



March 30, 2006

NICHOLAS F. BARRANCA
VICE PRESIDENT, PRODUCT DEVELOPMENT

SUBJECT: Audit Report – Hybrid Services
(Report Number MS-AR-06-001)

This report presents the results of our self-initiated, nationwide audit of hybrid services offered by the Product Management group (Project Number 05WG013MS000). We determined whether adequate controls were in place to track revenue related to hybrid services revenue sharing agreements during fiscal years 2004 and 2005.

The Product Management group does not have adequate controls in place to validate the amount of production or postage revenue submitted by hybrid services partners. Without adequate internal controls, the Product Management group cannot determine whether the U.S. Postal Service received the appropriate amount of revenue from hybrid services partners.

We recommended that Postal Service management identify and coordinate with a Postal Service group outside of the Product Management group, such as the Marketing Technology and Channel Management group, or a third party contractor, to generate test transactions for each of the hybrid services. We also recommended that Postal Service management determine the feasibility of each of the hybrid services partners establishing a mailing permit strictly for hybrid services mailings.

Management agreed with our recommendations and has initiatives planned addressing the issues in this report. Management did not concur with our finding. We remain concerned that the Product Management group cannot determine whether the Postal Service received the appropriate *amount* of revenue from the hybrid services partners. Management's comments and our evaluation of these comments are included in the report.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have any questions or need additional information, please contact Robert Mitchell, director, Marketing, or me at (703) 248-2300.

E-Signed by Mary Demory 
VERIFY authenticity with Approve!


Mary W. Demory
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Attachments

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EXECUTIVE SUMMARY

Introduction

This report presents the results of our self-initiated audit of the U.S. Postal Service Product Management¹ group's hybrid services program. We determined whether adequate controls were in place to track revenue related to hybrid services revenue sharing agreements during fiscal years 2004 and 2005.

Results in Brief

Controls in place to track revenue related to hybrid services revenue sharing agreements are not adequate. Specifically, the Product Management group cannot validate the amount of production or postage revenue submitted by hybrid services partners.

Without adequate controls in place to ensure the accuracy of production and postage revenue, the Product Management group is unable to determine whether the Postal Service is receiving the appropriate amount of revenue from hybrid services partners.

Summary of Recommendations

We recommended Postal Service management identify and coordinate with a Postal Service group outside of the Product Management group, such as the Marketing Technology and Channel Management group, or a third party contractor, to generate test transactions for each of the hybrid services. We also recommended that Postal Service management determine the feasibility of each of the hybrid services partners establishing a mailing permit strictly for hybrid services mailings.

Summary of Management's Comments

Postal Service management agreed with all four of our recommendations. The Product Management group will work to implement the four recommendations made in the report and they will also work with the hybrid services partners to establish an audit process verifying production and postage revenue. However, management did not concur with our finding that the Product Management group does not have adequate controls to validate the production or postage revenue submitted by hybrid services partners. Management's comments, in their entirety, are included in the appendix of this report.

¹ The Product Management group was the parent group of the Alternative Mail Solutions (AMS) group. The AMS group has been dissolved and is now referred to by its parent group's name, Product Management.

Overall Evaluation of Management's Comments

Management's comments are responsive to the recommendations and actions planned should correct the issues identified in our report.

Regarding management's disagreement with our finding, the Product Management group stated the revenue is being adequately accounted for through the use of the Business Development Measurement Database (BDMD). We noted on page 5 of our report that problems with the BDMD software have been corrected, and payments from the hybrid services partners can now be compared to the BDMD. All that remains is to reduce the risk that hybrid services partners might not report all revenue to which the Postal Service is entitled. Implementing our recommendations should reduce this risk.

