Major Management Challenges and Program Risks

U.S. Postal Service
A Glance at the U.S. Postal Service

The U.S. Postal Service is an independent establishment of the executive branch. It is the federal government’s largest civilian employer and had revenues of about $67 billion in fiscal year 2002. The Service’s overall mission is to

- bind the nation together through correspondence of the people;
- provide access to postal services in all communities;
- offer prompt, reliable postal services at reasonable rates;
- be self-supporting from postal operations; and
- break even financially.

The U.S. Postal Service’s Budgetary and Staff Resources

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Budgetary Resources (^a, b)</th>
<th>Staff Resources (^b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dollars in billions</td>
<td>FTEs in thousands</td>
</tr>
<tr>
<td>1998</td>
<td>62</td>
<td>837</td>
</tr>
<tr>
<td>1999</td>
<td>65</td>
<td>851</td>
</tr>
<tr>
<td>2000</td>
<td>65</td>
<td>848</td>
</tr>
<tr>
<td>2001</td>
<td>66</td>
<td>831</td>
</tr>
<tr>
<td>2002</td>
<td>71</td>
<td>826</td>
</tr>
</tbody>
</table>

Source: Budget of the United States Government.

\(^a\) Budgetary resources include new budget authority (BA) and unobligated balances of previous BA. The Postal Service receives minimal budgetary resources from the federal government and funds its operations primarily from postal revenues.

\(^b\) Budget and staff resources are actuals for FY 1998-2001. FY 2002 are estimates from the FY 2003 budget, which are the latest publicly available figures on a consistent basis as of January 2003. Actuals for FY 2002 will be contained in the President’s FY 2004 budget to be released in February 2003.

This Series

This report is part of a special GAO series, first issued in 1999 and updated in 2001, entitled the Performance and Accountability Series: Major Management Challenges and Program Risks. The 2003 Performance and Accountability Series contains separate reports covering each cabinet department, most major independent agencies, and the U.S. Postal Service. The series also includes a governmentwide perspective on transforming the way the government does business in order to meet 21st century challenges and address long-term fiscal needs. The companion 2003 High-Risk Series: An Update identifies areas at high risk due to either their greater vulnerabilities to waste, fraud, abuse, and mismanagement or major challenges associated with their economy, efficiency, or effectiveness. A list of all of the reports in this series is included at the end of this report.
The Service has made progress in addressing its challenges and has developed a Transformation Plan (the Plan) that contains steps to guide it in the future. Challenges remain, however, and leadership and sustained attention by the Service will be critical to carrying out its transformation.

- Implement the Transformation Plan and determine business model for the 21st century. The Service is struggling to fulfill its mission of providing affordable, high-quality, universal service while remaining self-supporting. The figure shows that despite multiple rate increases, net income has decreased. The Service’s business model is at risk as mail volumes decline and competition and alternatives increase.

- Control costs and improve productivity under the Service’s existing authority. The Service’s ability to control costs and improve productivity is key to improving its financial situation. The Service historically has had difficulty in achieving cost savings related to two costly areas—its workforce and its expansive physical infrastructure.

- Address unresolved financial issues. The Service’s cash flow from operations has not been sufficient to fund needed capital expenditures and reduce debt pressures. Furthermore, its liabilities continue to exceed its assets, and postretirement health obligations are increasing.

- Develop strategies to address human capital issues. Progress is needed in realigning the Service’s workforce planning and performance systems with its business model. Cooperation between labor and management will be critical to achieving transformation goals.

- Provide complete and reliable financial and performance information in a timely and transparent manner. The Service has not provided sufficient public information to explain its changing financial condition, outlook, and progress toward meeting its goals.
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January 2003

The President of the Senate
The Speaker of the House of Representatives

This report addresses the major management challenges and program risks facing the U.S. Postal Service (the Service) as it works to carry out its mission. The report discusses the actions that the Service has taken and that are under way to address the challenges GAO identified in its Performance and Accountability Series 2 years ago, along with major events that have occurred that significantly influence the environment in which the Service carries out its mission. Also, the report summarizes the challenges that remain, new ones that have emerged, and further actions that we believe are needed.

This analysis should help the new Congress and the administration carry out their responsibilities and improve government for the benefit of the American people. For additional information about this report, please contact Bernard L. Ungar, Director, Physical Infrastructure Issues, at (202) 512-2834 or at ungarb@gaogov.

David M. Walker
Comptroller General
of the United States
Major Performance and Accountability Challenges

As the federal government’s largest civilian employer, with a nationwide network that delivers more than 200 billion pieces of mail each year, the Postal Service is a vital part of the nation’s communications network and the hub of a $900 billion mailing industry. Over the past 2 years, the Service has experienced growing financial difficulties and has struggled to fulfill its primary mission of providing universal postal service at reasonable rates while remaining self-supporting from postal revenues. The Service continues to operate in an environment of growing financial, operational, and human capital challenges, as well as uncertainty about its future role. The events of September 11th and the subsequent use of the mail to transmit anthrax have introduced new issues related to mail safety and security that also must be addressed. These challenges require urgent attention to ensure that the Service will be able to fulfill its mission in the 21st century.

