December 5, 2001

SUZANNE F. MEDVIDOVICH
SENIOR VICE PRESIDENT, HUMAN RESOURCES

SUBJECT: Audit Report – Use of the Economic Value Added Concept in the Pay for Performance Program (Report Number LH-AR-02-001)

This report presents the results of our audit regarding the appropriateness of the Postal Service's use of the economic value added concept to fund its pay for performance program (Project Number 00EA012LM000). The audit was a self-initiated review that was included in our Fiscal Year 2000 Audit Workload Plan.

The audit revealed that the use of the economic value added concept was not appropriate to fund the Postal Service's pay for performance program. The concept, created for profit-making entities, did not fit the Postal Service's breakeven operating environment. To make the concept work, the Postal Service added an inflation adjustment. This resulted in program participants earning $805 million in incentive awards for the period, while the Postal Service experienced steeply declining profits. We recommended the Postal Service establish an alternative method for funding the pay for performance program that fits its breakeven operating environment. Management disagreed with our analysis, but agreed to look at alternatives to funding the pay for performance program. Management's comments, as well as our evaluation of these comments are included in the report.

The OIG considers recommendation 1 significant and, therefore, requires OIG concurrence before closure. This recommendation should not be closed in the follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed. We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions or need additional information, please contact Larry Chisley, director, Accepting and Processing, at (703) 248-2100, or me at (703) 248-2300.

//ORIGINAL SIGNED//

Ronald K. Stith
Assistant Inspector General
for Core Operations

Attachment

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EXECUTIVE SUMMARY

Introduction

This is our second report on the pay for performance program (Project Number 00EA012LM000). In our first report, we concluded that the program permitted incentive awards to executives during periods of declining profitability, which could negatively impact public perception of the Postal Service. We conducted this audit to determine the appropriateness of using the economic value added concept to fund the Postal Service's pay for performance program. The audit also generally addressed the Postal Service financial performance, because the economic value added concept is a financial performance measure. The audit was a self-initiated review that was included in our Fiscal Year 2000 Audit Workload Plan. We are reviewing whether the Postal Service's pay for performance program has improved organizational performance in a separate audit.

Results in Brief

The audit revealed the use of the economic value added concept was not appropriate to fund the Postal Service's pay for performance program. The concept, created for profit-making entities, did not fit the Postal Service's breakeven operating environment. To make the concept work, the Postal Service added an inflation adjustment. Management used the inflation adjustment to increase revenues by $4.9 billion for fiscal years (FY) 1998 through 2000. This resulted in program participants earning $805 million in incentive awards for that period, while the Postal Service experienced steeply declining profits. Without the adjustment, economic value added, and incentive awards would have been negative.

Summary of Recommendations

We recommended that management establish an alternative method for funding the pay for performance program that fits the Postal Service's breakeven operating environment.

Summary of Management's Comments

Management disagreed with our analysis but agreed with the recommendation. Management stated that while they believed indexing made the economic value concept fit the Postal Service environment, they agreed to evaluate alternative methods for funding incentive awards by FY 2002. The full text of management's comments is included in Appendix B.

Overall Evaluation of Management's Comments	Management's response to the recommendation should resolve the issues presented in the report. Our response to some of management's comments, which take exception to our analysis, is included in Appendix C.

INTRODUCTION

Background

The Postal Service implemented the economic value added concept in fiscal year (FY) 1996 to fund its pay for performance program. The program was established as a group incentive program to reward managers for increasing the economic value of the Postal Service and achieving strategic goals.

In its simplest form, economic value added equals profits[1] minus the cost of capital invested to produce those profits.[2] This formula is the first step in determining funding for incentive awards and, when combined with Postal Service strategic goals, is intended to reward employees for improving customer satisfaction, employee effectiveness, and financial performance. Under the program, without economic value added, there would be no funds available to reward program participants.

The economic value added concept was developed by consultants for profit-making entities to reward employees for continuously increasing the economic value of their company. The Postal Service adopted this concept, immediately following the fiscal year in which they experienced record profits, to change the Postal Service's focus from the traditional government culture to a more business-like culture. This is evidenced in the objectives of the Postal Service's pay for performance program. Specifically, the objectives were to:

- Increase revenues and profits.
- Reduce or maintain expenses.
- Assure expected returns on capital investments.

These objectives were designed to increase the economic value of the Postal Service.

See Appendix A for additional background information regarding the use of the economic value added concept as part of the Postal Service's pay for performance program.

