



August 18, 2010

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER AND EXECUTIVE VICE PRESIDENT

JOYCE H. CARRIER
MANAGER, ADVERTISING AND MEDIA PLANNING

SUBJECT: Audit Report – Advertising Cost Reporting
(Report Number CRR-AR-10-004)

This report presents the results of our review of controls over advertising cost reporting (Project Number 10RR001CRR000). Our objectives were to determine whether advertising costs were accurately reported to the Postal Regulatory Commission (PRC) and whether Priority Mail[®] advertising costs were shifted to other products in an attempt to make Priority Mail appear to be more successful.

The Postal Accountability and Enhancement Act of 2006 (Postal Act of 2006) requires managers to allocate costs directly related to a market-dominant or competitive product, including advertising costs, to that specific product.¹ Organizational costs that are not allocable to a specific market-dominant or competitive product are considered institutional costs. Institutional costs include overhead costs for the U.S. Postal Service and encompass items such as general administrative expenses, or advertising campaigns promoting the Postal Service brand and not a specific product. Each Postal Service product is priced to cover its own costs and to contribute to covering institutional costs.

The Postal Act of 2006 also requires the Postal Service to provide an Annual Compliance Report (ACR) to the PRC within 90 days of the end of each fiscal year (FY). The ACR contains a variety of data on costs, revenue, rates, and quality of service in order to demonstrate that products complied with the Postal Act of 2006.

The misallocation of competitive product costs between market-dominant product costs or institutional costs creates the potential for what is known as cross-subsidization. Cross-subsidization is prohibited to ensure the Postal Service does not gain an unfair pricing advantage over its competitors for competitive products and that prices for

¹ Market dominant products are those products for which the Postal Service has a legal monopoly to control and include classes of mail such as standard and First-Class[™]. Competitive products are those products that the Postal Service provides which compete with products offered by competitors and include mail such as Priority and Express.

market-dominant (monopoly) products are not improperly inflated. For example, shifting costs from a competitive product such as Priority Mail to a market-dominant mail product or to institutional costs could allow Priority Mail to be priced more competitively and the market-dominant product (such as First-Class Mail®) to be overpriced.

The Postal Service's advertising costs totaled \$104.2 million in FY 2009. The advertising budget for FY 2010 is \$ [REDACTED] million. As of February 24, 2010, \$77.1 million of the advertising budget had been committed to specific tasks by corporate advertising.² The Postal Service initiated a major Priority Mail advertising campaign in FY 2009 and is continuing this campaign in FY 2010. See [Appendix A](#) for additional information about this audit.

Conclusion

The Postal Service did not accurately report advertising costs to the PRC. Specifically, the Postal Service understated Priority Mail advertising costs, which made the product appear to be more profitable.

The Postal Service lacked written guidance for collecting and reporting costs for their ACR. Following passage of the Postal Act of 2006, management did not issue written instructions clarifying how to allocate advertising costs to various products and services because they did not view the act as a change to their previously used methods. The agency did not document this previous methodology. Therefore, management did not develop written policies and procedures as implementing guidance on this section of the act because they viewed the act as "status quo" regarding their methods.

In addition, during FY 2009, advertising managers changed their procedures for allocating advertising costs without notifying finance personnel of the change. The new procedures did not follow the PRC's established cost methodology. Using cost allocation criteria we developed in discussions with PRC and Postal Service managers, we determined that Finance managers corrected some, but not all, of these misallocations, resulting in a misstatement of advertising costs reported to the PRC. The remaining misallocations shifted Priority Mail advertising costs to other classes of mail.

We also recalculated reported advertising costs for recent advertising campaigns. For FY 2009, Postal Service advertising managers understated competitive product advertising costs by \$14.3 million.

² This is as of February 2010 and does not include potential advertising expenditures that may occur at Postal Service field locations.

Finance managers corrected some of these misstatements, with the following effects:

- Priority Mail costs were understated by \$ [REDACTED] million and other competitive product advertising costs were overstated by \$ [REDACTED] million. This resulted in a net \$ [REDACTED] million understatement of competitive product costs reported in the 2009 ACR.
- The \$5.6 million understatement of Priority Mail costs inflated the perceived profitability of Priority Mail.
- Although the \$3.1 million net understatement of competitive products does not meet the threshold for cross-subsidization as defined by the PRC,³ such shifting of advertising costs is prohibited.
- While these understatements of competitive product advertising costs are not large, accumulated misallocations, if uncorrected, may impact the future pricing of competitive products and could lead to cross-subsidization.