In April 2001, we placed the Service’s transformation efforts and long-term outlook on our high-risk list and recommended that it develop a comprehensive plan to determine the actions needed to address its financial, operational, and human capital challenges. This high-risk designation resulted in the development of the Service’s Transformation Plan (the Plan)—a document that contains steps to guide the Service in carrying out its future mission. The implementation of this plan is a new challenge facing the Service, and thus we added it to our current list of its major challenges. This challenge replaces two of the major challenges we identified 2 years ago, because they are key parts of the Plan: the Service’s ability to remain self-supporting while providing affordable, high-quality, universal service; and the need to address legal and regulatory issues. Three challenges that we previously identified still remain today: 1) controlling costs and improving productivity under the Service’s existing authority, 2) developing strategies to address human capital issues, and 3) providing complete and reliable financial and performance information in a timely and transparent manner. Additionally, in response to the Service’s deteriorated financial condition, we added a new challenge—addressing unresolved financial issues. The Service’s cash flows from operations have not been sufficient to fund needed capital expenditures and significantly reduce debt pressures; its workers’ compensation liability and postretirement health benefit obligations are large and increasing; and its liabilities exceed its assets. These underlying factors driving the Service’s financial condition cannot be ignored.
These key areas must be addressed because the Service is at a very important crossroads. Its current business model, which relies on increasing mail volumes to mitigate postal rate increases and cover the Service’s costs, is at risk in today’s environment of greater competition and communication alternatives. In fiscal years 2001 and 2002, despite multiple rate increases and significant cost-cutting efforts, the Service still incurred deficits of $1.7 billion and $676 million, respectively, as its volumes declined by the most significant amount since postal reorganization occurred over 30 years ago. Furthermore, uncertainties such as the effects of a slowing economy, the pace of diversion to electronic alternatives, and new measures taken to enhance the safety and security of the mail have affected postal finances during this time and may continue to do so in the future.

Opportunities exist, however, that may help the Service address these major management challenges and effectively carry out its transformation. For example, the results of a recent financial analysis may lead to a reduction in the Service’s pension liability and related annual payments if Congress takes legislative action in this area. This action could lead to further improvements in the Service’s financial condition and outlook beyond the $600 million net income that was budgeted for fiscal year 2003.
The additional “breathing room” could allow the Service to address other financial challenges, such as its outstanding debt, substantial postretirement health obligations, and current capital freeze. The Service also faces a large number of upcoming retirements, which provide an opportunity to realign its workforce and infrastructure to meet its future operational needs. The Service will need to develop and effectively implement strategies to address these five challenges in order to carry out its mission in the 21st century. Although various postal reform proposals addressing the Service’s future role and responsibilities have recently been debated in Congress, no consensus has been reached among postal stakeholders on what the future of the Service should be. The President recently established a commission to make recommendations regarding the future of the Postal Service. Committed leadership and sustained attention in addressing these challenges will be important to achieve the results necessary for us to reassess our inclusion of the Postal Service’s transformation efforts and long-term outlook on our high-risk list.

Implement Transformation Plan and Determine Business Model for the 21st Century

The key issues involved in implementing the Plan and determining a new business model are as follows:

- Ability to carry out mission is at risk;
- Mail volumes have declined, and multiple rate increases have been implemented;
- Growth in operating expenses has outpaced growth in operating revenues;
- No consensus has been reached on the Service’s future role and mission;
- More public information is needed on transformation progress.

The Service has struggled to fulfill its core function of providing affordable, high-quality, universal service while at the same time remaining self-supporting. Decreasing mail volumes, along with total expenses that are greater than total revenues, have led to the third consecutive year of deficits despite multiple rate increases during this period. Figure 1 shows that net income has decreased in 6 of the past 8 fiscal years.
These financial difficulties are not a cyclical phenomenon that will fade as the economy recovers. The Service’s business model, which is based on the premise that increases in mail volumes will cover rising costs and mitigate rate increases, is at risk because of growing competition from private companies, foreign postal operators, and technological alternatives, such as cell phones and the Internet. Total mail volume declined by 2.5 percent over the past 2 fiscal years. Further, Figure 2 shows that growth in First-Class Mail and Standard Mail has been, on average, declining since the 1980s. Declines in volume growth for these two mail classes are particularly important because the Service relies on them for approximately three-fourths of its annual revenue.
In addition to this slowing growth rate, the changing composition of the mail also affects the Service’s revenue. First-Class Mail volume declined in fiscal year 2002 for the first time in over 25 years, which is particularly important because the revenue generated from First-Class Mail is used to cover a significant portion of the Service’s overhead costs. In addition, the weight per mail piece—which is a key factor in determining the rate charged and the revenue earned—across most major mail categories is down. The Service’s reliance on rate increases to generate additional revenues is unlikely to reverse the change in composition or promote the volume growth that is needed to sustain financial viability. As volume growth in the major mail categories has declined and mail composition has changed, growth in the Service’s operating revenue also has declined. Figure 3 shows that over the past 3 fiscal years, on average, operating revenue growth has dropped below that of operating expenses growth.
Although the results of a new analysis by the Office of Personnel Management (OPM) could significantly reduce the Service’s annual Civil Service Retirement System (CSRS) pension payments, the Postmaster General (PMG) recently stated that this does not resolve the fundamental flaws in the Service’s business model. We agree, and believe that the Service must address its key long-term challenges for a successful transformation to a new business model. These challenges include revisiting the Service’s mission and determining the definition of universal postal service; devising operational strategies to address infrastructure and human capital matters; identifying actions needed to enhance mail safety and security; addressing issues of future governance and ratemaking structures; and determining proper accountability mechanisms and needed legislative changes. Addressing these challenges requires consensus among various stakeholders, which has been very difficult to achieve, in part, because numerous stakeholders have divergent needs and concerns. Since 1996, postal reform legislation has been considered many times in Congress; however, none of these reform proposals has been passed. As we
noted in February 2002, a commission may be needed to address unresolved issues related to the Service’s transformation to a new business model and to develop a comprehensive proposal for consideration by the Congress. On December 11, 2002, the President established a nine-member Commission on the United States Postal Service to prepare and submit a report on a proposed vision for the future of the Postal Service and recommend the legislative and administrative reforms needed to ensure the viability of postal services. The Commission is expected to submit its report to the President by July 31, 2003.