[1] The Postal Service refers to profits as net operating income.
[2] The Postal Service also makes accounting adjustments in calculating economic value added consistent with those made by private sector companies.

Objective, Scope, and Methodology

Our objective was to determine the appropriateness of using the economic value added concept to fund the Postal Service's pay for performance program.

To achieve the objective, we:

- Reviewed available documentation pertaining to the program.

- Interviewed various headquarters personnel and private consultants specializing in executive compensation.

- Reviewed program policies and procedures.

This audit was conducted from March 2000 through December 2001 in accordance with generally accepted government auditing standards, and included such tests of internal controls as were considered necessary under the circumstances. We discussed our conclusions and observations with appropriate Postal Service officials and included their comments, where appropriate.

In addition to this audit, we are performing other audits in the following key areas of the program:

- Total factor productivity, focusing on whether this measure accurately calculates increases or decreases in productivity.

- Performance measures, focusing on changes in the measures and the impact of those changes on Postal Service operations.

We also plan to issue a capping report summarizing the results of all of our audits.

Prior Audit Coverage

On July 31, 2000, we issued audit report number LB-AR-00-001, Economic Value Added Variable Pay Program. We concluded that the program might permit incentive awards during periods of declining financial performance, which could negatively impact public perception of the Postal Service. In this regard, we reported a trend that incentive awards remained stable while profits declined every year since the program began in 1996. In response to the report, the postmaster general briefed the Board of Governors (Board) on the trends presented in the report. However, management disagreed with our recommendation to consider alternatives to the program, stating that the program was sound and required no significant changes.

AUDIT RESULTS

Economic Value Added Does Not Fit the Postal Service

The use of the economic value added concept was not appropriate to fund the Postal Service's pay for performance program. Specifically, the concept, created for profit-making entities, did not fit the Postal Service's breakeven operating environment. To make the concept work, the Postal Service modified the concept to include an inflation adjustment[3] that would ensure funding for its pay for performance program. This resulted in program participants earning $805 million in incentive awards for FYs 1998 through 2000, while the Postal Service experienced steeply declining profits. Without the adjustment, economic value added and incentive awards would have been negative.

Postal Service Modifies Program to Fit Breakeven Environment

In the first 2 fiscal years--1996 and 1997-- the Postal Service had profits of $2.8 billion. After deducting the cost of capital, these profits yielded $1.9 billion in economic value added and $554 million in incentive awards for program participants. However, in 1997 Postal Service managers became concerned that the concept, as implemented, would no longer fit the breakeven environment and provide funding to reward employees for achieving strategic goals. Specifically, financial projections showed the Postal Service could not continue to generate positive economic value added; thereby, eliminating incentive awards for the foreseeable future.

In addition, management was concerned that financial performance would be hindered by the Postal Service's breakeven mandate[4] and lack of complete control over postage rate increases.[5] Finally, Postal Service managers were concerned that a lack of incentive awards would eliminate the motivational impact and acceptance of the program by 17,000 employees added to the program in FY 1998.

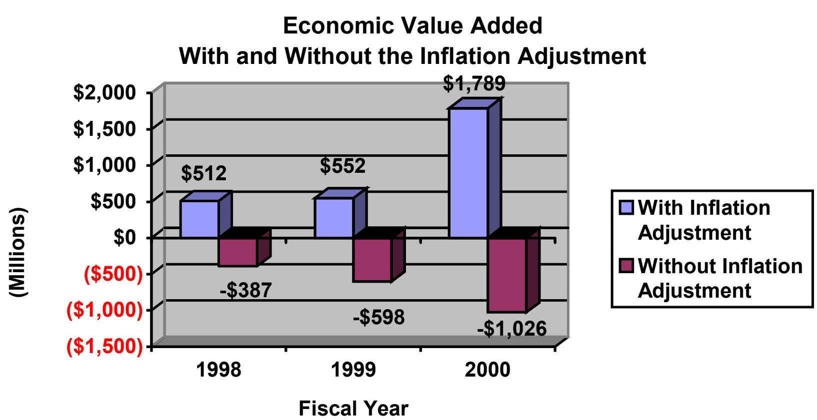
[3] Postal Service program guidance refers to this as a revenue adjustment. The net inflation adjustment is comprised of the consumer price index for urban consumers less postage rate increases both accumulated since 1997.
[4] 39 United States Code 3621 states Postal Service rates and fees shall provide sufficient revenues so that the total estimated income will equal as nearly as practicable the total estimated costs of the Postal Service. Total estimated costs includes operating expenses, depreciation, debt service, and a reasonable provision for contingencies.
[5] The Postal Service must submit any proposed rate increase to the Postal Rate Commission for review and approval.

