



U.S. Department of Justice

Bureau of Alcohol, Tobacco,
Firearms and Explosives

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Washington, DC 20226
www.atf.gov

MEMORANDUM TO: Inspector General

FROM: Director, Bureau of Alcohol, Tobacco, Firearms and Explosives

SUBJECT: Response to the Office of the Inspector General's Audit Report on the Bureau of Alcohol, Tobacco, Firearms and Explosives' Use of Income-Generating, Undercover Operations.

Thank you for allowing the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) the opportunity to review and comment on the report entitled "Audit of the Bureau of Alcohol, Tobacco, Firearms and Explosives' Use of Income-Generating, Undercover Operations." As noted in your report, ATF has exercised its authority to use proceeds generated from undercover operations to offset necessary and reasonable operational expenses (so-called "churning") exclusively for investigations of tobacco diversion, which involve criminal evasion of tobacco taxes.

As early as March 2011, ATF recognized issues with the manner in which income-generating undercover operations were being conducted.¹ ATF subsequently undertook remedial measures to correct operational deficiencies, including the issuance of an April 2011 memorandum and an April 2013 ATF Order (ATF Order 3380.1, Alcohol and Tobacco Enforcement Programs) setting forth more stringent controls and restrictions over the use of funds and procurement in churning operations. The 2013 Order sets out formal policy and instruction for all alcohol and tobacco investigations, including churning investigations. Under current policy, income-generating undercover operations are subject to detailed and rigorous application, review, approval, and oversight mechanisms that include the following:

- ATF personnel must complete churning investigation training prior to requesting authority to initiate and conduct a churning investigation.
- ATF's Undercover Review Committee must review and approve all requests for churning authority, which must include the appropriate U.S. Attorney's written concurrence with the investigative plan. The plan must also identify the specific targets of the investigation.
- ATF will only authorize churned fund expenditures for specific items and/or services. Expenditures will no longer be authorized for travel, confidential informant expenses, or to purchase investigative equipment.

¹ See Appendix 1, Timeline of Churning Remedial Measures.

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- All expenditures must be authorized in writing prior to their expenditure. When time-sensitive, supervisor approval for churned fund expenditures may be provided via e-mail to ensure pre-expenditure approval.
- Field offices are required to submit all requests for undercover product via e-mail to an Alcohol and Tobacco Enforcement Branch Outlook mailbox identifying specific information in the request.
- Field offices are required to note in the Case Management Log all undercover product movement.
- Field offices are required to note in the Case Management Log all Churning Undercover Bank Account (UCBA-C) deposits.
- Field offices are required to complete all UCBA-C deposits within 24 hours of the undercover sale.
- On a monthly basis, investigations must submit ATF Monitored Case briefing reports to ATF executives that identify the total amount of product procured and sold via undercover sale to each individual suspect, as well as the total of proceeds deposited to the UCBA-C, total UCBA-C funds expended, and current UCBA-C balance.
- Field offices must finalize all churned fund expenditures and dispose of churning property to the General Services Administration within 30 days of the conclusion of the operational undercover phase of the investigation.
- On a monthly basis, the Special Agent Churning Account Manager must conduct a physical inventory check of all undercover products.
- Special Agent Churning Account Managers must utilize accounting software to track all churning property and inventory.
- On a monthly basis, ATF forensic auditors must audit all churning financial and property inventory records.
- On an annual basis, ATF forensic auditors must conduct annual and/or case closing audits at the field office level and provide those results to the Special Agent in Charge and Deputy Assistant Director responsible for the investigation.

The report addresses an audit period of February 2006 through June 2011, a time-frame that predates the implementation of most of these policies. ATF agrees with the audit team that the

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policies and controls governing “churning” investigations during the bulk of the audit period were seriously deficient, and we accept full responsibility for the management and oversight lapses that allowed those deficiencies to develop. ATF believes, however, that readers of the report may inaccurately conclude that these historical problems continue to the current day. They do not. The report’s findings do not reflect current ATF policy or practice in this area. As the measures outlined above reflect, current ATF leadership has vigorously addressed the historical deficiencies identified in the report, and we are committed to ensuring that ATF conducts all investigations with the highest standards of accountability to the American public.