In response to our April 2001 recommendation to address its unresolved financial, operational, and human capital challenges, the Service released its Transformation Plan in April 2002. In the Plan, the Service outlined the steps, both current and long-term, it deemed necessary to guide it in carrying out its mission in the future. Specifically, the Plan presented actions to deal with transformation issues (1) in the short term, under its current authority and through moderate regulatory and legislative reforms, and (2) in the longer term, through fundamental structural transformation. To achieve its fundamental structural transformation, the Service proposed moving toward a Commercial Government Enterprise business model. This model differs slightly from its current model, and would allow flexible pricing and retained earnings. Table 1 provides a more complete comparison between the Service’s proposed Commercial Government Enterprise model and its current business model.
We have reported that the development of the Transformation Plan was a good first step in raising key postal reform issues.¹ Since the Plan was issued, the Postmaster General has highlighted the progress made in implementing initiatives set forth in the Plan, including significant cost savings achievements; improvements in service performance; efforts to improve the ratemaking process with targeted pricing initiatives; enhancements to existing products with the implementation of a new service, Confirm, that enables senders to monitor the status of their


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**Table 1: Comparison between the Service’s Current Model and Its Proposed Future Model**

<table>
<thead>
<tr>
<th>Key areas</th>
<th>Current model</th>
<th>Commercial Government Enterprise model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mission/Public policy</td>
<td>Provide affordable universal service</td>
<td>Provide affordable universal service</td>
</tr>
<tr>
<td>Universal service obligation</td>
<td>All addresses, 6 days/week</td>
<td>Negotiated with regulator</td>
</tr>
<tr>
<td>Ownership</td>
<td>U.S. government</td>
<td>U.S. government</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Board of Governors</td>
<td>Board of Governors refocused on fiduciary duties</td>
</tr>
<tr>
<td>Regulation</td>
<td>Postal Rate Commission</td>
<td>Postal Rate Commission</td>
</tr>
<tr>
<td>Monopoly</td>
<td>Letter and mailbox monopoly</td>
<td>Letter and mailbox monopoly</td>
</tr>
<tr>
<td>Product development</td>
<td>As the Service finds appropriate and in the public interest</td>
<td>Market-based -- cost/benefit model</td>
</tr>
<tr>
<td>Pricing</td>
<td>Rate setting includes public hearings and divided authority between the Postal Rate Commission and the Board of Governors.</td>
<td>Flexibility within broad parameters, complaint-based review</td>
</tr>
<tr>
<td>Human capital</td>
<td>Collective bargaining, third-party arbitration, federal salary cap, and pay comparability</td>
<td>Collective bargaining, Railroad Labor Act model, some private-sector laws, no salary cap</td>
</tr>
<tr>
<td>Financial requirement</td>
<td>Break-even mandate</td>
<td>Reasonable net income; retained earnings</td>
</tr>
<tr>
<td>Ability to invest</td>
<td>Through U.S. Treasury</td>
<td>Business alliances</td>
</tr>
<tr>
<td>Access to capital</td>
<td>$15 billion debt ceiling</td>
<td>Legislated debt ceiling; retained earnings</td>
</tr>
<tr>
<td>Earnings</td>
<td>Break-even mandate</td>
<td>Retained earnings to support Universal Service Obligation and capital and business continuity; dividends possible</td>
</tr>
<tr>
<td>Taxes</td>
<td>None</td>
<td>Determined through legislation</td>
</tr>
<tr>
<td>Security</td>
<td>Postal Inspection Service</td>
<td>Postal Inspection Service</td>
</tr>
</tbody>
</table>

Source: Postal Service and GAO.
mailings; and efficiency improvements to the Service's automated processing of flat mail, such as magazines and catalogs.

However, we feel that additional steps are needed to ensure effective implementation of the Plan. Specifically, periodic public information about the status of actions taken to implement the Plan should be provided to Congress and other postal stakeholders, including postal employees and customers. Little information has been made publicly available on the status of these actions. Postal officials told us that they have established accountability mechanisms, such as detailed project plans with strategies and time frames for implementing them; however, these documents are used for internal management purposes only and are not available to the public. Providing periodic public information on the status of actions taken to implement the Plan, including priorities, time frames, progress, and estimated financial impact, would be useful for congressional oversight purposes and for giving stakeholders, whose business plans may be impacted by the Service's planned actions, information on the Service's efforts. An example of such useful information is the "progress report" provided by the Service and the Mailing Industry Task Force, which provides periodic updates on the implementation status of the Task Force's recommendations to increase the effectiveness of the mail.

Further, effective leadership and sustained attention from the Service's Board of Governors and the PMG will be key to ensuring the successful implementation of its Plan. The role of the Board of Governors in the Service's transformation includes such major areas as: 1) providing strategic advice to management; 2) assisting in managing risk, including risk that is related to attempts to maximize current value at the expense of mortgaging the future; and 3) holding management accountable for results. In addition, the Service will need to work with Congress, the Presidential Commission on the Postal Service, and other stakeholders to implement legislative and operational changes.

2The Mailing Industry Task Force is a committee that includes Service management and various industry representatives. This Task Force assesses the current role and value of mail in business and consumer communication, evaluates the competitive environment affecting the postal industry's future, and identifies opportunities for future growth.
Control Costs and Improve Productivity under the Service’s Existing Authority

Key issues in controlling costs and improving productivity include the following:

- Difficulty in achieving cost savings and sustaining productivity gains;
- High infrastructure and workforce costs;
- Unknown costs related to safety and security;
- Capital freeze that may increase future costs.

The ability to control costs and sustain productivity gains is a key challenge to improving the Service’s financial situation. The Service made progress in cutting costs and improving productivity in fiscal years 2001 and 2002, and costs for both years were below budgeted amounts. Despite these short-term reduction efforts, the Service continues to face significant challenges in sustaining long-term cost savings and productivity gains, particularly in the workforce and infrastructure areas, where costs are difficult to cut. Further, the Service will be challenged to deal with unknown costs related to enhancing mail safety and security. Although the Service’s Plan includes long-term strategies that could greatly impact its future operational structure, a continuing emphasis on finding operating efficiencies within the current structure is a more immediate priority in order to mitigate postal rate increases.

