

July 31, 2000

WILLIAM J. HENDERSON  
POSTMASTER GENERAL,  
CHIEF EXECUTIVE OFFICER

SUBJECT: Interim Report - Economic Value Added  
Variable Pay Program  
(Report Number LB-AR-00-001)

This interim report is issued as part of our overall review of the economic value added variable pay program (EVA<sup>®1</sup>), (Project Number 00EA012LM001). We are continuing to analyze the economic value added formula and its application. After reviewing projected incentives for the current year, we believe the economic value added formula may permit incentives to postal executives that could negatively impact public perceptions of the Postal Service. We believe the potential risk posed by this issue warrants immediate attention.

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**Results in Brief**

Economic value added variable pay program incentives as a percentage of net income have increased annually from 16 percent of net income in fiscal year (FY) 1996 to an estimated 325 percent of net income in FY 2000.

The Postal Service is forecasting the lowest net income, \$100 million, since the inception of the economic value added program. At the same time, the Postal Service has requested a postal rate increase and is considering a reduction in workforce. However, as currently configured, the economic value added formula may still permit executives to receive significant economic value added incentives as a result of current year performance.

We recognize that when the economic value added variable pay program was developed, management and the Governors were aware that economic value could be

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created and resulting incentive payments could occur even in periods of declining net income.

However, indexing operating revenues for the purpose of calculating incentives has allowed the economic value added incentive funding pool to increase during a period of declining net income and goal achievement.

We also recognize the economic value added formula is based on the attainment of a number of goals, only one of which is net income. However, net income is arguably the most visible and objective measure of Postal Service performance, particularly to the general public and rate-paying customers. When economic value added incentives exceed net income, management increases the risk that the public will perceive that Postal Service officials do not place appropriate emphasis on achievement of financial goals. We recommend the postmaster general advise the Compensation Committee of the Board of Governors on the trends of economic value added payments, goal attainment, and net income. In addition, to mitigate the risk of negative public perception, we recommend that alternatives to the current projected economic value added payout be considered and presented to the Compensation Committee.

Management agreed with our recommendation to advise the Compensation Committee on trends, however, management disagreed with our recommendation to consider developing an alternative to the current projected economic value added payout. Management comments, in their entirety, are included in Appendix B.

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## Background

The Postal Service implemented the economic value added variable pay program in FY 1996. It is a group incentive based on an economic value added financial measure developed by the Postal Service. Approximately 84,000 employees in the Postal Career Executive Service and executive and administrative schedule participate in the program. Participants receive percentage-of-salary bonuses based on the achievement of performance targets established under the three voices of *CustomerPerfect!* (Voice of the Customer, Voice of the Employee, and Voice of the Business) approved by the Board of Governors. The incentives earned are credited to individual reserve accounts maintained by the Postal Service. Each

December, participants receive lump-sum distributions of 33 percent of the reserve account balances. In FY 1998, the Postal Service established FY 1997 as the base-year for the purposes of calculating the national economic value added financial measure. As a result, management adjusts operating revenues for the effects of inflation and rate case increases. The Postal Service calculates the national economic value added based on a formula illustrated at Appendix A.

This formula yields an indexed national economic value added figure that management uses as the basis to determine the variable pay program incentive pool. For FY 2000, the incentive pool is funded with 65 percent of the first \$400 million of indexed national economic value added plus 25 percent of any additional amount. To illustrate, an indexed national economic value added of \$1 billion would yield an incentive pool totaling \$410 million (\$400 million times 65 percent plus \$600 million times 25 percent).

To ensure a balanced focus on the three voices of the Postal Service—Customers, Employees, and Business—distributions from the incentive pool are based equally (1/3 each) on each organizational unit<sup>2</sup> achieving performance targets established annually for the indicators under the three voices of *Customer Perfect!*. If all targets pertaining to each voice are met, participants earn 100 percent of their incentive. For each target not met, incentives are reduced by the weight for that target.

Voice of Customer targets are based on achieving on-time delivery of external First-Class and Priority Mail. Voice of Employee targets are based on the results of facility, safety, and health evaluations, receipt of favorable responses to employee surveys, and reductions in the rate of lost workday injuries. Voice of Business targets are established based on achieving specified levels of national net income (for FY 2000, the target was \$100 million) and productivity improvements over thresholds established by management.