Reconciliation of Cigarette Inventory

While ATF agrees with the core conclusions set forth in the report with respect to inadequate historical policies, we believe that the report inaccurately implies that ATF cannot account for 2.1 million cartons of cigarettes, and wrongly concludes that this “un-reconciled” inventory should be valued based upon the retail price of cigarettes sold in legal commerce rather than the actual black market prices at which this merchandise was sold in the 20 investigations selected by OIG.

The report finds that, due to inadequate documentation of cigarette inventories within ATF’s case files OIG was unable to reconcile the disposition of 2.1 million cartons of cigarettes. *See* OIG Report, at iii, 18, 42-44. While ATF agrees that there was inadequate documentation of some tobacco transactions conducted in these investigations, we do not agree that those deficiencies in documentation prevent reconciliation of cigarette inventory to a far greater extent than that reached by the OIG audit team. ATF’s forensic auditors conducted a comprehensive reconstructive inventory² reconciliation of the disposition of cigarettes by reviewing reports of investigation, bank account transactions, expenditure reports, and invoices from the two largest cases among the investigations reviewed by the OIG; these two cases account for nearly 1.8 million of the 2.1 million cigarette cartons that the OIG Auditors were unable to reconcile (*i.e.*, more than 85% of the “un-reconciled” inventory). By expanding its review beyond documentation readily available in case files to the full range of available documentation, the ATF auditors conducted a far more in-depth analysis of the cigarette transactions at issue than did the OIG Audit team.³

In contrast to the 2.1 million cartons of cigarettes that the OIG auditors were unable to reconcile, the results of ATF’s reconstructive inventory showed that only 447,218 cartons of cigarettes could not be fully reconciled (due to insufficient documentation). While ATF stands accountable for all cigarette inventory acquired in these investigations, ATF believes that the results of the

² “Reconstructive inventory” is a well-established methodology used by ATF and other law enforcement investigators in financial investigations, and has been recognized as a reliable basis to support expert testimony in criminal prosecutions.

³ The deficiencies cited by the OIG with respect to documentation of cigarette transactions are primarily deficiencies relating to ATF’s compliance with its own (then-existing) policies.

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could not be fully reconciled (due to insufficient documentation). While ATF stands accountable for all cigarette inventory acquired in these investigations, ATF believes that the results of the reconstructive inventory reconciliation present a more thorough and accurate accounting of cigarettes than the figure reached by the OIG audit.

ATF provided draft language to the OIG that set forth the ATF forensic auditors' analysis, while at the same time acknowledging that OIG did not conduct a peer review of the forensic auditors work papers and supporting documentation and evidence. The OIG declined to include this language in its report. As a result, the report gives the misleading impression that the 2.1 million cartons of cigarettes are actually missing as opposed to lacking proper documentation from an accounting perspective.

Wholesale Versus Retail Price of Cigarettes

The consequence of failing to include the ATF forensic auditors' analysis is magnified by OIG's selection of a retail, rather than wholesale, price to calculate the value of the unreconciled cigarettes. The report concludes that, based upon the retail price of cigarettes, the 2.1 million cartons of unreconciled cigarettes equate to a value of \$127 million. *See* OIG Report, at iii, 18, 43. Using a retail price inflates the value of the cigarettes, particularly in the context of undercover trafficking operations. ATF believes that the value at which it actually sold cigarettes in these investigations --wholesale pricing -- is the more accurate and appropriate measure of value. The report's rationale that wholesale pricing should not be used because it fails to account for the "churning funds ATF would have raised had it sold the cigarettes as part of its investigation," the value of the "potential tax revenue lost by state and local governments" or "potential profits lost by legitimate businesses" is simply not correct. *See* OIG Report, at 45, n. 36. ATF churning investigations obtain cigarettes primarily from manufacturers at or near their cost, and then sell the cigarettes at wholesale pricing to known black-market traffickers. Black-market traffickers, in turn, realize their profit by evading taxes and selling untaxed product at a discount to legitimate retail pricing. Hence, ATF does not "raise" churning funds from retail sales of cigarettes, and black-market traffickers by definition deprive states of tax revenue and unfairly compete with legitimate retailers by significantly undercutting them on price. Hence, to measure the value of cigarettes utilized in churning investigations using retail pricing simply does not reflect the reality of the market.

