

OLMS Response to Draft Report


U.S. Department of Labor

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MEMORANDUM TO: ELLIOT P. LEWIS
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FROM: JOHN LUND, PhD 
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SUBJECT: OIG Audit of OLMS Compliance Audit Program

This memorandum responds to your June 27, 2012, transmittal of the Office of Inspector General Draft Audit Report Number 09-12-001-04-421, "OLMS Could Do More to Improve the Effectiveness of the Compliance Audit Program." We appreciate this opportunity to respond to the findings and recommendations of the OIG and to reiterate our demonstrated commitment to continuously improve the Compliance Audit Program (CAP). While OLMS agrees with many of the findings and recommendations, we will take this opportunity to provide comment and, in certain areas, our disagreement.

Recommendation 1: Develop performance measures that evaluate the effectiveness of the CAP in safeguarding union assets by verifying LMRDA compliance.

The draft report provides:

Overall, OLMS did not determine if its CAP was effective in improving safeguarding of union assets. The current measure only identifies whether the CAP is increasing or decreasing referrals for criminal cases, not whether the CAP is actually affecting financial integrity in unions. Further, the current measure only reflects referrals for criminal investigation while the majority of CAP resources identify non-criminal results. OLMS needs to create a performance measure that measures actual CAP outcomes and incorporates both criminal and non-criminal outcomes.

OLMS agrees with the importance of CAP in safeguarding union assets but does not concur with this specific recommendation. As explained below, CAP is an important tool that OLMS uses to detect criminal violations of the LMRDA. The CAP performance measure was not intended to serve as a broad compliance outcome measure. OLMS, in coordination with the Department of Labor, has pursued the creation of a compliance outcome measure using the audit program, but OLMS simply does not have the appropriated resources to implement it.

In support of its recommendation, OIG concludes that the key financial integrity measure used by OLMS with respect to CAP audits, the percentage of audits that “fall-out” into a criminal investigation, measured “outputs,” not program “outcomes.” OLMS recognizes that the fallout rate, for example, does not tell us whether OLMS in general or CAP specifically is changing behavior and increasing compliance in this area. This is not an oversight, however. Previous attempts to formulate such a compliance measure indicated that the sample size of random audits required to draw valid statistical inferences well exceeded the number of audits OLMS currently conducts with its available resources. Therefore, because OLMS is unable to conduct the required number of random audits necessary to produce a compliance outcome measure, OLMS has chosen to influence behavior by increasing its effectiveness in detecting and prosecuting criminal violators.

Even if OLMS were able to conduct the number of random audits necessary to produce a statistically valid compliance outcome measure, this initiative would by necessity reduce the number of targeted audits, i.e., audits selected due to the presence of predicates and indicators correlating with criminal activity. The result would therefore represent a tradeoff: random audits could not be increased unless these targeted audits were decreased. Forgoing targeted audits that are now successful at an approximate 15% rate (in terms of resulting in a criminal case) for the sole purpose of generating a measure constitutes a poor use of resources.

The draft report also observes (correctly) that the fallout rate measure fails to recognize “non-criminal” outcomes, such as “insufficient bonding of union assets, deficient filing, failure to file, or failure to maintain records.” OLMS does not agree that its performance measure should include these “non-criminal” outcomes.

The primary objective of CAP is to uncover embezzlement and other criminal and civil violations of the LMRDA.¹ When a CAP audit reveals embezzlement or fraud, a criminal investigation (i.e., “fallout”) is opened and pursued. The OLMS performance goal to increase the CAP-to-criminal case fallout rate reflects CAP’s primary function as a criminal discovery tool. Its purpose in detecting civil violations is important, but secondary.² Criminal violations are more serious, carry more severe penalties, receive higher Department of Justice priority, command greater public attention and generate a greater deterrent value than civil violations. In addition to a criminal conviction, other remedies attaching to criminal cases include restitution and debarment from serving in any union capacity for up to 13 years. The LMRDA, on the other hand, does not provide for any civil penalties. In our judgment it is, for example, more important to discover that a union officer is misappropriating union funds than it is to ensure that a union has corrected internal financial controls. This OLMS policy is consistent with a critical assessment OLMS’ predecessor agency, Labor-Management Standards Enforcement (LMSE), received in 1984 from the OIG. “CAP has uncovered few criminal violations... Although 2701 CAP audits were completed through FY 1983, data developed by LMSE... indicate that only 25

¹ It is a Federal crime for a labor union officer or employee to embezzle from or defraud the union. To protect unions and their members, OLMS conducts criminal investigations and refers cases to U.S. Attorney’s Offices so that violators are criminally prosecuted and barred from serving in any union capacity for 13 years.