When participants are unable to achieve established targets, incentives are reduced by the weight given to the particular target. For instance, national net income makes

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<sup>2</sup> Postal Service Headquarters, area office, and performance cluster.

up one-half of the one-third weight given to Voice of Business targets for headquarters and area office participants. Inability to achieve this target would reduce incentives for these participants by 16.7 percent, or approximately \$68 million (using the indexed national economic value added in the example above).

**Objective, Scope, and Methodology**

The overall objective of the ongoing audit is to determine if the economic value added variable pay program is effectively managed. The specific objective of this portion of our review was to evaluate the relationship of economic value incentives to achievement of related goals, including net income. We met with personnel at Postal Service Headquarters, Management Associations, and Unions, and analyzed financial information pertaining to the program. We conducted this portion of the audit between April and July 2000 in accordance with generally accepted government auditing standards and included tests of internal controls as were considered necessary under the circumstances. We discussed our conclusions and observations with appropriate management officials and included their comments, where appropriate.

**Economic Value Added Incentives as a Percentage of Net Income**

Economic value added variable pay program incentives as a percentage of net income have increased annually since inception. As depicted by the chart below, incentives have risen from 16 percent of net income in FY 1996 to an estimated<sup>3</sup> 325 percent of net income in FY 2000.

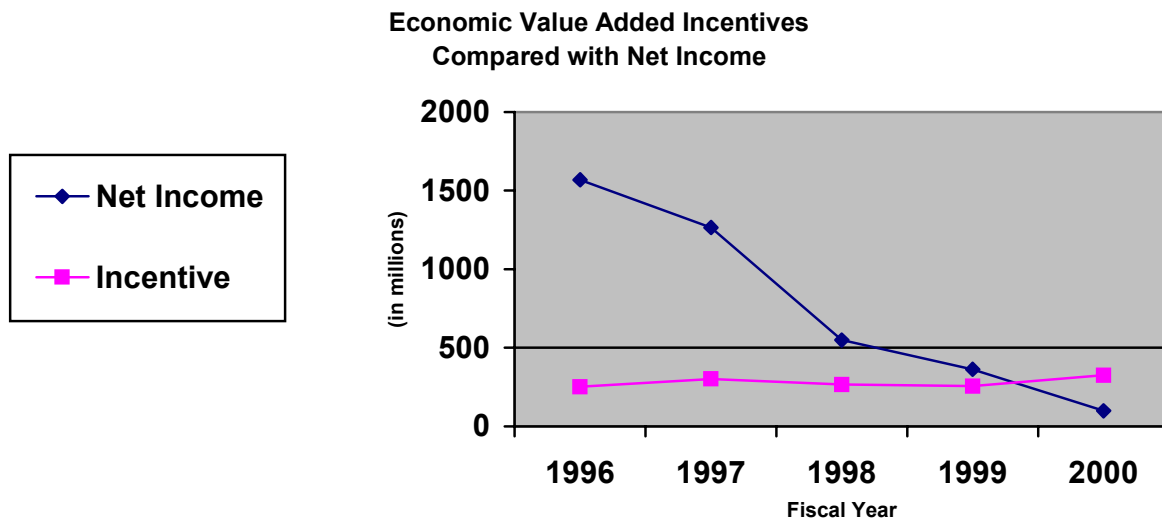
**Economic Value Added Incentives  
as a Percentage of Net Income  
(in millions)**

<u>FY</u>	<u>Net Income</u>	<u>Incentive</u>	<u>% Net Income</u>
1996	\$1,567	\$252	16%
1997	\$1,264	\$302	24%
1998	\$ 550	\$266	48%
1999	\$ 363	\$256	71%
2000 <sup>4</sup>	\$ 100	\$325	325%

<sup>3</sup> Based on projections as of accounting period 07 and goal accomplishment of 60 percent.

<sup>4</sup> Estimate as of accounting period 07.

