July 31, 2003

JOHN R. WARGO
VICE PRESIDENT, SERVICE AND MARKET DEVELOPMENT

SUBJECT: Audit Report – Postal Service Postmark America Store
(Report Number OE-AR-03-005)

This report presents the results of our audit of the Postmark America Store (Project Number 03BG040OE000). This was a self-initiated audit to identify whether the Postal Service was meeting its management challenge goal of achieving a positive return on investment on its activities.

Based on our calculations, the retail portion of the store has generated losses for the Postal Service totaling over $8.3 million. The Postal Service recently has taken steps to improve its return on investment, specifically, by eliminating significant storage costs on merchandise that was not selling. Although the store as a whole has generated total revenue of over $8.6 million, our audit disclosed that traditional postal services at the store, such as selling stamps and packaging supplies, accounted for most of the revenue, while the retail portion of the store accounted for only $1.7 million. We determined that retail sales represented only 20 percent of total revenue while retail merchandise accounted for 66 percent of the store's floor space. If the Postal Service had renewed and extended the current lease for an additional 2 years, the Postal Service would have continued to lose money.

Background

Postmark America is a retail store in the Mall of America in Minneapolis, Minnesota, that sells Postal Service related merchandise such as shirts and caps. The store was established in 1996 as a pilot to increase revenue by utilizing its brand image and expand its base through related retail merchandise. The store is considered a contract postal unit that is funded by the Postal Service and acts as a traditional Postal Service operation that sells stamps and provides postal services. The store is staffed by contract employees and managed by a Postal Service employee from the Northland District. The current lease for the store expires in May 2004.

Objective, Scope, and Methodology

The objective of the audit was to determine if the Postmark America store could operate at a profit without combining revenue from traditional postal services.

The scope of the audit was limited to the store located in the Mall of America in Minneapolis, Minnesota. To accomplish our objectives, we interviewed Postal Service officials at headquarters and the Postmark America store, reviewed applicable policies pertaining to contract postal units, analyzed profit and loss statements and other financial documentation for fiscal years (FY) 1997 through accounting period 6, FY 2003 and reviewed other materials necessary to gain an understanding of the subject matter.

This audit was conducted from March through July 2003, in accordance with generally accepted government auditing standards and included such tests of internal controls, as were considered necessary under the circumstances. We relied on computer-generated data for the profit and loss statements and our assessment of this data concluded that it was generally reliable. We discussed our conclusions and observations with appropriate management officials and included their comments, where appropriate.

Prior Audit Coverage

The Office of Inspector General (OIG) issued the audit report, PostmarkAmerica.com Financial and Management Issues (Report Number EM-AR-02-008, dated March 29, 2002), to address the development and operation of the Internet Web site PostmarkAmerica.com. The audit disclosed that the Postal Service did not effectively manage the development and operation of PostmarkAmerica.com. As a result, PostmarkAmerica.com: (1) was not economically justified and may not achieve a positive return on investment, (2) did not have a migration plan to USPS.com, and (3) did not have a Web site development that was based on authorized commitments and clearly spelled out in the contract scope. Management agreed with all recommendations related to PostmarkAmerica.com programmatic issues, but disagreed that its creation was outside the contract scope and based on unauthorized commitments. However, since the issuance of our report, management has taken actions which should correct the issues identified in the report.

The OIG issued the audit report, Postal Retail Store Operations (Report Number EM-AR-02-002, dated February 28, 2002), that responded to a request from the Governors to review the profitability and adequacy of management controls of Postal Service retail stores. The audit revealed the Postal Service lacked necessary data to accurately evaluate the financial performance of retail stores and that management was unable to reasonably compute the economic impact of building Postal Service retail stores because it had not developed methods to isolate financial and performance data for individual stores. Additionally, the OIG found that local managers did not implement management controls over Postal Service retail store operations. Management agreed with our recommendations and has initiatives in progress, completed, or planned addressing the recommendations.

Results

Retail Store Has Generated Losses, But Changes Made to Reduce Costs

Based on our calculations, the retail portion of the store has generated losses for the Postal Service totaling over $8.3 million. The Postal Service has incurred annual costs since 1997 to contract with Minnesota Diversified Industries to act as a fulfillment and storage center for retail merchandise for the Postmark America retail store. Merchandise was ordered by the Postal Service, the call center transmitted the orders, and Minnesota Diversified Industries shipped according to the instructions in the orders. For FYs 2000 through 2003 the Postal Service paid Minnesota Diversified Industries over $5.4 million for storage of Postmark America merchandise.

