officials indicated to us that, if federal requirements were imposed, they would expect (1) to be compensated for the cost of required system changes and (2) to be allowed to use federal funds to pay interest penalties.

Comments From State Officials

Based on responses to our inquiries during state visits and to our questionnaire, most state officials were not receptive to the implementation of federally imposed requirements. We held discussions with and received numerous written comments from high-level officials responsible for payment operations, including deputy comptrollers and directors of accounting or administration. Examples of their comments, which typify those received from other state officials, are summarized below.

- The additional administrative burden associated with ensuring statewide compliance with two prompt payment laws, one for federal funds and one for state funds, would be unreasonable. A requirement that states follow the provisions of the federal Prompt Payment Act would essentially mandate that the state change its prompt payment law to be in conformance with federal law.
- States that have already enacted prompt pay legislation should be excluded from any proposed federal criteria.
- Some states do not currently have a viable means of identifying which invoices are paid with federal funds and which are paid with state funds. One official said that confusion would arise over when interest was to be paid automatically and when vendors were to submit a request. An official in another state estimated that the imposition of federal criteria would require his state's agencies to develop a means of segregating approximately 1 million invoices monthly according to funding source.

- The federal government should pay the cost of redesigning state and local government payment systems to comply with federal requirements.
- If federal criteria were enacted, the states would need a phase-in period of several years to make necessary system and procedural changes.
- The costs would be considerable; the benefits to vendors doing business with states are unclear.

States Included in Our Review

State	Visited	Responded to our detailed questionnaire[a]
Alabama		X
Alaska		X
Arizona		X
Arkansas		X
California	X	
Colorado		X
Connecticut		X
Delaware		
District of Columbia		X
Florida	X	
Georgia	X	
Hawaii		X
Idaho		
Illinois	X	
Indiana		
Iowa		X
Kansas		X
Kentucky		X
Louisiana		X
Maine		
Maryland	X	
Massachusetts		X
Michigan	X	
Minnesota		X
Mississippi		X
Missouri		X
Montana		X
Nebraska		X
Nevada		X
New Hampshire		X
New Jersey		X
New Mexico		X
New York	X	
North Carolina	X	
North Dakota		
Ohio	X	
Oklahoma		X
Oregon		
Pennsylvania	X	

(continued)

State	Visited	Responded to our detailed questionnaire[a]
Rhode Island		X
South Carolina		X
South Dakota		X
Tennessee		
Texas	X	
Utah		X
Vermont		X
Virginia	X	
Washington		X
West Virginia		X
Wisconsin		X
Wyoming		X
Total	**12**	**32**

[a]We also sent a less comprehensive questionnaire to the 12 states that we visited. The responses to this questionnaire supplemented information obtained during our on-site visits.

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