For FY 2000, the Postal Service is forecasting the lowest net income since the inception of the economic value added program, \$100 million. At the same time, the Postal Service has requested a postal rate increase and is considering a reduction in workforce. However, as currently configured, the economic value added formula may still yield significant incentives for the current year. Postal Service net income has declined while incentives have remained relatively stable, providing the appearance that incentives are not clearly linked to Postal Service financial performance:



Similarly, comparing incentives earned since 1998 with economic value added goal attainment percentages makes it appear declining goal achievement has little impact on the amount of incentive earned:

<u>FY</u>	<u>EVA Goal Achievement %</u>	<u>Incentive Earned</u>
1998	90%	\$266 Million
1999	80%	\$256 Million
2000 <sup>5</sup>	60%	\$325 Million

The increase in the percentage of incentives to net income results primarily from the Postal Service's decision to index operating revenues to the base year of FY 1997. Indexing

<sup>5</sup> Estimate as of accounting period 07.

has allowed the national economic value added figure used to compute the incentive funding pool to increase during a period of declining net income. The inflation adjustment's impact on the indexed national economic value added is provide below:

<u>Revenue Adjustments</u>	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000<sup>6</sup></u>
+ Inflation	\$973 Million	\$ 2.4 Billion	\$ 4.2 Billion
- Rate Increase	( 74 Million)	(1.3 Billion)	(1.9 Billion)
Net Adjustment	\$899 Million	\$ 1.1 Billion	\$ 2.3 Billion
Indexed Nat. EVA	\$512 Million	\$552 Million	\$ 1.5 Billion

As portrayed above, in no year since indexing was initiated has there been a positive economic value added prior to the inflation adjustment.

We recognize the economic value added formula is based on the attainment of a number of goals, only one of which is net income (16.7 percent of incentive). However, net income is perhaps the most visible and objective measure of Postal Service performance--particularly to the general public and rate paying customers. Therefore, when financial goals are not achieved or economic value added incentives exceed net income, management increases the risk the public will perceive that Postal Service officials do not place appropriate emphasis on achieving financial goals.

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**Audit Comment**

Following initial disclosure of our concerns to senior Postal Service management, we were advised the Postal Service is considering a reduction in the inflation factor used in computing the national economic value added financial measure from 6.7 percent to 5.9 percent. In addition, management revised the estimated goal attainment from 60 percent to 43 percent. Implementation of these changes would decrease the estimated FY 2000 incentive from \$325 million to \$180 million. We are continuing to evaluate the economic value added formula and may further address this issue in our final report on the program.

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<sup>6</sup> Estimate as of accounting period 07.

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**Recommendations**

We offer the following recommendations:

The postmaster general should:

1. Advise the Compensation Committee of the Board of Governors on the trends of economic value added payments, goal attainment, and net income presented in this report.
2. Consider developing alternatives to the current projected economic value added payout to mitigate the risk of negative public perception and presenting these alternatives to the Compensation Committee of the Board of Governors.

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**Management's  
Comments**

Management concurred with the first recommendation and on July 10, 2000, advised the full Board of Governors on the trends of economic value added payments, goal attainment, and net income presented in the report. However, management disagreed with the second recommendation and stated that they feel the present economic value added system is sound and does not require significant revision.

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**Evaluation of  
Management's  
Comments**

Management's comments to recommendation 1 are responsive and addressed the issue raised in the finding. Management's comments to recommendation 2 are not responsive. However, since we are continuing our review of the economic value added program, we will defer resolution of this recommendation until after the audit is completed.

We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions, please contact Joyce Hansen or me at (703) 248-2300.

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for Oversight and Business Evaluations

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**APPENDIX A.**

**ILLUSTRATION OF NATIONAL  
ECONOMIC VALUE ADDED FORMULA**

<b>Operating Revenue</b>	<b>\$xx,xxx,xxx,xxx</b>	
Less: Rate Increases	-\$ x,xxx,xxx,xxx	
Plus: Inflation Adjustment	<u>+\$ x,xxx,xxx,xxx</u>	
<b>Indexed Operating Revenue</b>		<b>\$xx,xxx,xxx,xxx</b>
<b>Expenses</b>		<b>\$xx,xxx,xxx,xxx</b>
+/- Economic Adjustments	<u>\$ xxx,xxx,xxx</u>	
<b>EVA Expenses</b>		<b><u>-\$xx,xxx,xxx,xxx</u></b>
<b>Indexed Net Operating Income</b>		<b>\$ x,xxx,xxx,xxx</b>
Cost of Capital		<b><u>-\$ x,xxx,xxx,xxx</u></b>
<b>Indexed EVA (National EVA)</b>		<b><u>\$ x,xxx,xxx,xxx</u></b>

Note. The formula depicted above is for illustration purposes only.