As Postal Service officials have acknowledged, poor management decisions for ordering Postmark America merchandise early on in the program resulted in an overstock of merchandise. This resulted in 6,000 pallets of excess merchandise that had been stored at the Minnesota Diversified Industries facility since 1997. These items became outdated and little or no demand for the inventory existed even at reduced prices. In June 2002, Postal Service management made a decision to eliminate the costs to store merchandise that would not sell and terminated the contract with Minnesota Diversified Industries in April 2003. The remaining retail merchandise located at Minnesota Diversified Industries was then liquidated from June 2002 until March 2003.

Retail Store Has Not Performed As Intended

Since 1997, according to the Postal Service's profit and loss statements,[1] the store has generated total revenue of over $8.6 million of which over $1.7 million is for retail merchandise and the remainder is for traditional postal services. We noted, however, that the profit and loss statements did not contain the expenses related to Minnesota Diversified Industries and that the retail portion of the store has generated losses for the Postal Service totaling over $8.3 million. Although the retail merchandise floor space accounts for 66 percent of the Mall of America store, it only accounts for 20 percent of the total revenue for the store. The store is 2,774 square feet of which 1,830 square feet is attributable to retail merchandise.

[1] For the time period FY 1997 through accounting period 6, FY 2003.

Chart 1. Postmark America Store Information on Square Footage and Revenue Since Program Inception

Type of service	Square footage	Percentage of square footage	Store revenue since inception (in millions)	Percentage of revenue
Retail merchandise	1,830	66%	$1.7	20%
Traditional postal	944	34%	$6.9	80%
Total	2,774	100%	$8.6	100%

According to Postal Service management and the budget narratives, the store was first established to meet Postal Service goals and objectives to generate profit and increase revenue for the district. However, since that time, the Postal Service has changed its corporate direction and current goals to limit merchandise that does not directly complement its traditional business.

The retail portion of the store is losing money for the Postal Service because of several factors. Postal Service management established the store as a model unit and a test bed for evaluating new retail solutions for specialized, high traffic environments. The store was to serve as a lab to test new merchandise, much of which would ultimately be sold in post offices. The pilot never officially ended but continued to change to meet different goals identified by the Postal Service. With the issuance of the Transformation Plan, new Postal Service policy was created to limit merchandise that did not directly complement traditional business.

As a result, the Postal Service has not achieved its original goals to increase profit. For example, in FY 2002, it cost the Postal Service over $544,000 to operate the retail portion of the Postmark America store. Based on retail merchandise revenue of over $248,000 the Postal Service had a loss of $296,000 for the year. In addition, the Postal Service incurred a cost of over $1 million to Minnesota Diversified Industries for storage of retail goods. This amount is not reflected on the profit and loss statements. When included in total cost to operate the retail portion of the store, it would incur a loss for FY 2002 of almost $1.3 million.

Over the life of the store the retail portion has lost over $1.9 million according to Postal Service profit and loss statements. However, when the costs associated with Minnesota Diversified Industries are included, it has lost over $7.3 million (see Chart 2, column two, including storage expenses). In addition, the store is not in compliance with the current objectives of the Postal Service to strictly sell merchandise directly related to traditional business.

The following chart depicts the total revenue and expenses for the retail portion of the store since inception. The first column shows revenue, expenses, and profit/loss using the Postal Service profit and loss statements. The second column adds the additional expenses incurred using Minnesota Diversified Industries. The third column adds the additional expense of corporate transfer cost[2] charged by headquarters. Regardless of the method used, the retail portion of the store is operating at a loss.

Chart 2. Profit and Loss Information
For Retail Portion of Postmark America Store
FY 1997 Through Accounting Period 6, FY 2003

	Using profit and loss statements	Including storage expenses[3]	Including corporate transfer costs[4]
Revenue	$1.7	$1.7	$1.7
Expenses	$3.7	$9.1	$10.0
Profit/(loss)	**$(1.9)**	**$(7.3)**	**$(8.3)**

Note: Dollars in millions.

Summary

The retail portion of the Postmark America store has not performed as intended nor increased profit for the Postal Service. In fact, the retail portion of the store has cost the Postal Service $8.3 million since inception, an average of almost $1.2[5] million a year. Furthermore, the store was not in compliance with the current objectives of the Postal Service to strictly sell merchandise directly related to traditional business operations. If the Postal Service were to renew and extend the current lease for an additional 2 years, we estimate the Postal Service would continue to lose money over this period.

