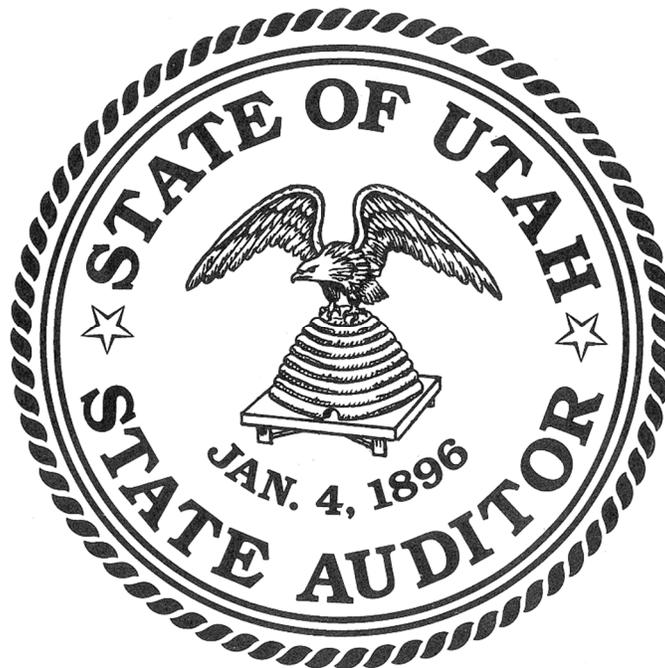


DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

Special Financial Audit
For Procedures Performed During Fiscal Year 2019

Report No. 19-51



OFFICE OF THE STATE AUDITOR

AUDIT LEADERSHIP:

John Dougall, State Auditor
Hollie Andrus, CPA, Audit Director
Sean Clayton, Audit Senior



OFFICE OF THE
STATE AUDITOR

June 1, 2020

Members of the Utah Alcoholic Beverage Control Commission
and
Mr. Salvador D. Petilos, Executive Director
Department of Alcoholic Beverage Control

Dear Commissioners and Mr. Petilos:

We have performed various procedures on certain aspects of the Department of Alcoholic Beverage Control's (DABC's) review of Type 2, 3, and 5 Package Agencies, and the Underage Drinking Prevention and Enforcement Program. These procedures were performed in accordance with *Utah Code*, Section 32B-2-302, agreed to by DABC management, and approved by the Alcoholic Beverage Control Commission.

These procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, the objectives of which would be the expression of an opinion on DABC's internal control. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our recommendations resulting from the procedures are found within this report.

By its nature, this report focuses on exceptions, weaknesses, and problems. This focus should not be understood to mean there are not also various strengths and accomplishments. We appreciate the courtesy and assistance extended to us by DABC's personnel during the course of the engagement, and we look forward to a continuing professional relationship. If you have any questions, please contact me.

Sincerely,

Hollie Andrus, CPA
Audit Director
handrus@utah.gov
801-808-0467

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Finding 1: Inadequate Monitoring of Type 5 Package Agencies

Despite the finding in the 2015 audit report, the Department of Alcoholic Beverage Control (DABC) still does not adequately monitor breweries, distilleries, and winery manufacturing production to verify the accuracy of sales reports submitted to the department.

Type 5 package agencies submit self-certified monthly sales reports to DABC. These reports are used to determine the amount of money these package agencies should remit to DABC. These remittances are used by the Department of Public Safety¹, the Uniform School Fund to support the school lunch program², and by DABC³. The numbers in these monthly sales reports are not verified by DABC on a monthly basis and do not appear to be adequately verified during DABC's annual compliance audit of each package agency. From our perspective, it appears that the compliance personnel are recipients of the reports, but do not use the reports to validate package agency reporting.

To assess the adequacy of procedures to ensure the proper collection of taxes and administrative fees, we selected a sample of seven Type 5 package agencies. We identified circumstances at two package agencies where inventory was transferred in a manner that did not comply with existing regulations. We also noted that a DABC compliance personnel failed to notice that a package agency's July 2018 monthly sales report used to calculate tax and administrative fees was incomplete. As a result, DABC under invoiced that package agency by \$5,407.64. Subsequently, DABC finance personnel identified the error and sent out a corrected invoice. As such, we consider the existing monitoring procedures inadequate and are concerned with the lack of care of certain DABC personnel to ensure proper collection of taxes and fees.

Inadequate monitoring of these types of package agencies could create incentive for the manufacturers to under-report their sales, distorting the competitive landscape as well as resulting in a loss of remittances to the State.

Recommendation:

We recommend DABC verify reported Type 5 package agency sales on at least an annual basis. We recommend DABC strengthen its monitoring of production, inventory transfers, and inventory storage to ensure the proper collection of taxes and administrative fees.

¹ UCA 32B-2-305(4)

² UCA 32B-2-304(4)

³ UCA 32B-2-202(1)(h)

Finding 2: Inadequate Inventory Control

Maintaining inventory controls is important to effective business operations. Key controls include an effective inventory ordering system, point-of-sale systems, and periodic counting of in-store inventory.

During our test work, we noted that many of the Type 2 and Type 3 package agencies⁴ did not maintain effective inventory controls. This can make it difficult for these package agencies and DABC to track monthly sales of bottle. While package agencies are compensated on their purchase quantity, tracking monthly sales is important to ensure package agencies aren't improperly stockpiling inventory.