The Service has made progress in the past 2 fiscal years in controlling the growth in costs and improving productivity. Although total costs increased by $2.8 billion in fiscal year 2001, those costs declined by about $400 million in fiscal year 2002. The Service reduced its staff by about 11,500 employees in fiscal year 2001 and by about 23,000 in fiscal year 2002. These results were due in part to a reduced workload from lower-than-planned mail volumes over the 2-year period, which resulted in significant work-hour reductions. The Service increased its productivity by 1.3 percent in fiscal year 2001 and 1.1 percent in fiscal year 2002 from actions including the deployment of automation and other operational and administrative efficiencies. Productivity is the relationship between the Service’s outputs—mail processing and delivery to an expanding network—and the resources expended in producing these outputs. The Service also postponed a number of program expenditures and froze some capital spending during this time to control expenses and improve its cash position. The above actions helped offset cost increases for health care
benefits, cost-of-living adjustments, safety and security, fuel, transportation, unemployment compensation, and workers compensation, as well as continued expansion of its infrastructure and delivery network.

The Service plans to continue efforts to cut costs and increase productivity in fiscal year 2003. Its budget calls for a $1 billion cost reduction that includes a decrease of 12,000 employees by attrition, deployment of automation equipment, and reduction in work hours. Further progress in this area may face impediments, including the following:

- Historically, the Service has had difficulty in sustaining cost savings and productivity improvements, and numerous reports by us and by the Postal Service’s Inspector General have noted inefficiencies in the postal system and difficulties challenging the Service in realizing opportunities for savings over the long term.

- The Service has controlled the growth of its expenses over the past year in areas such as reducing overtime and staff costs through attrition, as mail volumes have declined. However, the Service will be challenged to continue controlling and reducing its expenses if mail volumes increase.

- Despite heavy investments in automation over the past decade, postal employee–related costs continue to account for over three-quarters of total operating expenses. The Service reported that growth in salaries and benefits has been driven by wage inflation, not by growth in work hours. The Service’s workforce included over 854,000 employees as of the end of fiscal year 2002, of whom 753,000 were career employees (see table 2).
Some of the Service’s employee-related costs, including those related to postretirement health benefits and workers’ compensation, are expected to continue increasing for the foreseeable future. The Service reported that its health benefit cost rose by 10 percent in fiscal year 2002 and is forecasted to rise 14 percent in fiscal year 2003. Workers’ compensation expenses increased by over $500 million to $1.5 billion in fiscal year 2002 and are expected to increase approximately 5 percent in fiscal year 2003.

The Service has high costs related to its nationwide infrastructure and transportation network, which delivers 6 days a week and to over 139 million addresses nationwide. This network grows by approximately 1.7 million new addresses annually. These costs are difficult to cut when volumes decrease, as carriers must service every delivery unit even if they have fewer letters to deliver. Furthermore, the Service faces legal requirements and practical constraints that affect the size of its

<table>
<thead>
<tr>
<th>Table 2: The Service's Workforce Composition in Fiscal Year 2002</th>
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</thead>
<tbody>
<tr>
<td><strong>Career employees</strong></td>
</tr>
<tr>
<td>Clerks</td>
</tr>
<tr>
<td>City delivery carriers</td>
</tr>
<tr>
<td>Mail handlers</td>
</tr>
<tr>
<td>Rural delivery carriers—full-time</td>
</tr>
<tr>
<td>Building and equipment maintenance personnel</td>
</tr>
<tr>
<td>Supervisors/managers</td>
</tr>
<tr>
<td>Postmasters/installation heads</td>
</tr>
<tr>
<td>Professional/administrative/technical personnel</td>
</tr>
<tr>
<td>Motor vehicle operators</td>
</tr>
<tr>
<td>Headquarters-related</td>
</tr>
<tr>
<td>Vehicle maintenance personnel</td>
</tr>
<tr>
<td>Inspection Service (field)</td>
</tr>
<tr>
<td>Area offices and nurses</td>
</tr>
<tr>
<td>Inspector General</td>
</tr>
<tr>
<td><strong>Total career employees</strong></td>
</tr>
<tr>
<td><strong>Non-career employees</strong></td>
</tr>
<tr>
<td><strong>Total employees</strong></td>
</tr>
</tbody>
</table>

Source: Postal Service.

*Noncareer employees include casuals, nonbargaining temporaries, rural substitutes, evening relief/leave replacements, and transitional employees.
infrastructure network, including a prohibition on closing small post offices solely for operating at a deficit. Figure 4 shows the various components of this network.

The Service faces significant investment decisions and operating costs related to its efforts to improve the safety and security of the mail as a result of the terrorist events and subsequent use of the mail to transmit anthrax. The Service’s Emergency Preparedness Plan has projected costs for prevention, detection, and protection measures to total almost $800 million in fiscal year 2003, and the Service has submitted a fiscal year 2004 appropriations request to Congress of $350 million for emergency preparedness costs. We recently raised concerns about whether the Service had conducted sufficient testing prior to making additional investments for security-related equipment in this area. Further, we are concerned that the Service has not specified costs related to operating, maintaining, and replacing any of this new equipment.

In fiscal year 2002, the Service continued its freeze on capital spending primarily for new facilities, and capital outlays amounted to $1.2 billion less than those in fiscal year 2001. Freezing capital spending may have detrimental financial and operational effects on the Service. These

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**Figure 4: Overview of the Service’s Infrastructure and Transportation Network in Fiscal Year 2002**

<table>
<thead>
<tr>
<th>Collection</th>
<th>Retail facilities</th>
<th>Mail processing facilities</th>
<th>Transportation network</th>
<th>Delivery points</th>
</tr>
</thead>
<tbody>
<tr>
<td>303,000 collection boxes</td>
<td>Almost 38,000 post offices, stations, and branches</td>
<td>354 facilities</td>
<td>209,000 vehicles; $5.1 billion for purchased transportation</td>
<td>Over 139 million business and residential delivery points</td>
</tr>
</tbody>
</table>

Source: GAO and Postal Service.