Misallocation of advertising costs by advertising managers increased in FY 2010. If the figures in place at the time of our audit were reported to the PRC, the Postal Service would have understated Priority Mail costs by \$ [REDACTED] million and competitive product costs would have been misallocated to market-dominant and institutional costs by this amount. These misstatements may have increased during FY 2010 because management had not yet allocated \$ [REDACTED] million of the budgeted advertising costs to specific products at the time of our audit. We present the details regarding the misstatements and their impact below.

Allocation of Advertising Costs

The misstatements occurred for the following reasons:

- Finance management did not issue written guidance for collecting and reporting product costs in accordance with the Postal Act of 2006.
- During FY 2009, advertising managers changed their procedures for allocating advertising costs for single product advertising campaigns (for example Priority Mail), which did not follow established cost allocation methodologies. Senior advertising management held discussions with the advertising contractor, which led to changes whereby costs for single product advertising campaigns were often allocated at 70 percent to the product and 30 percent to institutional costs

³ The PRC determines whether total revenue from all competitive products equal or exceed the total incremental costs of all competitive products. Incremental costs are the costs avoided by eliminating a mail product or service, assuming all other products continue to be provided at their current volume. Incremental costs may include portions of institutional costs.

rather than 100 percent to the product as required. See [Appendix B](#) for the impact of the 70/30 percent cost allocation.

- Advertising, Legal, and Finance managers did not properly coordinate to ensure there was a mutual understanding regarding the cost reporting requirements for the ACR.
- Advertising management relied on Tracker,⁴ an inadequate project management system, to record and allocate advertising costs. For example, the budget categories in the Tracker system do not align with the product categories required in ACR reporting.

We present specific details of the misstatements for each fiscal year below:

[FY 2009 - Advertising Costs Reported by Advertising Management](#)

FY 2009 advertising costs reported by advertising managers to Finance were misstated. If Finance had not corrected these misstatements, the following would have occurred:

- Priority Mail advertising costs would have been understated by \$ [REDACTED] million, inflating the perceived profit of this product, which made it appear to be more successful.
- \$14.3 million of competitive product costs would have been misallocated to market-dominant and institutional costs.

See [Appendix D](#) for detailed information regarding the misstatements and the U.S. Postal Service Office of Inspector General (OIG) calculated advertising costs for FY 2009 reported by advertising management.

[FY 2009 - Advertising Costs Reported in the ACR](#)

In FY 2009 Finance became aware that certain corrections were needed to the cost data provided by the advertising managers prior to reporting that data to the PRC. After consultation with Segment Advertising management, Finance managers corrected some of the reporting errors. However, our recalculations indicate they did not correct aggregate adjustments totaling \$11.2 million reported to the PRC.

The following are examples of misstatements the Postal Service reported to the PRC:

- Priority Mail advertising costs were understated by \$ [REDACTED] million and other competitive product advertising costs were overstated by \$ [REDACTED] million. These

⁴ Tracker is a web-based application, developed in 2002, that is used to program the corporate advertising budget; create and track tasks associated with individual campaigns; reconcile vendor invoices with deliverables; and calculate year-end product cost allocations.

misstatements inflated the perceived profit of Priority Mail, which made it appear to be more successful.

- \$3.1 million of competitive product costs were misallocated to market-dominant and institutional costs.

See [Appendix E](#) for detailed information regarding the misstatements and the OIG's calculated FY 2009 advertising costs reported in the ACR.

[FY 2010 – Interim Advertising Costs](#)

We examined the \$77.1 million of corporate advertising costs committed as of February 24, 2010, and determined they were misstated by an aggregate of \$44 million. These misstatements may have increased during the fiscal year, as the Postal Service had not yet allocated \$■ million of the budgeted advertising costs to specific products at the time of our audit. If uncorrected, the following are examples of the misstatements that would have occurred:

- Priority Mail advertising costs would have been understated by \$■ million. This would have increased the perceived profitability of Priority Mail. Cumulative uncorrected misallocations could delay future price increases.
- \$21.8 million of competitive product costs would have been misallocated to market-dominant and institutional costs.

See [Appendix F](#) for detailed information regarding the misstatements and the OIG-calculated advertising costs for FY 2010.

Advertising management took action during our audit to correct the FY 2010 advertising cost misstatements related to the 70/30 percent cost allocation. However, management has not yet corrected other misstatements related to the costs of multiple-product advertising campaigns because they believe there can be some additional flexibility in allocating costs for these campaigns. Accordingly, further adjustments may be necessary to be consistent with established costing methodologies. We are making recommendations to management to bring reporting of advertising expense into full compliance with cost allocation methodologies established with the PRC.