The Postal Service hired two consultants to address these concerns. Each of the consultants provided a proposal to modify the program. Management also developed their own proposal. All three proposals recommended some form of inflation adjustment to be added to the funding formula. The Postal Service presented their analyses of the three proposals to the Board of Governors for consideration. Ultimately, management's proposal was adopted, which was consistent with, but less conservative than the consultants' proposals. In essence, management's proposal, which was implemented, would provide larger incentive awards to program participants. In 1999, the Postal Service hired a third consultant to review their program. This consultant commented that the inflation adjustment was unique to the Postal Service but otherwise appeared sound and reasonable given distortions caused by the rate cycle.

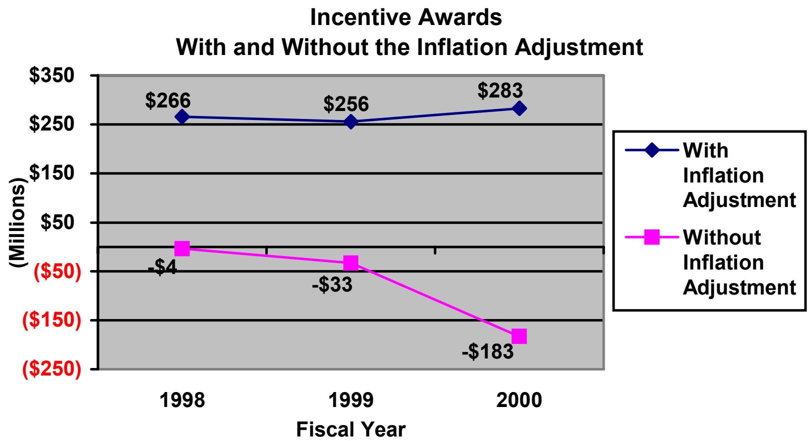
Following is a discussion of the inflation adjustment's impact on economic value and incentive awards.

Inflation Adjustment's Impacts on Economic Value Added and Incentive Awards

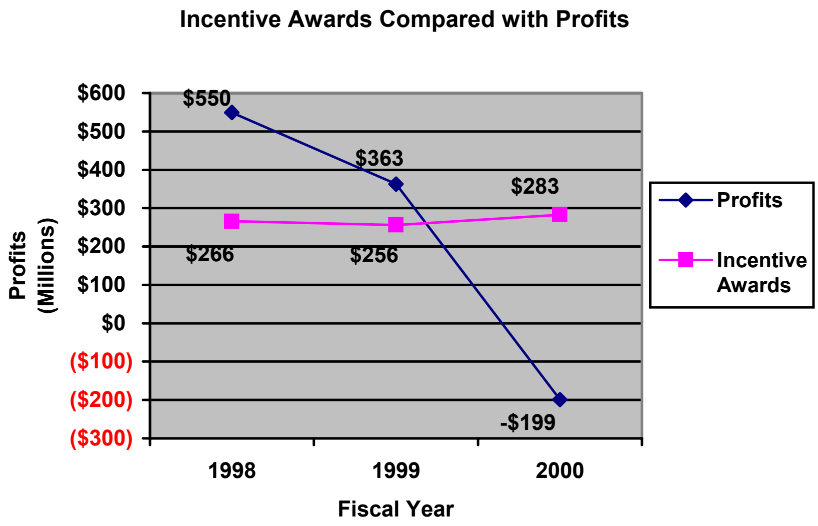
Using the inflation adjustment, the Postal Service increased revenues by $4.9 billion for FYs 1998 through 2000. This allowed the Postal Service to create $2.9 billion in economic value added. Without the inflation adjustment, economic value added would have been a negative $2 billion for the same period. The following chart shows economic value computed with and without the inflation adjustment:



Based on the inflation adjustment, program participants earned $805 million in incentive awards for FYs 1998 through 2000. Without the inflation adjustment, economic value and incentive awards would have been negative for that period. The following chart shows incentive awards with and without the inflation adjustment:



In addition, while the Postal Service was profitable for 4 of the 5 years of the program, the profits for FYs 1998 through 2000 were not sufficient to generate funding for incentive awards without the inflation adjustment. Specifically, program participants earned incentive awards totaling $805 million during a period of steeply declining profits. As illustrated in the following chart, incentive awards remained relatively constant from FYs 1998 through 2000, while Postal Service profits fell from $550 million to a loss of $199 million.