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delays may result in higher future capital costs, operational delays, deteriorating infrastructure, deferred maintenance costs and efficiency gains, and difficulty in meeting growth demands for providing universal service.

- The Service may also incur costs associated with the implementation of its Transformation Plan, but it has not specified its expected costs or projected revenue increases for implementing various actions included in the Plan.

The Service must continue exploring ways to control costs and improve productivity, particularly in connection with the Service’s nationwide infrastructure and transportation network and the workforce that supports it. The Service’s nationwide network has developed piecemeal over time and may not represent the most effective strategy to support current postal operations. For example, the locations of some postal facilities may have been based on operating strategies that are now outdated, as the Service has moved from a manually oriented processing and delivery environment to a highly automated environment. Further, mailers are now performing more mail preparation and processing functions that may bypass some of the Service’s processing steps. Also, alternatives are available that may be more cost-effective for the Service and may increase customer convenience and accessibility. For example, stamp purchases account for about 450 million transactions in post offices each year. As Figure 5 shows, it costs less for the Service to sell stamps at ATMs and through other retail alternatives such as supermarkets, drugstores, and other large retail vendors than it does at post office counters.
As part of its Transformation Plan, the Service has started to lay the groundwork for addressing possible inefficiencies in its current operating network. First, the Service is developing proposals for implementing its Network Integration Alignment program to align mail-processing infrastructure with its logistics and operational strategies. On the retail side, the Service has also ended its self-imposed moratorium on post office closings, and is examining alternative methods to provide retail services in
a more cost-effective and customer-friendly manner.\textsuperscript{4} The Service has recently launched a national advertising campaign to promote the purchase of stamps at ATMs and other alternatives, such as grocery stores. The Service is also pursuing other retail alternatives, such as partnering with commercial retail outlets to sell postal products and services.

These actions represent a good starting point to address possible inefficiencies in its current operating network. The Service’s ability to control costs and improve productivity will help restrain postal rate increases and improve its overall financial position. Looking to the future, as the Service determines its business model and incorporates measures to enhance security and safety, it will be challenged to realign its infrastructure and workforce to support the new business model.

Address Unresolved Financial Issues

Key issues concerning unresolved financial issues include the following:

- Insufficient cash flow has increased pressure to borrow;
- Outstanding debt remains high;
- Workers’ compensation liability and postretirement health obligations are increasing;
- Difficulties remain in generating sufficient revenues to cover funding needs.

The Service’s unresolved financial issues may have significant long-term impacts on its financial condition and outlook. The Service’s cash flows from operations have not been sufficient to fund needed capital expenditures and significantly reduce debt pressures; its workers’ compensation liability and postretirement health benefit obligations are large and increasing; and its liabilities exceed its assets. Furthermore, we recently reported that the Service should reassess the accounting treatment of its pension and postretirement health obligations, in part

\textsuperscript{4}Lifting the moratorium on closing post offices, the Postmaster General stated that the Service would restart the process of closing those post offices that have been “suspended” or effectively closed. He stated that alternative services were provided for postal customers in these communities (that is, contract stations, community post offices, and so forth).
because of these financial challenges. Considering the Service’s current difficulties in generating sufficient revenue and net income, concerns remain about how its obligations and liabilities will be funded under the current rate process. The recent discovery that the Service may be overfunding its pension liability may provide an opportunity for the Service to address financial challenges, such as its outstanding debt and postretirement health obligations. The Service will need to take a leadership role and examine how best to address these issues, both under its current authority and within the context of a new business model.

### Insufficient Cash from Operations to Finance Capital Expenditures Necessitates Borrowing

Over the past 2 years, the Service has had insufficient cash flow from operations to cover needed capital expenditures. This decreasing cash position has also increased pressure on borrowing as the Service has approached its statutory debt limit of $15 billion. During fiscal years 2001 and 2002, the Service froze part of its capital program to improve its cash position and limit borrowing. Specifically, in fiscal year 2001, the Service froze $1 billion in construction and renovation on more than 800 postal projects. However, a slowing economy led to a $1.68 billion net loss for fiscal year 2001, and a decreased cash position necessitated a $2 billion increase in borrowing. As seen in figure 6 below, this increase in outstanding debt put the Service within $4 billion of its statutory debt limit.

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In fiscal year 2002, the Service continued its freeze on capital spending primarily for new facilities, and capital outlays were $1.2 billion less than those in fiscal year 2001. This reduction in capital expenditures, combined with additional revenues from a mid-year rate increase and cost-cutting efforts, improved its cash flows from operations and allowed the Service to reduce debt by $200 million. This was the first debt reduction in the past 6 years. Despite these improvements, the Service incurred a $676 million net loss for the fiscal year. The Service is also planning on continuing its capital freeze on new facilities in fiscal year 2003 and budgeting an $800 million debt reduction. While freezing capital expenses has helped to keep the Service’s borrowing below planned levels in the short term, this action is not a viable long-term solution. As we stated earlier, these delays may result in higher future capital costs, operational delays, deteriorating infrastructure, deferred maintenance costs and efficiency gains, and difficulty in meeting growth demands for providing universal service.
Liabilities and Obligations

As of the end of fiscal year 2002, the Service’s liabilities (as reported in the Service’s annual financial statement) and obligations were estimated at approximately $117 billion. Table 3 lists some of the major expenses paid in fiscal year 2002 and the remaining liability and obligation balances for key financial categories as of the end of fiscal year 2002.