² The question of whether OLMS is accurately measuring CAP’s effectiveness depends in large part on a shared understanding of the purpose of CAP. Its primary purpose is to identify fraud and embezzlement. Detecting civil violations is a primary purpose of other OLMS programs.

convictions have resulted; a success rate of less than one percent.”³ OLMS’ policy to use CAP for criminal discovery is also consistent with guidance OLMS received in 1987 from the OIG. The 1987 OIG report provided, “The CAP handbook is a good functional tool which could be used selectively to screen embezzlement allegations, but should not be applied as a blanket enforcement program.”⁴ For these reasons and others, we believe it is evident that a proportional increase in the CAP- to-criminal case rate is weighty evidence that OLMS is indeed meeting its statutory mandate to protect union member assets.

OLMS can demonstrate CAP effectiveness in its intended objectives, both in detecting criminal violations (through higher fallout rates) and in preserving and protecting union assets (through criminal indictments and convictions). Since implementing this performance measure in FY 2009, OLMS has accomplished the following results:

- (1) In FY 2009, OLMS exceeded its performance goal (12.0%) by increasing its CAP-to-criminal case fallout rate to 12.1 percent. OLMS field offices completed 746 CAP audits in the year, 91 of which resulted in 99 criminal fallout investigations (some yielded more than one). All 99 of these criminal investigations have been completed. Of these cases, 46 were referred with a recommendation for prosecution. Those 46 referred cases have thus far yielded 40 indictments and 31 convictions. The 31 convictions yielded to date from criminal case fallouts arising from these 746 audits represent a CAP-to-fallout-to-conviction rate of 4.2% - far exceeding the less-than-1% rate the OIG noted in 1984. This rate will continue to increase as additional convictions are obtained from 10 cases that have been referred but are still pending.
- (2) In FY 2010, OLMS exceeded its goal (12.5%) by increasing its CAP-to-criminal case fallout rate to 14.6 percent. OLMS completed 541 CAP audits, 79 of which fell out, resulting in 88 criminal investigations. Of these 88 criminal investigations, 77 have been completed. Of the 77 cases, 29 were referred with a recommendation for prosecution. The 29 referred cases have thus far yielded 21 indictments and 11 convictions. This represents a CAP-to-fallout-to-conviction rate of 2.0%. This rate will continue to increase as additional convictions are obtained from the 11 active and 13 pending cases.
- (3) In FY 2011, OLMS exceeded its goal (13.0%) by increasing its CAP-to-criminal case fallout rate to 15.2 percent. OLMS completed 461 CAP audits, 70 of which fell out, resulting in 77 criminal investigations. With 32 active investigations and 14 cases pending adjudication, it is too early to report or evaluate the CAP-to-fallout-to-conviction rate for FY 2011 fallouts.

While OLMS does not dispute the OIG’s conclusion that this performance measure may not measure civil violations of the LMRDA, the measure shows the success of CAP in its primary objective: detecting embezzlement.

³ See Recommendations for LMSA Reorganization, Office of Inspector General (1984).

⁴ See Survey of the Compliance Audit Program Administered by the Office of Labor-Management Standards, Office Audit, Office of the Inspector General (Draft) (1987). OLMS records do not contain a version of this survey designated as a “final” report.

Recommendation 2: Implement a risk-based process that will define the most significant LMRDA violations and use strategies to direct OLMS CAP resources to unions with the most significant LMRDA violations.

In support of this recommendation, OIG concluded:

OLMS could not demonstrate it was using the most effective risk-based strategies to identify unions with the most significant LMRDA violations. OLMS did not have a process to correlate CAP strategies for selecting unions for audit with CAP outcomes. In addition, OLMS had not determined which LMRDA violations were the most significant in terms of protecting union financial integrity. As a result, OLMS could not demonstrate it was selecting unions for audit that had the greatest risk for LMRDA violations that affected the safeguarding of union assets.

OLMS concurs, but only in part, with this statement.⁵ OLMS does not dispute the OIG's conclusion that OLMS could not demonstrate, at the time of the audit, it was using the *most effective* risk-based strategies to identify unions with the most significant LMRDA violations. However, OLMS has developed and is currently evaluating two risk-based strategies in addition to those used over the review period. Moreover, those risk-based strategies used by OLMS during the period of review to target CAP audits were still quite effective in identifying unions with the most significant LMRDA violations (i.e., criminal violations); from FY 2009 to FY 2011, the CAP-to-criminal case fallout rates rose from 12.1% in FY 2009 to 14.6% in FY 2010, and up to 15.2% in FY 2011.

OLMS disagrees that it failed to identify which LMRDA violations were the most significant in terms of protecting union financial integrity. LMRDA criminal violations are the most significant in protecting union financial integrity, and OLMS has thus implemented its union financial integrity goal to increase CAP's detection of criminal violations. OLMS further disagrees with the finding that it was unable to demonstrate it was selecting unions for audit that had the greatest risk for LMRDA violations. OLMS has been highly successful in selecting unions for audit that had a high risk for LMRDA violations, as demonstrated by the increased CAP-to-criminal case fallout rates, discussed above.