[FY 2008 – Advertising Costs Reported in the ACR](#)

We reviewed FY 2008 advertising costs to develop a baseline as to how advertising costs were reported, and our recalculations determined that advertising costs reported to the PRC in the FY 2008 ACR were misstated by an aggregate of \$19.8 million.⁵ We noted that management did not follow the established cost allocation methodology for

⁵ For the details of the aggregate misstatements for each fiscal year, see Appendices E-H.

single product campaigns. We also noted that management did not use the 70/30 percent cost-allocation methodology in FY 2008. However, the following are examples of misstatements that we noted:

- Overstatement of market-dominant product advertising costs by \$1.3 million.
- Overstatement of competitive product advertising costs by \$8.6 million.
- Understatement of institutional costs by \$9.9 million.

As a result, the perceived profitability of various market-dominant and competitive products was understated by \$9.9 million in FY 2008. See [Appendix G](#) for detailed information regarding the misstatements and the OIG calculated advertising costs for FY 2008.

Strengthening controls over reporting of advertising costs could assist the Postal Service in maintaining stakeholder confidence and goodwill in the processes used to price products and services and ensure that the potential for cross-subsidization does not occur.

We recommend the chief financial officer and executive vice president direct the manager, Regulatory Reporting and Cost Analysis, to:

1. Coordinate with the Law Department and Segment Advertising to develop adequate guidance, controls, and processes to ensure reporting of advertising costs is done in compliance with Postal Regulatory Commission-approved costing methodology and correct any remaining misstatements in fiscal year 2010 advertising costs.
2. Develop an approval process to ensure changing advertising cost allocation methodologies is done in accordance with Postal Regulatory Commission-approved costing methodology.
3. Consult with the Postal Regulatory Commission to determine whether restating fiscal years 2008 and 2009 Annual Compliance Reports is necessary.

We recommend the manager, Advertising and Media Planning, direct the manager, Segment Advertising, to:

4. Develop and implement detailed system requirements for the Tracker System to provide project management information that ensures ability to appropriately attribute advertising costs.

Management's Comments

Management agreed with our recommendations. Although management did not agree with all of the assertions, methodologies, and conclusions contained in the finding, they stated they agree and intend to comply with all of the recommendations.

With regard to recommendation 1, management stated that no formal written guidelines were provided to the Segment Advertising staff. As a result, they were unfamiliar with the cost categories needed to develop the ACR. Management stated that its guidelines for allocating the costs of advertising tasks relating to two or more products may differ from those the audit team used and questioned the methodology of the audit staff, particularly for splitting advertising costs evenly between two products. Management, in consultation with Segment Advertising and the Law Department, will develop written guidelines for determining and reporting advertising costs that meet the cost allocation strategy within the PRC's approved costing methodologies by September 30, 2010.

Regarding recommendation 2, management stated that, until this year, Segment Advertising was not aware that changes to their budget categories might have an impact on product totals required by ACR reporting and Finance was not always aware that budget categories had changed. Management also stated that Finance would coordinate with Segment Advertising to develop a process by September 30, 2010, to ensure that Advertising communicates any changes to their cost categories or cost allocation methodologies to Finance for review and approval. If compliance is in question, Finance will coordinate with Segment Advertising to develop a mutually agreed-upon approach.

Regarding recommendation 3, management stated they notified the PRC on July 7, 2010, of the audit findings and an estimate of the impact of the potentially misstated costs on the total contribution of competitive products to institutional costs in the FY 2009 ACR. The letter also included a revised calculation of Priority Mail's cost coverage.

Regarding recommendation 4, management stated that they designed the current Tracker system (in use since 2002) for budgeting and project management purposes and that Segment Advertising was not aware that the system's outputs did not always meet ACR requirements. Management stated that Finance would coordinate with Segment Advertising to develop detailed system requirements for generating outputs that align with current regulatory reporting categories and comply with PRC-approved cost methodologies. The new or upgraded system will produce ACR product totals in time for production of the FY 2011 ACR. Management indicated that some manual summarization might be needed for both FY 2010 and 2011 ACRs. Management's comments, in their entirety, are included in [Appendix I](#).

Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendations and corrective actions should resolve the issues identified in the report.

Management agreed that there was some misallocation of costs but stated they did not agree with the method the OIG used to calculate cost misallocations and the summary of non-monetary benefits. At the time of our audit, the Postal Service did not have written guidance on how single- and multi-product advertising costs should be allocated. In addition, interim guidance distributed by Finance to Advertising management on February 2, 2010, did not specifically describe how to allocate multi-product advertising costs. Finally, eliminating the 50-50 split from the OIG's allocation criteria for evaluating the advertising costs for two products would increase, not decrease, the misallocations we would have reported in Appendices D through H. As noted in management's response, there may be "gray areas" in interpreting how to properly report advertising expenses; however, we did not include amounts related to "gray areas" in our calculation of misallocated advertising costs.