Furthermore, the use of an inflation adjustment reduced the risk of loss of incentive awards credited to participants' reserve accounts. Not all incentive awards are paid to participants in the year they are earned. Incentive awards are first credited to reserve accounts established for each participant. A fixed percent of the total reserve account balance is then paid to participants. Reserve account balances were intended to be "at risk." Implementation of the inflation adjustment reduced the negative impact that declining profits would have on reserve account balances for the period 1998 through 2000.

For example, because of the inflation adjustment, losses in excess of $2 billion would have been needed before reserve accounts were reduced in FY 2000. Also, for FY 2001--a year in which postage rates increased 6.2 percent--a similar loss would be needed before reserve accounts would be reduced.

Without the inflation adjustment, the risk associated with the reserve accounts would have been maintained and participants would still have received payments totaling $110 million in FYs 1998 and 1999. However, no incentive award payments would have been made in FY 2000, because reserve accounts would have been depleted.

Briefing to the Board of Governors and Conclusion	On August 6, 2001, we briefed the Board of Governors on the results of our audit. We presented our concern that Postal Service officials adopted an economic value added concept to fund its pay for performance program, which does not fit the Postal Service's breakeven operating environment. The postmaster general agreed to provide the Board of Governors with alternatives.
Changes to the Draft Report Based on Interim Discussions with Management	Based on discussions held with management since the issuance of the draft report, we made changes to the report to more clearly reflect that we do not take issue with the Postal Service's use of pay for performance—just its methodology for computing incentive funding.
Recommendation	We recommend the senior vice president, Human Resources: 1. Establish an alternative method for funding the pay for performance program that fits the Postal Service's breakeven operating environment.
Management's Comments	Management disagreed with our analysis but agreed with the recommendation. Management stated that while they believed indexing made the economic value added concept fit the Postal Service environment, they agreed to evaluate alternative methods for funding incentive awards by FY 2002.
Evaluation of Management's Comments	Management's comments to the recommendation are responsive, and should resolve the issues presented in the report. Our response to some of management's comments, which take exception to our analysis, is included in Appendix C.

APPENDIX A. ADDITIONAL BACKGROUND INFORMATION

The economic value added variable pay program (now called the pay for performance program), developed in coordination with outside consulting firms, was modeled after the economic value added concept developed for profit-making companies. The Postal Service states economic value added is superior to other measures of financial performance because it provides an incentive to employees to increase revenues and reduce expenses while optimizing capital deployment. The program includes a formula used to calculate the maximum funding available for incentive awards. Attainment of performance targets is considered in determining the amount of incentive awards allocated to program participants.

Funding of Incentive Awards. Determining economic value added is the first step in calculating the maximum funding available for incentive awards. In its simplest form, economic value added is calculated as:

Revenue - Operating Cost - Cost of Capital = Economic Value Added[6]

Once economic value added is calculated, the maximum funding for incentive awards is calculated as 65 percent of the first $400 million in economic value added, and 25 percent of economic value added over $400 million.

Attainment of Performance Targets. Each year performance targets are established to improve customer satisfaction, strengthen employee and Postal Service effectiveness, and improve financial performance. The percent of targets attained is applied to the maximum funding available for incentive awards to determine the actual amount of incentives to be allocated to program participants.

Allocating Incentive Awards to Program Participants. Incentive awards are first credited to reserve accounts established for each participant. A fixed percent of the total reserve account balance is then paid to each participant. The remaining reserve account balances are intended to be “at risk” to encourage long-term performance improvements. For instance, if performance is not maintained or improved negative economic value can be allocated to each employee, reducing their reserve account balances.

In exchange for participating in the program, approximately 84,000 Postal Service managers agreed to forgo automatic general pay and cost of living increases. Included are participants who agreed to forgo premium pay for overtime worked. All managers are still eligible for salary increases through the Postal Service merit pay program.

[6] The Postal Service also makes accounting adjustments in calculating economic value consistent with those made by private sector companies.

The following chart illustrates the calculation of incentive awards since 1996.