## APPENDIX B. MANAGEMENT'S COMMENTS



July 17, 2000

BILLY SAULS

SUBJECT: Response to Inspector General Interim Audit Report – Economic Value Added Variable Pay Program (Report Number LV-AR-00-DRAFT)

This response will address the formal recommendations of the draft audit report of the Economic Value Added (EVA) Variable Pay Program (VPP).

The first recommendation is that the Postmaster General advise the Compensation Committee of the Board of Governors (BOG) on the trends of net income, goal attainment, and EVA payments presented in the draft report.

The full BOG was briefed in closed session on Monday, July 10, 2000.

The second recommendation of the draft audit report was that the Postal Service consider developing alternatives to the current projected EVA payout to mitigate the risk of negative public perception and present these alternatives to the Compensation Committee of the BOG.

**We disagree with this recommendation.** We feel the present EVA system is sound and does not require significant revision. Its Indexed EVA funding calculation is a fair and equitable measure of the results of managerial effort and provides incentive funding to the VPP that is entirely consistent with organizational goals. The Variable Pay Program is an essential part of our approach to managerial compensation.

The current VPP, based on indexed EVA funding, is the product of four years experience in the Postal Service. During that time it has been audited, reviewed, and modified as experience has dictated. The BOG has approved the program on an annual basis. The entire program was reviewed as recently as last year by Towers Perrin and modified per their recommendations with the BOG approval. We feel the current system reflects a mature product that needs no significant modifications at this time. The system rewards performance across a balanced slate of goals. It has been effective at driving performance increases in all three voices.

By many measures of postal productivity, fiscal year 2000 represents the best performance in ten years. This will be the cornerstone of our communications strategy.

The following are items that should be corrected in your report as they reflect misunderstood or incomplete data.

- 2 -

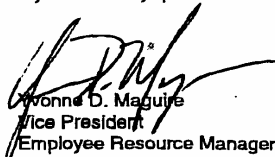
"Results in Brief" (p. 1)


- In the second paragraph, last sentence, after the words "... current year...", please insert the words, "and past year's." This will help the readers understand that the EVA VPP provides payments for sustained organizational success over the long run, not just the short run.

"Background" (p. 2-4)

- In the first paragraph, fourth sentence, please replace the word "bonuses" with "incentive credits." This will help distinguish our VPP from other Federal government recognition programs, and more accurately reflect the nature and operation of the program.
- In the top paragraph on page 4, please insert the word "potential" before the two references to "incentive pool." This will help reinforce to the reader that full funding will not result in incentive credits unless other organizational targets are achieved.
- In the second paragraph on page 4, first sentence, replace the word "distributions" with "credits."
- In the second paragraph on page 4, second sentence, replace the word "earn" with "are credited with." We generally try to avoid the word "earn" since it connotes a vested amount, when in reality it is not available as money to employees until the plan rules say to make a payment. Also, if it was truly "earned," there would be an income tax liability.
- In the fourth paragraph on page 4, replace the word "incentives" with "incentive credits."

If you have any questions concerning this feedback on your draft report, please call us.

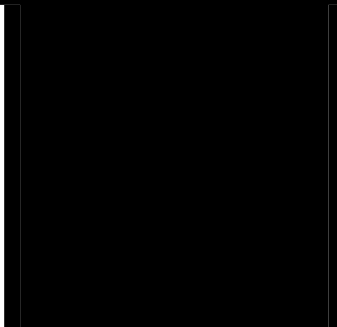
  
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**Major Contributors**

A large black rectangular redaction box covers the content of the table under the 'Major Contributors' header.