Assuming that ATF should be held responsible for 2.1 million cartons of unreconciled cigarettes -- a finding that ATF disagrees with as discussed above -- applying a wholesale price of \$16.36 per carton to that inventory (the actual average price per carton at which ATF actually sold cigarettes in the 20 churning investigations OIG reviewed) would equate to a value of \$34.4 million, not \$127 million. More accurately, applying wholesale pricing to the 447,218 cartons of cigarettes that ATF's reconstructive inventory was unable to reconcile with sufficient documentation, would equate to a value of \$7.3 million.

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Report Recommendations

In undertaking the corrective actions outlined above, ATF has already addressed nearly all of the recommendations in your report. Specifically, ATF believes that OIG Recommendation numbers 2 through 15, and 17 have been addressed by ATF O 3380.1, Alcohol and Tobacco Enforcement Programs, implemented in April 2013 and ATF O 3200.1, Monitored Case Program, implemented in May 2013.

In summary, ATF's primary concern is that the serious findings set forth in the OIG report do not accurately present the complete picture of the ATF today – under current policy, churning operations are conducted in a manner consistent with the OIG recommendations and, more importantly, in a manner that fulfills ATF's core values of safety and accountability.

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APPENDIX 1: TIMELINE OF CHURNING REMEDIAL MEASURES

- In March 2011, ATF's Office of Professional Responsibility and Security Operations (OPRSO) issued an internal ATF report, Report of Churning Account Review identifying issues with the manner in which churning operations were conducted, and recommended a number of corrective actions.
- In the fall of 2011, ATF initiated a comprehensive review of ATF's overall tobacco enforcement programs, with a particular emphasis on the use of churning authority.
- In July 2012, the ATF Assistant Director (Field Operations) issued a memorandum regarding the ATF "Tobacco Enforcement Program," implementing new procedures for approval and oversight of tobacco cases, including requirements for Financial Investigative Services Division (FISD) support to ensure compliance with accounting standards and financial reporting requirements in churning cases.
- In August 2012, the ATF Assistant Director (Field Operations) issued a memorandum regarding "Immediate Corrective Actions for Churning Financial Reporting," implementing corrective actions for the reporting of churning requests and expenditures, including corrections related to the use of financial reporting forms, approval requirements for expending proceeds generated from undercover operations, and reporting requirements for open churning accounts.
- In September 2012, the ATF Assistant Director (Field Operations) convened an Alcohol and Tobacco Enforcement Programs Orders Revision Workshop. This workshop assembled a group of subject matter experts tasked with making sure that key recommendations and interim corrective measures for churning cases were incorporated into the revised order governing alcohol and tobacco enforcement programs.
- In February 2013, the ATF Assistant Director (Field Operations) issued a memorandum regarding "Churning Property and Reporting Requirements," requiring designation of a Churning Account Manager in each field division, setting out procedures for the disposition of churning property and for concluding a churning case, and prescribing a series of churning investigation policy requirements.
- In April 2013 the ATF Assistant Director (Field Operations) issued ATF Order 3380.1, Alcohol and Tobacco Enforcement Programs. This Order sets out formal policy and instructions relating to the alcohol and tobacco enforcement programs within ATF. Chapter C of this Order specifically addresses churning investigations, and includes directions for, among other things, requesting and authorizing churning cases, monitoring churning cases, ensuring that financial and property reports are completed accurately and timely at the field division level and reviewed by FISD prior to being submitted for management approval, managing churning proceeds and undercover bank accounts,

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ensuring that churned fund expenditures are appropriate, and conducting periodic audits of churned funds generated and expended.