INTRODUCTION

Background

The U.S. Postal Service Product Management group currently manages three hybrid services revenue sharing programs: NetPost CardStore (CardStore), NetPost Premium Postcard (Premium Postcard) and NetPost Mailing Online (Mailing Online). The combined production² and postage³ revenue the Postal Service received from the hybrid services partners was \$6.45 and \$7.77 million in fiscal years (FY) 2004 and 2005, respectively.

These hybrid mail services combine electronically generated mail with hard copy mail for delivery by the Postal Service. Customers access the hybrid services through the Postal Service website, where they can link to the partner companies for any of the three services chosen. For each hybrid service, the Postal Service has revenue sharing agreements with partner companies that provide the hard copy production of customers' orders and share an agreed-upon percentage of the revenue from the customers' orders with the Postal Service. The Postal Service receives all postage revenue from these transactions.

Using CardStore, a printing and mailing service, customers can electronically create a greeting card that is mailed to another party or back to themselves for personalization. Effective in September 2004, the Postal Service expanded its original contract with its partner, Touchpoint Incorporated, to include gift cards for a variety of retailers.

With Premium Postcard, another printing and mailing service, customers can produce customized full-gloss postcards online and have the cards printed and mailed by the Postal Service. AmazingMail Incorporated entered into an agreement with the Postal Service in March 2001 to establish Premium Postcard as a revenue sharing program.

Mailing Online allows customers to create postcards, flyers, letters, and booklets on their computers and have them professionally printed and mailed the next day. Rich

² Production revenue is revenue received from hybrid services partners from their sales of products.

³ Postage revenue is revenue received from hybrid services partners from their purchase of indicia.

Graphics Corporation (RGC) entered into an agreement with the Postal Service in September 2003 to establish Mailing Online as a revenue sharing program.

By entering into a revenue sharing agreement with RGC, the Postal Service reduced its operating costs, reducing the Product Management group's hybrid services budget from \$855,000 in FY 2004 to \$50,000 in FY 2005. The \$50,000 in FY 2005 was for database maintenance and upgrades.

Objective, Scope, and Methodology

Our objective was to determine whether adequate controls were in place to track revenue related to hybrid services revenue sharing agreements for the period FYs 2004 through 2005.

To accomplish our objective, we interviewed Postal Service officials in the Product Management group, Business Evaluations, Segment Advertising, Law Department, and Supply Management. We reviewed contracts, agreements, and scorecards associated with hybrid services. We also reviewed applicable sections of the *Postal Service's Strategic Transformation Plan*.

We reviewed data on postage, the general ledger, and the Business Development Measurement Database (BDMD).⁴ We also reviewed copies of electronic funds transfers and checks provided by Product Management officials for FY 2004 through April 2005. We conducted limited testing to assess the reliability of the total production revenue data from the BDMD and found the data sufficiently reliable to meet our objective. However, we did not assess the reliability of other data obtained from Postal Service databases; therefore, we base no conclusions or recommendations solely on those data.

We conducted this audit from May 2005 through March 2006 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. We reviewed management controls over the hybrid services as they related to the audit objective. Specifically, we reviewed policies and procedures and held

⁴ The BDMD is a Postal Service database used by the Product Management group to collect revenue information on production and postage, based on transaction-level data provided by the business partners.

discussions with program officials to determine whether controls were adequate to track revenue related to hybrid services revenue sharing agreements. We discussed our observations and conclusions with management officials and included their comments where appropriate.

Prior Audit Coverage

In our audit report, *Financial Performance of eCommerce Initiatives-Net Post Services Program* (Report Number OE-AR-03-007 dated September 30, 2003), we reported that the program fell short of the original financial projections approved by the Board of Governors (BOG), and the Postal Service had used an inadequate basis for revising revenue projections. We also reported that the Postal Service had not prepared and submitted to the BOG a modification to the original Decision Analysis Report, and the *Investment Highlights* reports to the BOG did not include key performance information.