<table>
<thead>
<tr>
<th>In billions of dollars</th>
<th>Selected expenses in fiscal year 2002</th>
<th>Remaining liability balance as of 9/30/02</th>
<th>Remaining obligation balance as of 9/30/02</th>
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<tr>
<td>Retirement-related</td>
<td>$9.1</td>
<td>$32.2</td>
<td>n/a</td>
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<tr>
<td>Retiree health insurance premiums</td>
<td>1.0</td>
<td>n/a</td>
<td>$45.0^a</td>
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<tr>
<td>Subtotal, retirement-related</td>
<td>10.1</td>
<td>32.2</td>
<td>45.0</td>
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<tr>
<td>Compensation and benefits^b</td>
<td>41.5</td>
<td>2.0</td>
<td>n/a</td>
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<tr>
<td>Workers’ compensation</td>
<td>1.5</td>
<td>6.7</td>
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<tr>
<td>Outstanding debt</td>
<td>0.3^c</td>
<td>11.1</td>
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<td>Accumulated leave</td>
<td>n/a</td>
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<tr>
<td>Leases</td>
<td>0.8</td>
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<td>9.6^d</td>
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<tr>
<td>Payables and accrued expenses</td>
<td>n/a</td>
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<td>n/a</td>
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<tr>
<td>Other</td>
<td>12.9^e</td>
<td>5.7^f</td>
<td>n/a</td>
</tr>
<tr>
<td>Total</td>
<td>$67.2</td>
<td>$62.0</td>
<td>$54.6</td>
</tr>
</tbody>
</table>

Source: Postal Service.

n/a -- not applicable.

^aThe Service’s 2002 Annual Report estimated that its postretirement health benefits obligation ranged from $40 billion to $50 billion. Therefore, we used the midpoint of the range for an estimate of the Service’s postretirement health obligation.

^bExcludes retirement and workers’ compensation expenses, which have been listed separately.

^cInterest expense paid for the Service’s borrowing.

^dFuture minimum lease payments for all noncancelable operating leases.

^eIncludes transportation; emergency preparedness, net; and other expenses.

^fIncludes estimated prepaid postage; prepaid box rentals and permit and metered mail; outstanding postal money orders; and other liabilities.

The Service’s total liabilities exceeded its total assets by $3.0 billion at fiscal year’s end 2002. Under the Service’s current break-even business model, ratepayers are responsible for these liabilities. However, despite multiple rate increases, revenues have been insufficient to fund both operating expenses and expenses related to these liabilities, which
continue to exceed total assets. As Figure 7 shows, this imbalance has been growing since fiscal year 1999.

Figure 7: The Imbalance between the Service’s Assets and Liabilities Has Been Increasing

This imbalance could change in fiscal year 2003 if Congress takes legislative action based upon recent OPM analysis of the Service’s CSRS pension liability. OPM’s analysis showed that the Service would overfund its pension liability if the current statutory funding mechanism remains unchanged. Consequently, OPM proposed legislative action that would change this mechanism and reduce the Service’s annual pension payments to OPM. Figure 8 compares the estimated future payments under current

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As part of a separate review, we asked OPM to estimate how much of the underfunded CSRS pension liability is attributable to the Service and to estimate the Service's postretirement health obligations.
law with the estimated future payments under the OPM legislative proposal provided in November 2002. However, if legislation is enacted that differs from this proposal, the Service’s estimated future payments could change.

The potential for reduced future payments in this area offers opportunities to address some of the Service’s major financial challenges. The Service has stated that it would use available cash from these reductions in the future payments to further reduce debt in 2003 from $800 million to more than $3 billion. Another consideration would be to fund the Service’s significant obligation for retiree health benefits, which ranges from $40 billion to $50 billion according to the Service’s 2002 Annual Report. The annual payments for these retiree health benefits are currently calculated on a pay-as-you-go basis and have been increasing at an average rate of 15 percent over the past 2 years. Furthermore, uncertainties remain about the future direction of mail volumes and revenues, and thus, any available cash may have to be used to cover operating and capital expenditures.
Difficulty in Generating Sufficient Revenue and Funding the Service’s Needs

Under the Service’s current business model, sufficient revenues have not been generated to cover all of its funding needs and obligations (see Figure 9). This has resulted in an accumulated deficit of $6.0 billion as of the end of fiscal year 2002, which represents the amount by which cumulative expenses have exceeded cumulative revenues since the Service’s inception.

Figure 9: Needs for Funds Outweigh Sources of Funds

Opportunities may exist under the current rate-setting process to generate additional revenues. Over the past year, the Service has explored options within the current rate-setting process to generate more volume and
revenues, such as the use of Negotiated Service Agreements (NSAs). NSAs, which are sometimes referred to as “contract rates,” provide an agreement between the Service and its customers that the customers would perform specific activities to their mailings (for example, improved address quality or mail preparation enhancements), and that these mailings would exceed a preset volume threshold. In exchange, the Service would provide discount rates and/or predetermined services. The Service hopes that such agreements would result in additional volume and revenue. Although an NSA was recently submitted for approval, it is too early to tell whether additional net revenues would result. Further, some mailers are concerned about whether NSAs would ensure fair and equitable pricing among postal customers, particularly among smaller mailers. Although much discussion remains for these and other ratemaking alternatives, joint mailing industry–Service efforts, such as the postal summits, provide an opportunity to explore improvements to the ratemaking process that can be mutually beneficial. Actions in this area need to be further explored; without them, the Service is likely to experience difficulty in generating sufficient revenues to cover its increasing funding needs and to carry out its mission of providing universal service at reasonable rates.

Further, changes in the accounting treatment for future obligations, including those for retiree health benefits, may impact the Service’s funding needs. We recently reported that the Service should consider the potential accounting ramifications of its unique statutory obligations and reassess how best to account for and disclose them.7 Such fundamental funding issues raise many questions, including:

- How will the Service’s obligations be paid—from increased rates, volume growth, or other revenue sources, such as federal appropriations?
- Who will pay these obligations—current ratepayers, future ratepayers, or taxpayers?
- When will these obligations be paid—now, later, or incrementally over time?

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Develop Strategies to Address Human Capital Issues

Key issues for developing such strategies are as follows:

- Workforce planning needs to support transformation;
- Pay comparability and performance-based pay issues are unresolved;
- Labor-management cooperation is needed to support transformation.