The OIG considers recommendations 1, 2, and 4 to be significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. These recommendations should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendations can be closed.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Paul Kuennen, director, Cost, Revenue, and Rates, or me at 703-248-2100.

E-Signed by Darrell E. Benjamin, Jr. 
VERIFY authenticity with ApproveIt

Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Revenue and Systems

Attachments

cc: Mary A. Gibbons
Joseph D. Moeller
Jeffrey L. Colvin
Dennis J. Gomes
Corporate Audit Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

The Postal Act of 2006 requires the Postal Service to provide an ACR within 90 days after the end of each fiscal year. The ACR contains a variety of data on costs, revenues, rates, and quality of service in order to demonstrate compliance with reporting requirements.

The Postal Act of 2006 requires managers to attribute costs, including advertising costs, directly related to a product to that specific product. Organizational costs not allocated to a specific product are considered institutional costs. Institutional costs includes, essentially, overhead costs for the Postal Service and encompass items such as portions of executive salaries and general administrative expenses, or advertising campaigns promoting the Postal Service brand and not a specific product. Prices for specific market-dominant and competitive products⁶ are established with a pricing strategy to generally cover attributable costs, plus a contribution margin to defray institutional costs.⁷ Cross-subsidization of market-dominant and competitive product costs is prohibited to ensure the Postal Service does not gain an unfair pricing advantage over competitors. See [Appendix C](#) for OIG's interpretation of PRC's guidance on the treatment of advertising costs for ACR reporting.

The Postal Service incurs advertising costs to promote various products, services and overall brand awareness. The Postal Service's advertising costs totaled \$104.2 million in FY 2009 and \$106.6 million in FY 2008.⁸ In FY 2009, Advertising and Media Planning managed \$84 million in advertising costs. Expedited Shipping Services managed an additional \$10.1 million in advertising costs while field and miscellaneous advertising costs totaled another \$10.1 million. While the FY 2008 advertising campaign did not focus on a particular product, the Postal Service initiated a major Priority Mail campaign in FY 2009.

Advertising management uses the Tracker system to perform project management functions, including authorization, monitoring, and reporting of advertising costs. Annually, advertising management provides summary advertising cost data to Finance management to prepare the ACR, and the Law Department files the ACR with the PRC.

⁶ Market-dominant products are mailing services and competitive products are shipping services.

⁷ The Postal Act of 2006 requires that competitive products cover a minimum of 5.5 percent of the Postal Service's institutional costs. In FY 2009, competitive products contributed \$2.0 billion toward institutional costs, which exceeded the 5.5 percent requirement by \$368 million.

⁸ Advertising costs are a small portion of the Postal Service expenses of \$71.8 billion.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to determine whether advertising costs were accurately reported to the PRC and whether Priority Mail advertising costs were shifted to other products in an attempt to make it appear more successful. Specifically, we determined whether methods for collecting, allocating, and reporting advertising costs for mail products and services were appropriately and consistently applied.

We reviewed statutory requirements and met with PRC, Law Department, and Finance managers to discuss reporting criteria. Advertising and contractor personnel provided information regarding budgeting, approval, and reporting of advertising costs. Finance personnel described adjustments they made to advertising cost data that were needed for the ACR.

We used computer-generated data from Tracker and performed comparative analysis tests with general ledger data to ascertain the validity of reported advertising costs. We found the data to be reliable to accomplish the audit objective. We recalculated the allocation of advertising costs for FYs 2008, 2009, and 2010⁹ based on statutory requirements and guidance we received from PRC, Law Department, and Finance.

We conducted this audit from January through August 2010 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We discussed our observations and conclusions with management officials on July 7, 2010, and included their comments where appropriate.

PRIOR AUDIT COVERAGE

The OIG has not conducted any prior audits of advertising costs specifically related to the objective of this audit.

⁹ FY 2010 advertising costs are as of February 24, 2010, as reflected in Tracker.

APPENDIX B: DETAILED ANALYSIS

Misallocation of Single Product Advertising Costs (70/30 Allocation)

During FY 2009, advertising management discussed with contractor support personnel the need to begin allocating, where possible, 70 percent of advertising costs related to single mail products (for example Priority Mail) to the product and 30 percent to institutional costs. While senior management officials were uncertain whether there were direct instructions to advertising contractors to begin using the 70/30 allocation percentage, the contractors submitted task orders for approval with this percentage and advertising management routinely approved them.