Finally, OLMS does not dispute the finding that *at the time of the audit*, OLMS did not have a process to correlate CAP strategies for selecting unions for audit with CAP outcomes. However, as the OIG acknowledges, OLMS has such a process now. OLMS has developed and is currently testing *two* such models, one based on CAP predicates and the second based upon financial and other data gleaned from the Form LM-2, Form LM-3 and Form LM-4 reports filed each year by covered unions:

CAP predicate risk-based model: In October 2010, OLMS revised its Case Data System (CDS) to better track the predications for opening CAP cases and allow OLMS to correlate CAP predications to fallout rates. If particular CAP predications or combinations of predications correlate to higher fallout rates, then OLMS can emphasize those targeting methods in the future. As of June 30, 2012, OLMS had 18 months of data and correlated CAP predicates with fall-out

⁵ For the reasons discussed above, OLMS does not concur with the recommendation that it should develop audit targeting criteria that would select for unions with civil violations.

rates. In one analysis, two key sets of facts regarding each of the 18 predicates are captured. The first concerns each single predicate, standing alone. In this case, the number of audits and fall-outs associated with each standalone predicate is listed, enabling us to calculate a fallout rate. These include such predicates as complaints from union officials or members, single year delinquent reports or an open delinquency case, or a cash reconciliation imbalance in one year's report. In a separate analysis, each predicate is analyzed in conjunction with one or two other predicates, to determine whether predicates in combination better correlate with fraud than each does separately. For example, union affiliation standing alone generated no fallouts, but matched together with other predicates, was associated with a 27.3% fallout rate.

OLMS will refresh these analyses in the same format and distribute them to all field offices on a quarterly basis, emphasizing the best targeting practices and direct field offices to refine or change their office strategies as appropriate.

LM report data risk-based model: In 2011, OLMS developed its own risk-based model based on labor organization report filing data. The database analyzes annual financial report data for the prior four-year period to identify certain "red flag" conditions for CAP targeting purposes that enable a "risk scoring" of each filer. To date, 29 CAP audits opened using this risk-based model have been completed and yielded 6 fallout criminal cases (20.7 % fallout).

OLMS is confident that it has indeed implemented a risk-based process to identify and utilize strategies to direct OLMS CAP resources to unions with the most significant LMRDA violations (i.e., criminal violations).

Recommendation 3: Develop a process that verifies unions correct financial controls over recordkeeping.

The OIG report provides:

OLMS did not always ensure correction of financial control weaknesses that allowed union recordkeeping violations. While OLMS required corrective action for violations in other areas, such as bonding and financial reporting, they did not follow up with unions to ensure they corrected control weaknesses related to recordkeeping to prevent violations from reoccurring. OLMS officials stated that they did not have enough resources to follow up with unions on recordkeeping violations. However, recordkeeping violations represented financial control weaknesses that, left uncorrected, could put union funds at risk.

OLMS does not concur with this finding and recommendation. Although OLMS recognizes the importance of unions correcting recordkeeping deficiencies, agency resources prevent OLMS from taking the additional steps implicitly recommended by the report. While OLMS acknowledges that it does not have a formal process to ensure correction of financial control weaknesses, such a process would be an imprudent use of OLMS staff resources. Each CAP audit consumes about 10 staff days. To be meaningful, a program designed to effectively "follow-up with unions on recordkeeping violations" would require OLMS to subsequently conduct an onsite review of the union records to physically verify that proper internal controls are actually in place and to verify that the recordkeeping deficiencies had been remedied. Assuming that this abbreviated financial inquiry could be done in two staff days (which is a

conservative estimate, in that it does not include travel time), following up on 461 audits would require 922 staff days. Absent new resources, this increased workload would result in 92 fewer CAP audits being conducted on an annual basis. Assuming a 13% fallout rate, this would equate to approximately 12 fewer embezzlement cases uncovered. In OLMS' judgment, union financial integrity is better secured by conducting an additional 12 criminal investigations, rather than a return visit to 922 unions whose recent audit history proved them to be free of criminal wrongdoing.

It is worth noting that a prior OIG audit report (1987) faulted the CAP program for focusing on "non-significant" violations that had "no material effect" on the union's financial position:

Most violations occurring at local unions (170 of 212, or 80 percent) appeared to have no material effect on the reported labor organization financial position, or represented no serious potential for loss to the membership. For example, 145 of the 170 violations we classified as non-significant fell into three violation categories – failure to maintain adequate records, filing deficient annual reports, and failure to file updated constitution/bylaws with OLMS... The majority of reported violations reflected technical, clerical, or administrative error or oversight on the part of labor organization administrative staff or officials.

While OLMS does not agree with the OIG's 1987 description of recordkeeping violations as "non-significant," OLMS does agree that recordkeeping violations are less significant than criminal violations. Developing and implementing a program to follow-up with unions on recordkeeping violations would not be a prudent use of agency resources.