The Service has the second largest civilian workforce in the nation, with over 854,000 employees, and its personnel-related costs make up over three-quarters of its total annual operating expenses. Consequently, the Service faces major human capital challenges, including (1) planning for the appropriate workforce, (2) addressing unresolved pay and compensation issues, and (3) enhancing labor-management relations. The Service faces major transitions in each of these areas, as it is increasingly affected by a large number of upcoming retirements and by rising costs associated with these retirements that are difficult to control. The strategies developed to address these issues will have significant financial and operational impacts in the future. The Service will be challenged to align its human capital strategies with its transformational goals. It will need to work together with its major unions and management associations to find common ground to achieve progress in addressing these long-standing issues.

Workforce Planning Needs to Support Transformation

Current Service workforce planning generally focuses on the short term—up to 3 years—and supports operations in the current environment. However, the Transformation Plan is outlining changes to the postal operating environment, and the Service needs to align its workforce to correspond with these changes. For example, under its current authority, the Service has already taken actions to increase its operational efficiency by examining alternatives to traditional postal facilities, increasing its use of automation and information technology, consolidating operating shifts, and offering new products and services. These actions require a different mix in the number, skills, and deployment of its employees, and they may involve repositioning, retraining, outsourcing, and reducing the workforce.

Developing strategies to determine the appropriate workforce to support the Service’s operations structure will be challenging. The Service has an opportunity, however, with its large number of impending retirements to gain resource flexibility to aid realignment. As shown in figure 10, the
Service has projected that from fiscal year 2003 through fiscal year 2010, 75 percent of its executives, 51 percent of its managers/supervisors/postmasters, and 38 percent of its carriers, clerks, and other bargaining employees will reach eligibility for regular retirement.

Note: Percentages may not add due to rounding.

The decisions regarding these retirements (that is, whether or not to fill these slots, and if so, when, with whom, and where) may have significant financial and operational impacts. For example, we have reported that the Service faces potentially serious succession problems in its managerial ranks. As of late 2001, the Service’s Senior Vice President for Human

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Resources estimated that the Service had qualified staff to replace about three-quarters of its current leadership positions, and some of these replacement staff members were themselves approaching retirement eligibility. The Service will be challenged to ensure that it has a sufficient number of managers with the competencies to lead its workforce.

As part of its long-term planning, the Service will be challenged to realign its workforce to support its new business model. Specifically, legislative or regulatory changes that would address restrictions on closing or consolidating postal facilities, change the universal service obligation, or modify the postal monopoly provision could also affect the appropriate number, skills, and deployment of the postal workforce. Regardless of the time frame, the Service needs mechanisms and milestones, along with the flexibility to align its workforce with its goals. These mechanisms and milestones would provide the measures to assess progress and make necessary adjustments to effectively implement changes to its large workforce and vast operations network.

Resolve Pay Comparability and Performance-Based Pay Issues

A significant portion of the Service’s personnel-related expenses is used for employee salaries and benefits. Properly aligning these pay systems with the Service’s transformation goals would contribute to the Service’s ability to attract, motivate, and retain high-performing employees and help focus the workforce’s efforts toward achieving organization goals. The Service will be challenged to develop strategies that align these systems to its goals because of long-standing issues, including (1) developing performance-based pay systems for all employees, and (2) other pay issues, including disagreements related to private-sector pay comparability and statutory pay caps for selected positions, which may hinder recruitment and retention for these positions.

Recent events in the Service’s performance-based pay system have brought needed attention to this area. The Service initiated a performance-based pay system for its executives, managers, postmasters, supervisors, and other nonbargaining employees in fiscal year 1995 that was intended to align rewards with measured results. Concerns were raised among some postal stakeholders about the effectiveness of the incentives in this system, and the Service recently announced that it discontinued this system in fiscal year 2002 and is in the process of revising it. As the Service develops strategies to enhance its performance-based compensation system, some key factors to consider include (1) the basis on which payments are made, and (2) whether the incentives provided in the system would actually
reduce costs and support organizational goals. Furthermore, the Service’s performance-based pay system covered only certain segments of the Service’s workforce; namely, postal management. The Service’s bargaining unit employees (union), who make up most of its workforce, have generally opposed performance-based compensation systems.

Other pay issues also challenge the Service, some of which are statutorily set. First, the Service is required by law to maintain employee compensation and benefits on a standard comparable to the compensation and benefits paid for comparable levels of work in the private sector. The Service and its major employee unions, however, have often disagreed with the way in which the comparability standard should be applied and have frequently relied on third-party arbitration to settle compensation-related disputes. Studies have been completed that support both sides of the argument, and disagreements continue as to the appropriate level of compensation and benefits (pension, retiree health, and so forth) for postal employees. Furthermore, other statutorily set pay-related issues are also challenging the Service, such as the salary cap on postal executive salaries. Postal officials believe that this cap constrains its ability to provide compensation that is comparable to that in the private sector for selected managerial, executive, and officer-level positions, thus making it more difficult for the Service to retain and recruit key talent. In today’s environment of increased competition and uncertain financial conditions, the Service will be challenged to develop strategies to enhance its performance-based system so that employee performance is effectively aligned with organizational goals.

Labor-Management Cooperation Is Needed to Support Transformation

As we have often reported, the Service has long-standing adversarial labor-management relations. In human capital areas, including workforce deployment, work rules, and pay comparability, disagreements between the two sides have existed for quite some time and, in many cases, were resolved by third-party arbitration. Disagreements between these groups can have major financial, operational, and human capital implications, because personnel-related costs represent the largest single element of the Service’s annual expenses, and they are the primary determinant of prices and the key factor in the Service’s overall financial viability. The Service will also be challenged to develop strategies to improve this relationship and to effectively plan and carry out the changes needed to implement the Transformation Plan.
Recent actions between the Service and its unions have shown that these parties can work together and achieve positive results. Following the terrorist attacks, the Service worked closely with its unions and management associations to develop strategies to protect the mail, customers, and postal employees. The Service and some of its unions also worked together to implement the first negotiated rate settlement in fiscal year 2002, which expedited the rate process and generated additional revenues that enabled the Service to address financial difficulties caused by the terrorist events and the slowing economy. More recently, the Service and the leaders of its largest union, the American Postal Workers Union (APWU), proposed a 2-year extension of the current negotiated contract.