Use of this 70/30 allocation percentage began in November 2008 and accelerated during FY 2010. For example, FY 2009 task orders totaling \$ [redacted] million used the 70/30 allocation percentage for single product advertising, while \$ [redacted] million in FY 2010 task orders used the 70/30 allocation percentage. See Table 1 for summary information regarding the use of the 70/30 percent cost allocation on single product advertising task orders and [Appendix C](#) for PRC reporting guidance.

Table 1. FY 2008 - 2010 Allocation of Single-Product Advertising Costs Using 70/30 Allocation Percentage (\$ in Millions)

	FY 2008		FY 2009		FY 2010	
	Number	Amount	Number	Amount	Number	Amount
Task Orders with 70/30 allocation (a) 0		\$0	166	\$ [redacted]	111	\$ [redacted]
Task Orders - Total (b) 1,700		\$ [redacted]	1,677	\$ [redacted]	556	\$ [redacted]
Ratio (a / b) -		-	10%	54%	20%	72%

Using costing methodologies we developed in consultation with the PRC, these allocations resulted in the understatement of product-specific costs by \$ [redacted] million¹⁰ in FY 2009, and would have understated product-specific costs by \$ [redacted] million¹¹ in FY 2010 if the ACR were prepared based on advertising cost data as of February 24, 2010. These allocations contravened the PRC’s established costing practices because the advertising costs should have been allocated 100 percent to the specific products associated with the task orders. During our audit, management corrected single-product cost allocations for FY 2010.

Project Management System

Management relied on Tracker, a project management system, to record and allocate advertising costs. The Tracker system is an ad hoc system developed by a contractor to

¹⁰ 30 percent of \$34.6 million.

¹¹ 30 percent of \$44.4 million.

perform project management functions such as tracking advertising task orders, allocating costs among products, and generating management reports. Advertising management also uses it as a budget-tracking tool. However, the system does not properly capture the necessary information to track the costs in accordance with PRC's established costing practices. In addition, the budget categories in the Tracker system do not align with the product categories required in ACR reporting. This occurred because adequate system requirements were not developed prior to implementation of the system. As a result, manual summarization is required to gather the necessary advertising cost information required in the ACR. This inefficient process is prone to error.

APPENDIX C: COST ALLOCATION CRITERIA

The Postal Act of 2006 defines “attributable costs” as direct and indirect Postal Service costs that have a reliably identified causal relationship to a specific product. The PRC states¹² that when an activity supports a single product, the costs for that activity should be attributed to that product.

In the “*Summary Description of USPS Development of Costs by Segments and Components Fiscal Year 2008*,” Section 16.3.15, filed with the PRC on July 1, 2009, the Postal Service stated they reported advertising costs as follows:

Advertising: Costs for advertising are incurred to provide public information, to promote the Postal Service, and to encourage mailers to perform activities to improve postal efficiency, such as “mail early” and “use ZIP” campaigns. ***With the exception of media costs for the promotion of particular products (which are treated as product specific costs toward those products)***, these costs represent management decision factors and are unrelated to mail volume. As a result, these other advertising costs are classified as institutional costs. Costs for promotional supplies for specific products, such as posters and fliers do not vary with volume and are classified as product specific to the individual classes of mail.

We held discussions with PRC, Law Department, and Finance managers, and reviewed applicable PRC and Postal Service guidance. Based on these discussions and a review of the guidance, we established and applied the following criteria to calculate advertising costs by product in FYs 2008 through 2010 year to date:

- For advertising costs related to one product (such as Priority Mail), 100 percent of the costs are attributed to that product.
- For advertising costs related to two products in equal ratios (such as 50 percent to Priority Mail and 50 percent to Express Mail®), half of the costs are attributed to each of the two specific products.
- Advertising costs related to all other situations (such as, three products or two products with unequal ratios) are allocated to institutional costs.

¹² Docket Number RM2008-2 filed on October 10, 2008.

APPENDIX D: FY 2009 - ADVERTISING COSTS REPORTED BY ADVERTISING MANAGEMENT

Category	Advertising	OIG Calculated	Over/ (Under) Statement	Aggregate Misstatement
Market Dominant Products:				
First-Class	\$ 617,243	\$ 107,033	\$ 510,210	\$ 510,210
Standard Mail®	6,018,375	5,979,309	39,066	39,066
Market Dominant Services	1,343,395	643,854	699,541	699,541
Subtotal Market Dominant	7,979,013	6,730,196	1,248,817	1,248,817
Competitive Products:¹³				
Express Mail	██████████	██████████	██████████	██████████
Priority Mail	██████████	██████████	██████████	██████████
Parcel Select Mail	██████████	██████████	██████████	██████████
Premium Forwarding Service	██████████	██████████	██████████	██████████
International Mail and Services	██████████	██████████	██████████	██████████
Subtotal Competitive	57,282,431	71,573,956	(14,291,525)	19,218,469
Institutional Costs	38,934,540	25,891,832	13,042,708	13,042,708
Total Advertising Costs	\$104,195,984	\$104,195,984	\$ 0	\$33,509,994

¹³ For FYs 2009 and 2010, allocation of core team expenses to Priority Mail and institutional costs was based on the ratio of Priority Mail advertising costs to the total corporate advertising costs net of core team expenses. The contractors were unable to provide a supportable estimate of core team expense allocations.