Calculation of Incentive Awards ($000)

	1996	1997	1998	1999	2000
Operating Revenue	$ 56,401,456	$ 58,215,774	$ 60,072,459	$ 62,725,701	$ 64,539,722
Total Expenses	$ (54,055,214)	$ (56,025,043)	$ (59,048,463)	$ (61,847,872)	$ (63,906,850)
Capital Charge	$ (1,276,436)	$ (1,364,112)	$ (1,410,875)	$ (1,475,882)	$ (1,658,976)
Economic Value without Inflation Adjustment	**$ 1,069,805**	**$ 826,619**	**$ (386,879)**	**$ (598,053)**	**$ (1,026,104)**
Net Inflation Adjustment[7]			$ 899,173	$ 1,149,751	$ 2,815,192
Economic Value with Inflation Adjustment[8]			**$ 512,294**	**$ 551,698**	**$ 1,789,088**
Maximum Funding Available for Incentive Awards[9]	**$ 367,451**	**$ 346,655**	**$ 288,074**	**$ 297,925**	**$ 607,272**
Percent Target Attainment[10]	69%	87%	93%	86%	48%
Incentive Awards Allocated to Participants	**$ 252,398**	**$ 302,065**	**$ 266,370**	**$ 256,344**	**$ 283,320**

[7] This approach resulted in a net upward adjustment of revenue for 1998, 1999, and 2000 totaling $4.9 billion.
[8] There was no inflation adjustment in the calculation of economic value for 1996 and 1997.
[9] In 1996, this amount was calculated as 50 percent of the first $400 million in economic value added, plus 25 percent of any amount over $400 million. In 1997, this amount was calculated as 60 percent of the first $400 million plus 25 percent of any amount over $400 million. Since 1998, this amount calculated as 65 percent of the first $400 million plus 25 percent of any amount over $400 million. Changes in the formula were the result of additional participants being added to the program.
[10] Target attainment differs between organizational levels. Thus, these percentages are for illustration purposes only and do not represent actual target attainment percentages for the Postal Service.

APPENDIX B. MANAGEMENT'S COMMENTS

DEWITT O. HARRIS
VICE PRESIDENT
EMPLOYEE RESOURCE MANAGEMENT

UNITED STATES
POSTAL SERVICE

December 5, 2001

RON STITH

SUBJECT: Response to Inspector General Interim Audit Report—Use of the Economic Value Added Concept in the Pay for Performance Program (Report Number LB-AR-01-DRAFT)

This is a revised response of our November 19 memorandum regarding the group incentive program.

The group incentive plan has been a pioneering concept in the federal government and has driven significant improvements in our organizational performance. Further, it is a key feature of our compensation strategy that is market-based and performance-driven. From its inception, the purpose of the program has been to provide compensation linked to performance for over 80,000 non-bargaining employees. By any objective measure, the group incentive program has been an overwhelming success.

The Office of Inspector General has chosen to provide their assessment of the group incentive program in a phased approach. This approach limits a comprehensive assessment of the effectiveness of the program and its role in the total compensation strategy.

Regarding this report on incentive plan funding, the Postal Service has a basic difference in opinion on the appropriateness of the funding formula. The Postal Service views the funding formula as justified under the USPS breakeven operating environment and has several qualified independent experts to support that position. The Office of Inspector General views the funding formula as inappropriate under the USPS breakeven operating environment.

Management has been considering alternative methods for funding group incentives for approximately a year before this report was issued. Due to the consultative process that is required by law, alternatives will not be finalized until the end of fiscal year 2002. Therefore, the Postal Service agrees with the OIG's recommendation and will evaluate an alternative method for funding the group incentive program by the end of FY 2002.

Below are detailed points of clarification that management needs to address.

OIG Statement: Economic Value Added (EVA) is not appropriate to fund the Postal Service's Pay for Performance program. (p. i & 4)
USPS Response:
- Qualified independent experts have reached an opposite conclusion than that of the OIG.
- Objective evidence reveals that EVA, as designed, is appropriate for the Postal Service's Pay for Performance programs.

OIG Statement: Economic Value Added (EVA) concept was created for profit-making entities, not USPS breakeven operating environment. (p. i & 4) EVA concept was developed by consultants for profit-making entities... (p. 1) Without the inflation adjustment, economic value added and incentive awards would have been negative. (p. i & 4 & 6) Economic Value Added (EVA) could not be generated without the inflation adjustment since 1997. (p. 7)

USPS Response:

The Office of the Inspector General (OIG) has addressed the issue of the indexing formula in the past, and we continue to disagree with their analysis. Ironically, it is indexing that moves EVA from a measure that "does not fit the Postal Service's breakeven operating environment" to one that does. Indexing for inflation recognizes the unique nature of our rate-setting constraints and adjusts accordingly. It also insures that no incentives are earned based on increased postal prices.