We recommended that management take immediate action to obtain updated market research data, incorporate these data into revised projections for the NetPost Services program, and assess the impact the Postal Service's partnership with other hybrid mail companies could have on the NetPost Services program. We recommended management assess the program's viability to determine whether continued investment is in the best interest of the Postal Service, and if so, prepare and submit to the BOG a Decision Analysis Report Modification Request. We also recommended that they identify key performance measures for the NetPost Services program and require these measures to be reported to the BOG if the program is continued.

Subsequent to fieldwork, but before we issued our final report, the Postal Service converted the Mailing Online component of the hybrid services program into a revenue sharing agreement with RGC.

Management disagreed, in whole or in part, with all five of the recommendations, stating that since it was making changes to the Mailing Online component of the hybrid services program, the recommendations were no longer valid.

AUDIT RESULTS

The Product Management group does not have adequate controls to track revenue related to hybrid services revenue sharing agreements. Specifically, the group cannot validate the production or postage revenue submitted by hybrid services partners.

Analysis of Controls Over the Hybrid Services

The Product Management group does not have adequate controls to validate the production or postage revenue submitted by hybrid services partners. This is due to the Product Management group's belief that the partners would not jeopardize their business relationship with the Postal Service. Without adequate internal controls, the Product Management group cannot determine whether the Postal Service received the appropriate amount of revenue from the hybrid services partners.

The *Strategic Transformation Plan* states:

. . . Through Enterprise Risk Management, the Postal Service will enhance its system of internal controls to evaluate and control risk and enhance business performance. It will act to eliminate risk revealed by internal control reviews. Managers will be held accountable for the ongoing application and assessment of internal controls in their areas of responsibility. . . .⁵

We believe adhering to this guidance will provide the Product Management group with adequate control over revenue.

The Postal Service has basic controls in place over hybrid services. For example, the manager of the Alternative Mail Solutions group (now referred to as the Product Management group) said the Postal Inspection Service conducted site surveys at the partners' business locations to check building and server security. In addition, the manager stated that when one of his team members uses the hybrid services for personal use, the transaction is tracked to verify that the Postal Service received the appropriate revenue share and postage from that transaction, and that the Product Management group makes unannounced site visits

⁵ *United States Postal Service Strategic Transformation Plan*, September 2005, Enhance Corporate Financial Responsibility, page 40.

to the partners' business locations to monitor their processes. However, these controls are not adequate to validate production and postage revenue reported by the business partners.

Production Revenue	<p>The Postal Service does not have an adequate method of ensuring the accuracy of production revenue provided under agreements with its hybrid services partners. Although the Product Management group reported year-end production revenue of approximately \$528,000 for FY 2004 and \$890,000 for FY 2005, the group had no method of ensuring that the Postal Service was provided with the correct amount of revenue from the hybrid services partners.</p> <p>We could not validate the accuracy of the hybrid services partners' payments to the Postal Service for production revenue because the total dollar amount of the electronic funds transfers and checks received by the Postal Service did not always match the information in the BDMD. Errors in the BDMD software caused the BDMD to report inaccurate production revenue. During our review, the Product Management group corrected the problems with the BDMD software so they can compare payments from the hybrid services partners to the BDMD.</p> <p>Although the Product Management group corrected problems with the BDMD software, the corrections will not ensure the accuracy of the partners' production revenue data used to populate the BDMD.</p> <p>Coordinating with Postal Service groups outside the Product Management group to generate test transactions for each of the hybrid services would improve controls over the accuracy of revenue reported by hybrid services partners. Test transactions could provide the Product Management group with data on the ordering and receipt of goods, as well as information on print quality and the timeliness of mailings.</p>
Postage Revenue	<p>We also could not validate the accuracy of the postage revenue data in the BDMD because the hybrid services partners do not have separate permits for hybrid services mailings. Specifically, hybrid services partners combine hybrid services mail with non-hybrid services mail, which does not allow separate tracking.</p>

Validating the postage revenue⁶ reported by the hybrid services partners would require contacting business mail entry units for permit information on the partners' mailings. However, we learned from the Product Management group that hybrid services partners do not have separate permits that they use only for hybrid services mailings.