APPENDIX E: FY 2009 - ADVERTISING COSTS REPORTED IN THE ACR

Category	ACR	OIG Calculated	Over/ (Under) Statement	Aggregate Misstatement
Market-Dominant Products:				
First-Class	\$ 617,243	\$ 107,033	\$ 510,210	\$ 510,210
Standard Mail	6,018,375	5,979,309	39,066	39,066
Market Dominant Services	1,343,395	643,854	699,541	699,541
Subtotal Market Dominant	7,979,013	6,730,196	1,248,817	1,248,817
Competitive Products:				
Express Mail	██████████	██████████	██████████	██████████
Priority Mail	██████████	██████████	██████████	██████████
Parcel Select Mail	██████████	██████████	██████████	██████████
Premium Forwarding Service	██████████	██████████	██████████	██████████
International Mail and Services	██████████	██████████	██████████	██████████
Subtotal Competitive	68,424,612	71,573,956	(3,149,344)	8,076,288
Institutional Costs	27,792,359	25,891,832	1,900,527	1,900,527
Total Advertising Costs	\$104,195,984	\$104,195,984	\$ 0	\$11,225,632

APPENDIX F: FY 2010 - INTERIM ADVERTISING COSTS¹⁴

Category	Advertising	OIG Calculated	Over/ (Under) Statement	Aggregate Misstatement
Market-Dominant Products:				
First-Class	\$ 83,389	\$ 75,550	\$ 7,839	\$ 7,839
Standard Mail Domestic Market Dominant Services	1,910,786	1,909,411	1,375	1,375
	629,756	559,232	70,524	70,524
Subtotal Market Dominant	2,623,931	2,544,193	79,738	79,738
Competitive Products:				
Express Mail				
Priority Mail				
Parcel Select Mail				
Premium Forwarding Service				
International Mail and Services				
Subtotal Competitive	44,745,000	66,568,961	(21,823,961)	22,167,413
Institutional Costs	29,689,604	7,945,381	21,744,223	21,744,223
Total Advertising Costs	\$77,058,535	\$77,058,535	\$ 0	\$43,991,374

¹⁴ Includes advertising costs tracked by advertising management only.

APPENDIX G: FY 2008 - ADVERTISING COSTS REPORTED IN THE ACR

Category	ACR	OIG Calculated	Over/ (Under) Statement	Aggregate Misstatement
Market-Dominant Products:				
Total First-Class	\$ 171,978	\$ 84,517	\$ 87,461	\$ 87,461
Total Standard Mail	11,086,897	10,510,881	576,016	576,016
Total Market				
Dominant Services	690,121	89,955	600,166	600,166
Subtotal Market Dominant	11,948,996	10,685,353	1,263,643	1,263,643
Competitive Products:				
Express Mail				
Priority Mail				
Parcel Select Mail				
Premium Forwarding Service				
International Mail and Services				
Subtotal Competitive	16,831,046	8,199,394	8,631,652	8,631,652
Institutional Costs¹⁵	77,782,233	87,677,528	(9,895,295)	9,895,295
Total Advertising Costs	\$106,562,275	\$106,562,275	\$ 0	\$19,790,590

¹⁵ Institutional costs for FYs 2008 and 2009 include costs reported by advertising management, field advertising, and others that are classified as institutional by Finance.

APPENDIX H: NON-MONETARY IMPACTS

A misallocation of costs can occur when Postal Service costs are misclassified as volume variable, product-specific or institutional costs. These misclassifications do not result in any recoverable costs, but could shift costs between and among mail products and institutional cost categories. The aggregate misstatement of advertising costs encompass product specific and institutional costs and are described in detail in Appendices E, F, and G, and are summarized below:

Non-Monetary Impacts

Finding Impact	Category	Amount
1	Misallocation of Costs - FY 2008	\$19,790,590
1	Misallocation of Costs - FY 2009	11,225,632
1	Misallocation of Costs - FY 2010	43,991,374
	TOTAL	\$75,007,596

APPENDIX I: MANAGEMENT'S COMMENTS



August 6, 2010

LUCINE M. WILLIS
DIRECTOR, AUDIT OPERATIONS

SUBJECT: Transmittal of Draft Audit Report – Advertising Cost Reporting (Report Number CRR-AR-10-DRAFT)

This provides management's response to the subject audit report. We appreciate the opportunity to review and provide comments.