EVA is a business metric created by Stern-Stewart and Co. who have copyrighted the term. The concept is really their "intellectual property". We consulted extensively with Stern-Stewart and Co. in applying the EVA metric to the Postal Service. They were also involved in the creation of the EVA indexing methodology. Stern-Stewart and Co. has never indicated to us that they felt the concept of EVA was not appropriate to the Postal Service. We will continue to rely on them as "subject matter experts" in this area.

With the existing indexing methodology, the EVA calculation is entirely consistent with the financial objectives of the Postal Service. The EVA calculation creates an appropriate funding pool for the Pay for Performance program based not only on net income, but also on our ability to minimize rate increases. This funding mechanism creates incentives to increase profitable revenue, control costs and to maximize return on capital assets entirely consistent with EVA principles.

OIG Statement: Program participants earned incentive awards totaling $805 million during a period of steeply declining profits. (p. 6) A supporting graphic uses net income in 1998, 1999, and 2000.

USPS Response:

- In the 30-year history of the Postal Service, there was an unprecedented five straight years of positive net income from 1995 to 1999.
- In 2000 and 2001, productivity gains helped the Postal Service avoid $2.5 billion in losses.

I appreciate the opportunity to revise our response to your audit report.

DeWitt O. Harris

cc: Suzanne F. Medvidovich
Richard J. Strasser

APPENDIX C. OIG's RESPONSES TO MANAGEMENT'S COMMENTS

Management's Comments

Management states that because the OIG is reviewing the pay for performance program in phases, a comprehensive assessment of the effectiveness of the program is limited based on this report.

OIG Comments

The pay for performance program is composed of three key elements: funding of the program, attainment of performance targets, and allocation of incentive awards to program participants. The OIG decided to audit these elements separately to facilitate timely reporting of opportunities for improvement. The OIG will issue a report summarizing the overall conclusions regarding the pay for performance program, once we have completed reports on the three elements.

Management's Comments

Management stated that Stern-Stewart and Company, the consultants who developed the economic value added concept never indicated to management that they felt the concept was inappropriate for the Postal Service. They stated they would continue to rely on Stern-Stewart as the "subject matter experts."

OIG's Comments

Management consulted Stern-Stewart when they initially adopted the economic value added concept in 1996. The concept was adopted without indexing and applied in the same manner as applied by profit making companies. The concept was successful in generating funding of $554 million in incentive awards for 1996 and 1997. However, in 1997 management became concerned that the concept, as implemented, would no longer fit the postal breakeven environment. Specifically, financial projections showed the Postal Service could not continue to generate funding for incentive awards for the foreseeable future. Thus, management again consulted with Stern-Stewart and another consultant to recommend ways to address this issue. The two consultants proposed indexing as a way to address the issue. Management also proposed a form of indexing. We note that while management refers to Stern-Stewart as the "subject matter expert in this area," they did not adopt their indexing proposal. Instead, management adopted their own proposal, which was more aggressive than the proposals offered by the consultants. If either of the consultant's proposals had been adopted, the incentive awards for 1998 through 2000 would have been significantly reduced or eliminated.

Management's Comments

Management disagreed with the OIG's analysis and stated indexing makes the economic value added concept fit the Postal Service's breakeven operating environment. Management stated that indexing recognizes their rate-setting constraints, and ensures that incentive awards are not earned based on increased postage rates. Management also stated that the economic value added concept creates an appropriate funding pool for the program based on net income and management's ability to minimize rate increases.

OIG Comments

We acknowledge that keeping postage rates below inflation would benefit Postal Service customers if these rates allowed the Postal Service to recover all costs, including debt service and a reasonable reserve for contingencies as required by law. However, while the Postal Service may have kept postage rates below inflation, it has experienced steeply declining profits including a loss of about $1.6 billion at the end of FY 2001. In addition debt has increased by over $5 billion. We noted that Postal Service profits fell $3.9 billion short of covering capital costs for FYs 1998 through 2000; however, $805 million in incentive awards were earned by pay for performance program participants. Thus, any benefits to customers are short-term at best because the Postal Service has had to borrow to fund financial shortfalls and capital investments, and will eventually need to increase rates to pay these debts.