Recommendation

We recommend the vice president, Service and Market Development:

1. Not renew the Postmark America store lease with the Mall of America.

Management's Comments

Management agreed with the recommendation. Management stated that a nonrenewal notice for the Postmark America Store was given by headquarters Retail to the Mall of America and affected headquarters and area units. Management's comments, in their entirety, are included in the appendix of this report.

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[2] Transfer costs include costs to transport, process, and deliver mail for which postage is sold. These costs are charged back or transferred to the store to reflect corporate cash flow.
[3] We were only able to obtain storage costs for FYs 2000 through 2003.
[4] The allocation of the corporate transfer costs to the retail portion of the store was based on our calculation of the retail store's portion of revenue 20 percent or $883,000.
[5] This figure is calculated using the $8.3 million divided by the 7 years the retail store has operated.

Recommendation

We recommend the vice president, Service and Market Development:

2. Implement controls to monitor ordering of new merchandise at the Postmark America store to coincide with the termination of the current lease and closing of the store in May 2004.

Management's Comments

Management agreed with the recommendation and plans to closely monitor inventory levels at the store through closing in May 2004, and will also develop a plan to transfer or dispose of any remaining merchandise prior to the store closing.

Evaluation of Management's Comments

Management's comments are responsive to recommendations 1 and 2, and actions taken or planned should correct the issues identified in the report.

Although they agreed with our recommendations, management stated they did not agree that transfer costs should be considered in determining the profit and loss for the store. However, charging the store transfer costs is a corporate decision made by Postal Service Headquarters. In addition, this report shows that even without these transfer costs included the store is operating at a loss. Management's comments also questioned the $5.4 million in storage costs at Minnesota Diversified Industries stating, "the warehousing and order fulfillment operation at Minnesota Diversified Industries supported more than 12,000 Postal Service locations, not solely Post Mark America." We determined from headquarters officials, the manager of the store and Minnesota Diversified Industries officials that although shipments of Postmark America merchandise were on occasion made to other locations it was very infrequent. In addition, we were told that the purpose of the storage unit was to support the store at the Mall of America and if the store did not exist these costs would not have been incurred.

The OIG considers recommendation 1 significant and, therefore, requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective action(s) are completed. 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 audit. If you have questions or need additional information, please contact Linda J. Libician, director, Organizational Effectiveness, at (650) 412-3001, or me at (703) 248-2300.

Ronald D. Merryman
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Attachment

cc: Robert J. Sheehan
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APPENDIX. MANAGEMENT'S COMMENTS

JW 7/29/03

SERVICE AND MARKET DEVELOPMENT

UNITED STATES POSTAL SERVICE

July 1, 2003

RONALD D. MERRYMAN

SUBJECT: Postal Service Postmark America Store (Report Number OE-AR-03-DRAFT)

Management's general comments regarding the audit report/review:

Management agrees with the two recommendations and has taken steps to discontinue the contract with Mall of America and will continue to reduce merchandise inventory over the next 12 months. However, we believe that the Postmark America (PMA) store has generated a net income of $3.5 million since inception–a difference from the report's finding of $300,000 (revenue of $8.6 million and expense of $8.3 million). The difference is the assignment of transfer costs at the rate of 75 percent of mailing revenue–an allocation which is not required or considered for any other contract postal unit.

The report also associates $5.4 million in storage costs for PMA merchandise at the MDI warehouse, when in fact the warehousing and order fulfillment operation at MDI supported more than 12,000 postal locations, not solely PMA.

The report states that the objective of PMA was to increase revenue for the district and serve as a test bed for various retail initiatives and the retail portion has been operating as a loss. We are in agreement that the mission and purpose of PMA has changed over time, but we do not agree with the methodology that allocates the entire cost of store operations ($544,000 in FY 02) to only retail revenue. While the retail and postal revenue generated from PMA were accounted for separately, the success of PMA was not solely dependent on either revenue source. Total revenue and total expenses were reported and used to measure store performance.

Recommendation #1: Do not renew the PMA store lease with the Mall of America.

Response: As indicated at the April 23, entrance conference, it was management's intention to support PMA through the lease term and to either transfer administration to the Northland District commencing in FY 04 if they desired or to terminate operations.

During the audit process, the District indicated they did not want to maintain the PMA operation and a non-renewal notice was given by Headquarters Retail to Mall of America and affected Headquarters and Area units. Management believes this recommendation has been fully implemented.

Recommendation #2: Implement controls to monitor ordering of new merchandise at the PMA store to coincide with the termination of the current lease and closing of the store in May 2004.

Response: Management agrees with the recommendation and will not only closely monitor inventory levels at PMA through closing in May 2004, but also will develop a plan to transfer or dispose of any remaining merchandise prior to the store closing.

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