Furthermore, movement toward transformation provides an opportunity for the Service and unions to make continued progress that can be beneficial to both parties. With the Service’s leadership, these groups will need to address other issues that will also impact transformation, including: (1) developing a new business model; (2) determining processes to make operational changes, including changes to its infrastructure (such as facility closings) to support the new model; (3) realigning and restructuring the workforce—particularly in light of the large number of impending retirements—through prevailing collective bargaining agreements and other available means; and (4) reaching agreement on and improving the collective bargaining process. The Service and the National Association of Letter Carriers announced in September 2002 the formation of a joint task force to address transformation issues. Also, the Service and the APWU announced that they will establish a joint task force to explore methods of repositioning the workforce, with the goals of minimizing employee dislocation, maximizing customer service, and maintaining efficient operations. Although disagreements still exist between the Service and these groups, including concerns about some aspects of the Transformation Plan, we believe that these parties have taken steps in the right direction and need to continue communication and cooperation.
Provide Complete and Reliable Financial and Performance Information in a Timely and Transparent Manner

Key issues to address in providing financial and performance information include the following:

- Greater transparency is needed in quarterly financial information;
- Accounting and disclosure of long-term obligations and liabilities need reassessment;
- Performance information could be improved.

Given the vital role of the nation’s postal system and the importance of its financial viability, it is imperative that the Service, its stakeholders, and the public have adequate information available to them to understand the Service’s changing financial situation and assess its progress toward meeting its performance goals and future plans. The Service has made some improvements in its financial information since 2001; however, we continue to have concerns about the transparency of its financial and performance information. Although the Service has traditionally provided detailed financial data to stakeholders throughout the fiscal year, its periodic financial reports have not clearly explained changes in its financial condition and outlook or results of operations, and they have not always been readily available to the public. Further, we believe that the Service should reassess its accounting treatment and disclosure of some of its long-term obligations, including its pension and postretirement health obligations. The Service has also made mixed progress in implementing our recommendations relating to improved reporting on its new products and services and enhanced performance plans and reports. Improved transparency is necessary to reflect economic reality and to enhance accountability and decisionmaking for the Service.

Greater Transparency Is Needed in Quarterly Financial Information

Despite the fact that the Service publicly releases periodic financial information, significant changes in its financial outlook over the past 2 years were not evident from this information and came as a surprise to many stakeholders. We have raised concerns and made recommendations regarding the lack of transparent, timely, and readily accessible periodic information necessary to explain changes in the Service’s financial situation and expected outlook. In response to our recommendations, the Service committed to providing quarterly financial statements similar to those provided by publicly traded enterprises, and posting them to its Web site. However, we recently reviewed the Service’s quarterly financial
reports and reported that they provided only limited analysis and explanation to help stakeholders understand what had changed, why it had changed, and how the changes affected its financial condition, operating results, and expected outlook. Additionally, the quarterly reports were neither consistent in their format and content nor readily available to the public. Consistency in the format and content, as well as availability of recent and past reports, is necessary for stakeholders to assess the Service’s performance over time. Since the issuance of our report, the Service released a first-quarter report for fiscal year 2003 that was an improvement over its previous quarterly reports because it contained more information.

Accounting and Disclosure of Long-Term Obligations and Liabilities Need Reassessment

The magnitude of the Service’s annual revenues and the importance of its financial situation to the mailing industry, its ongoing transformation efforts, and both Congress’s and the public’s calls for more information and additional transparency regarding financial reporting matters in general have focused attention on the Service’s reporting of some of its major long-term obligations and liabilities. We recently reported that because of these factors and the potential effects on current and future ratepayers, the Service should reassess the accounting treatment of its pension and postretirement health obligations. Further, we also reported that the Service should disclose its estimated postretirement health obligations in its financial statements. We believe that decisionmakers’ ability to fully consider the impact of these obligations is hindered by the current lack of recognition and disclosure. Accounting and reporting should reflect economic reality to provide stakeholders with a clear understanding of the Service’s true financial condition, so that decisions can be made about what funds will be needed and how to address these liabilities and obligations in the future.

Performance Information Could Be Improved

Over the past 2 years, we have reported concerns about the quality and transparency of the Service’s performance information—information that is critical for effective management, as well as for communication with customers, Congress, and other stakeholders. For example, we reported

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concerns that the Service did not include important net income and delivery scores in its preliminary fiscal year 2002 performance plan.\textsuperscript{11} We continue to have concerns in this area. The Service’s fiscal year 2003 Performance Plan included targets for all four quarters only for one service category—First-Class overnight mail. In addition, as we reported in our January 2001 report on the Service’s major management challenges, a number of issues have been raised relating to the reliability and credibility of the data the Service uses for ratemaking.\textsuperscript{12} The Service’s progress in this area continues to be a concern for congressional oversight.

Furthermore, we have also raised concerns that the Service’s information related to its e-commerce and other new products and services was not complete, accurate, and consistent. We recommended that the Service provide Congress and the Postal Rate Commission (PRC) with an annual report that includes information on revenues and expenses for all its new products and services. The Service issued its first report in May 2002; however, the report provided information only on selected new products and services. We are concerned that without complete and consistent information, the Service will not be able to assess its progress toward meeting overall performance goals, and Congress, the PRC, and other interested parties will not have sufficient information for oversight purposes.


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<td>Human capital issues</td>
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<td>Outstanding debt</td>
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