While the Postal Service agrees with and intends to comply with all of the audit team's recommendations, it does not agree with certain of the team's assertions, methodologies, and conclusions. Our response to the recommendations and our discussion of these areas of disagreement are provided below.

The audit team recommended the chief financial officer and executive vice president direct the manager, Regulatory Reporting and Cost Analysis, to:

Recommendation 1

Coordinate with the Law Department and Segment Advertising to develop adequate guidance, controls, and processes to ensure reporting of advertising costs is done in compliance with Postal Regulatory Commission-approved costing methodology and correct any remaining misstatements in Fiscal Year 2010 advertising costs.

Response

As reported, no formal written guidelines were provided to the Segment Advertising staff, with the result that Advertising was unfamiliar with the cost categories needed to develop the Annual Compliance Report (ACR). Instead, Finance relied on discussions and email contact to resolve questions and redistribute costs it had reason to believe could be more accurately allocated to products. This was most particularly the case during the preparation of the FY 2009 ACR, when Finance consulted frequently with Advertising in an attempt to correctly ascertain the costs attributable to Priority Mail. The meetings were enlightening to both organizations, as Finance gained insight into how the advertising costs were developed while Advertising learned why and in what form the costs were needed.

To further promote cooperation between the two groups and to comply with the above recommendation, I have directed the manager, Regulatory Reporting and Cost Analysis, to work with the Law Department and Segment Advertising to develop written guidelines for the determination and reporting of advertising costs. These guidelines will include a cost allocation

strategy that complies fully with Postal Regulatory Commission (PRC) approved costing methodologies. As a result of this effort, we will ensure that the FY 2010 advertising costs reported to Finance are allocated to products as accurately as possible. These guidelines will be agreed upon and written by September 30, 2010.

The Postal Service wishes to note that its guidelines for allocating the costs of advertising tasks relating to two or more products may differ from those utilized by the audit team (see the report's Appendix C). We question why it should be acceptable to utilize Advertising's estimate of a 50-50 split between two products yet unacceptable to utilize an equally well-founded 60-40 estimate. In fact, as we were advised by the audit team, not all of the PRC staff they consulted agreed with this approach, and the auditors themselves acknowledge the existence of "gray areas" when it comes to allocating this small portion of advertising costs. The audit team's approach would move some product-related costs to the institutional category, whereas our practice, in keeping with past PRC rulings, is to attribute all product-related costs for which supporting evidence exists.

Recommendation 2

Develop an approval process to ensure changing advertising cost allocation methodologies is done in accordance with Postal Regulatory Commission-approved costing methodology.

Response

Until this year, Segment Advertising was not aware that changes to their budget categories might have an impact on product totals required for ACR reporting, and Finance was not always aware that budget categories had changed. Therefore, I will direct the manager, Regulatory Reporting and Cost Analysis, to coordinate with Segment Advertising to develop a process to ensure that any changes to Advertising cost categories or cost allocation methodologies are communicated to Finance. Finance will review the changes and determine whether they comply with PRC-approved costing methods. If compliance is in question, Finance will further coordinate with Segment Advertising until a mutually agreed-upon approach is developed. This process will be developed by September 30, 2010.

However, the Postal Service takes issue with the assertion that "during FY 2009, advertising managers changed their procedures for allocating advertising costs without notifying finance personnel of the change." Segment Advertising knows of no instance where procedures were changed and strongly denies the assertion that staff or contractors were instructed to allocate 30 percent of single-product costs to the "Brand" category in order to divert a percentage of Priority Mail advertising costs to the ACR's institutional category. Advertising believes a misunderstanding may have arisen when investigators were told it was the typical practice within the advertising industry to allocate 30 percent of costs to brand for budgeting purposes. This was not, however, the normal practice within the Postal Service. In most cases where a portion was allocated to brand, the percentage was based on a quantifiable analysis of ad content—and, again, with Advertising's own budget categories in mind. Accordingly, the Postal Service disputes the OIG contention that there was a "70/30" directive, as indicated at pages 2-5 and in Appendix B.

Recommendation 3

Consult with the Postal Regulatory Commission to determine whether restating fiscal years 2008 and 2009 Annual Compliance Reports is necessary.

Response

On July 7, 2010, I wrote to PRC Chairman Ruth Goldway to apprise her of the audit team's findings and to provide her with an estimate of the impact of potentially misstated costs on the total contribution of competitive products to institutional costs in the FY 2009 ACR. The letter also included a revised calculation of Priority Mail's cost coverage. Chairman Goldway responded on July 15, acknowledging receipt of the updated calculations and indicating that she had forwarded the letter to the Commission's Secretary to be posted on the PRC website as part of the 2009 ACR docket.