The Product Management group reported postage revenue of \$5.92 million for FY 2004 and \$6.88 million for FY 2005. Without knowing whether the production revenue is accurate, and because the hybrid services partners do not have permits that they use only for hybrid services mailings, the Product Management group has no method of validating the accuracy of postage revenue received from the hybrid services partners.

If each hybrid service partner established a mailing permit used only for hybrid service mailings, this would allow the Product Management group to validate the postage revenue reported by the partner.

Recommendations

We recommend the vice president, Product Development, direct the manager, Product Management, to:

1. Identify and coordinate with a Postal Service group outside of the Product Management group, such as the Marketing Technology and Channel Management group, or a third party contractor, to generate test transactions for each of the hybrid services.
2. Coordinate with the Postal Service Office of Statistics to determine the number of test transactions necessary to give the Product Management group sufficient data on the ordering and receipt of goods from the test transactions, as well as information on print quality and timeliness of mailings.
3. Compare the test transaction data obtained in recommendations 1 and 2 to the Business Development Measurement Database to determine whether the data and resulting revenue from each test transaction were accurately reported in the Business Development Measurement Database.

⁶ We learned from the Product Management group that even using permits, residual postage such as stamps would not be captured. The Product Management group agreed that dedicated permits could improve postage tracking.

4. Determine the feasibility of each of the hybrid services partners establishing a mailing permit strictly for hybrid services mailings.

<p>Management's Comments</p>	<p>Postal Service management agreed with all four of our recommendations; however they did not concur with our finding that the Product Management group does not have adequate controls to validate the production or postage revenue submitted by hybrid services partners. The Product Management group stated the revenue is being adequately accounted for through the use of the BDMD.</p> <p>For recommendation 1, management stated the Product Management group will identify and coordinate a proposal to generate test transactions. By March 2007, Marketing executive management will evaluate the feasibility of the proposed options and develop a course of action. For recommendation 2, management stated by September 2006, the Product Management group will identify the appropriate functional area to determine the quantity of test transactions required to achieve a statistically valid confidence level. If recommendations 1 and 2 produce usable data, the Product Management group will implement recommendation 3 as quickly as resources permit. For recommendation 4, management stated by September 2006, the Product Management group will explore the feasibility and efficacy of each of the hybrid services establishing permits strictly for hybrid services mailings.</p>
<p>Evaluation of Management's Comments</p>	<p>Management's comments are responsive to recommendations 1, 2, 3, and 4. Management's planned actions should correct the issues identified in our report.</p> <p>Regarding management's disagreement with the finding, we noted on page 5 of our report that problems with the BDMD software have been corrected, and payments from the hybrid services partners can now be compared to the BDMD. All that remains is to reduce the risk that hybrid services partners might not report all revenue to which the Postal Service is entitled. Implementing our recommendations should reduce this risk.</p>

APPENDIX. MANAGEMENT'S COMMENTS

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March 10, 2006

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SUBJECT: Transmittal of Draft Audit Report – Hybrid Services
(Report Number MS-AR-06-DRAFT)

This responds to the above mentioned Audit Report dated February 17, 2006, which investigated the controls in place to track revenue related to USPS Netpost Services during years 2004 and 2005. Concluding that the USPS does not have adequate controls in place to track revenue, it recommends that third-party test transactions be implemented and unique permit imprints be required as measures that will provide quantifiable data to access the accuracy of reported revenues.

The Product Management Group does not concur with the OIG assessment that adequate controls are not in place to validate the amount of production or postage revenue submitted by hybrid services partners. The current volume of business and total revenue produced by the three alternate mailing services; Premium Postcards, Card Store and Mailing Online, is being adequately accounted for through the Business Development Measurement Database (BDMD). The use of such a system is commensurate with the organization's need to balance a reasonable assurance of accurate accounting with the practical need to minimize costs to stay competitive in the marketplace.