Recommendation 4

The audit team recommended the manager, Advertising and Media Planning, direct the manager, Segment Advertising, to:

Develop and implement detailed system requirements for the Tracker System to provide project management information that ensures ability to appropriately attribute advertising costs.

Response

The Tracker system has been in use since 2002 and was designed for budgeting and project management purposes. ACR reporting categories, on the other hand, were not formalized until FY 2007 and have undergone some changes every year since. Prior to this audit, Segment Advertising was not aware that the Tracker system's outputs did not always meet ACR reporting requirements. To resolve differences, Segment Advertising had manually summarized the Tracker data into categories more meaningful to Finance, and Finance had performed further disaggregation or consolidation of the categories. To eliminate as much of this end-processing as possible, I will direct the manager, Segment Advertising, to coordinate with Finance to develop detailed system requirements for generating outputs that align with current regulatory reporting categories and that comply with PRC-approved costing methodologies. These changes cannot be implemented in time for FY 2010 reporting because the contract under which the Tracker system was developed is expiring very shortly and may not be re-awarded to the same vendor. Therefore, for FY 2010, Segment Advertising will manually summarize Tracker outputs to align with ACR categories. The new or upgraded system will produce ACR-ready product totals in time for FY 2011 ACR production. Note, however, that because changes or additions to ACR reporting categories are not finalized until well into the reporting year, some manual summarization may continue to be necessary.

In addition to the above recommendations and related issues, the Postal Service would like to address several assertions in the audit team's report that it believes to be erroneous.

1. In several instances, the audit team asserts that shifting costs from a product could delay price increases—for example, on page 5, where the report states, "Cumulative uncorrected misallocations could delay future price increases." Quite apart from the ambiguous reference to "cumulative" misallocations, the only requirement for pricing competitive

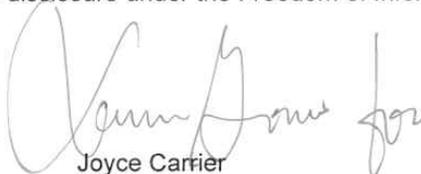
products under the Postal Act of 2006 is that they collectively meet the 5.5 percent contribution requirement and that they individually cover their costs—which Priority Mail does by a very wide margin. Otherwise, many non-cost factors are also considered in our pricing decisions, as is the case in the private sector. For market-dominant products, outside of an exigent price change, increases to the major classes of market-dominant mail (First-Class, Standard, etc.) are capped by a formula using a Consumer Price Index. Accordingly, we disagree with the notion that the issues identified here, at least on the scale identified, would affect pricing.

2. The Postal Service does not agree with the calculations of “Aggregate Misstatement” amounts in Appendices D through H. The totals appear to overstate the amount of advertising expense the audit team has determined to be misstated by tallying “misstated” dollars twice—i.e., by adding up both the under- and over-stated amounts. Furthermore, the Postal Service does not understand the function of Appendix H, Non-Monetary Impacts, and is concerned that the total amount of \$75 million may cause the reader to misunderstand the scale of the issues identified. This total is particularly troubling in that the largest portion of this amount is for FY 2010—a year that has not yet been reported.
3. As discussed with the audit team, the Postal Service takes issue with some of the terminology used in the report. For instance, in the first paragraph, the report states that one objective was to determine whether there was “an attempt to make Priority Mail appear to be more successful.” We appreciate that this is listed as an objective of the audit, rather than a finding; however, the mere mention of it, albeit as an “objective,” may lead the reader to believe that such an attempt existed. To put the issue into perspective, as we stated in our letter to Chairman Goldway, the adjustments to FY 2009 Priority Mail costs suggested in this audit would change its cost coverage from 130.0 percent to 129.9 percent. Also, the \$5.6 million under-statement identified for competitive products represents only 0.1 percent of the total costs reported for these products in FY 2009. Again, the Postal Service does not disagree that there was some misallocation of costs, and certainly we want our products to be successful, but we had no motivation to falsely allocate costs to create the appearance of success.

This report contains information in its appendices that is treated as “non-public” by the PRC since it involves competitive products. Therefore, these appendices (i.e., all but Appendix C) do contain information that may be exempt from disclosure under the Freedom of Information Act.



Joseph Corbett
Chief Finance Officer, Executive Vice President



Joyce Carrier
Manager, Advertising and Media Planning

cc: Mary A. Gibbons
Joseph D. Moeller
Jeffrey L. Colvin
Dennis J. Gomes
Corporate Audit Response Management