However, after review Product Management does agree to work with each business partner to establish an on-site audit process in the coming year which is detailed later in this response. This option will improve discovery and better identify potential errors in revenue and postage calculation and reporting without adding substantive attributable costs to the program(s).

Recommendation [1]:

Identify and coordinate with a Postal Service group outside of the Product Management group, such as the Marketing Technology and Channel Management group, or a third party contractor, to generate test transactions for each of the hybrid services.

Response

We agree to explore this recommendation to determine if it can be developed and implemented in such a way as to be cost neutral to the final price of the service(s) and it adds more than simply qualitative data to help identify potential errors in accounting. Obtaining statistically relevant information via this method may prove too costly, but the approach will be examined. As the audit notes, there may be some ancillary benefits to conducting such mailings, even if statistical relevance to production and postage revenues cannot be accurately correlated.

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Product Management will identify and coordinate a proposal to generate test transactions for each of the hybrid services. This proposal will be completed by the end of FY 2006. At proposal completion, Product Management, along with USPS Marketing executive management, will evaluate the feasibility of the proposed options and develop a course of action. This will be complete by March 2007.

Recommendation [2]:

Coordinate with the Postal Service Office of Statistics to determine the number of test transactions necessary to give the Product Management group sufficient data on the ordering and receipt of goods from the test transactions, as well as information on print quality and timeliness of mailings.

Response

We will comply with this recommendation as we work to devise a plan for Recommendation #1. Product Management will identify the appropriate functional area with expertise in determining the quantity of test transactions required to achieve a statistically valid confidence level in representing the total population of transactions. To the extent it is possible and makes economic sense, we will attempt to also gather beneficial information regarding any print quality issues and a measure of delivery timeliness. It must be noted, however, that with 100,000 customers, over 500,000 transactions, and 91 Million mailpieces since inception of these programs, complaints on either of these issues have been relatively nonexistent.

This assessment will be complete by September 2006.

Recommendation [3]:

Compare the test transaction data obtained in recommendations 1 and 2 to the Business Development Measurement Database to determine whether the data and resulting revenue from each test transaction were accurately reported in the Business Development Measurement Database.

Response

If Recommendations 1 and 2 produce a tracking mechanism that can provide usable audit data, Product Management agrees to implement this recommendation and verify the accuracy of data reported through the BDMD. Depending upon the number of transactions involved, Product Management will implement this recommendation as quickly as resources permit.

Recommendation [4]:

Determine the feasibility of each of the hybrid services partners establishing a mailing permit strictly for hybrid services mailings.

Response

Product Management agrees to explore the feasibility and efficacy of requiring that each hybrid services partner establish a mailing permit strictly for use with USPS hybrid services mailings. This assessment will be completed by September 2006. However, such a practice will have very limited value in providing new audit capability. It is neither practical nor desirable to require the segregation of USPS volume from other partner volume on any given day because of the deeper discounts achieved through density of sortation, other scales of economy obtained through multiple order integration and processing efficiencies the Postal Service will experience through finer depth of sort.

Summary:

As noted, Product Management will work with each of its three NetPost Business Partners to establish an audit process verifying production and postage revenue. Borrowing from experience with optional procedure postage payment systems, the audit trail will consist of the partners' own production records, financial documents and postage payment documents. It is envisioned that the audits will be conducted on-site at the partner's premises and will likely take place at a

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reasonable frequency that is prudent and cost-effective. Their information will be validated against BDMD data for accuracy and completeness.

We feel it necessary to point out that this audit was self-initiated by the OIG. It was not undertaken because of any hint or suspicion of revenue reporting inaccuracy or impropriety. The audit was merely an evaluation to ensure that appropriate measures are in place to assess the continued accuracy of the BDMD.

This report contains no FOIA exempt information.



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