After reviewing the reports DABC sends to these package agencies, we determined that DABC does not provide reports to each package agency that contain the bottle count that DABC sold to that package agency. Instead, these reports identify the number of cases sold. Since different cases may contain different numbers of bottles per case, these reports lack useful critical operational information.

While the ordering system contains product information supplied by DABC to a package agency, existing point-of-sales systems provide limited information back to DABC. For example, a package agency's point-of-sales system might only report the number of bottles sold via credit/debit cards and not the type of product sold nor the number of bottles sold via cash sales.

In addition, we noted a lack of periodic inventory counts, particularly on the part of DABC compliance personnel.

In summary, the result is limited understanding of what is sold via the package agencies as well as disagreements regarding the product sales of package agencies and their associated compensation.

Recommendation:

We recommend DABC improve its inventory control of Type 2 and Type 3 package agencies. We recommend DABC strengthen its supply chain with improved understanding of bottles sold, specifically as inventory flows into a package agency as well as when it is sold, whether via cash or credit/debit. We recommend DABC implement reporting that

⁴ Package agencies are liquor outlets operated by private individuals or corporate entities under contract with the state for the purpose of selling packaged liquor, wine and beer to the general public for off-premise consumption. Package Agencies are located in communities too small to warrant the establishment of a state store, and in resorts and hotels where the outlets exist primarily for the benefit of their guests. (abc.utah.gov/about/package_agencies.html)

improves bottle-level reporting to help DABC and package agencies operate from common metrics.

Finding 3: Improper Compensation Concerns

Per the contract that DABC has with a Type 2 and Type 3 package agency, a package agency's monthly compensation is based on the average monthly bottle counts that package agency purchased from DABC the previous year.

After reviewing all invoices and LQ-9⁵ forms for a sample of package agencies, we determined that bottle counts were inaccurate. Specifically, the bottle count of certain cases of product had changed over time, but that change was not reflected in DABC's accounting system. As a result, in some situations the bottle counts were under counted while in others they were over counted⁶. This could have the effect of undercompensating certain package agencies and possibly overcompensating others. These errors occurred due to DABC not adequately understanding aspects of its new accounting system, particularly in regards to inventory.

Once DABC discovered the fiscal year 2017 bottle counts were incorrect, they proceeded to correct the error. They also proceeded to terminate existing contracts with package agencies in order to create new contracts with the correct bottle count. It is concerning that DABC initially ignored the petitions of certain package agencies who pointed out these errors. We also recognize that while DABC has the stronger negotiating position, fairness dictates that package agencies should be compensated under an accurate bottle-count arrangement and not compensated based on erroneous statistics.

Recommendation:

We recommend DABC ensure it reports accurate counts of bottles delivered to package agencies. We recommend DABC review its contracts to properly compensate package agencies for contractual arrangements.

⁵ "Broken and Missing in Delivery" form.

⁶ As an example, for a single package agency, we noted that the FY17 count (used for the FY19 contract) showed an over count of 2,344 bottles. A recount by DABC showed an under count of 4,086 bottles. The FY18 count (used for the FY20 contract) showed an under count of 9,787 bottles.

Finding 4: Sales Tax Collection

Each package agency is responsible for submitting the sales taxes it collects directly to the Utah State Tax Commission. Under the current arrangement, cash sales remain with the package agency, while all credit/debit sales flow through DABC⁷. This can create a cash flow concern for a package agency. While a package agency does receive a credit for all credit/debit sales on a weekly basis, this is applied against future product purchases and is not provided as cash to the package agency. While this arrangement mitigates certain risks for DABC, it also impacts how a package agency orders product, operates its business, and manages its cash flow. This can be particularly problematic for package agencies when a high-sales month (such as December) is immediately followed by a low-sales month.

Recommendation:

We recommend DABC revise its practices in regards to package agency sales tax collection.

⁷ We noted our sampled package agencies paid an average sales tax of \$1,438 in January 2019 and \$1,761 in August 2018 for credit card purchases.

Department of Alcoholic Beverage Control's Response to Findings and Recommendations



GARY R. HERBERT
Governor

SPENCER J. COX
Lieutenant Governor

State of Utah

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

1625 South 900 West
P.O. Box 30408
Salt Lake City, Utah 84130-0408
(801) 977-6800 Telephone
(801) 977-6888 FAX
abc.utah.gov

June 8, 2020

Mr. John Dougall, Utah State Auditor
Office of the Utah State Auditor
Utah State Capitol Complex
East Office Building, Suite E310
Salt Lake City, UT 84114-2310

Dear Mr. Dougall:

Thank you for the opportunity to respond to Audit Report 19-51, "Special Financial Audit for Procedures Performed During FY 2019." The DABC appreciates the audit team's efforts in regard to the audit.

The DABC agrees with the findings and recommendations as they confirm areas in which, based on operational observations and communications with the package agencies, improvements in the administration and oversight of the Package Agency Programs are needed. The DABC has initiated changes in processes and operations to implement the recommendations, although much remains to be done. Among these changes, the most significant may well be the investment in additional personnel and the creation of a four person "Package Agency Team," whose primary focus is communicating with, and providing assistance to the package agencies.

Actions taken or contemplated with regard to specific recommendations are outlined in more detail below:

1. **Finding - Inadequate Monitoring of Type 5 Package Agencies.**

Recommendation: We recommend DABC verify reported Type 5 package agency sales on at least an annual basis. We recommend DABC strengthen its monitoring of production, inventory transfers, and inventory storage to ensure the proper collection of taxes and administrative fees.

Response: We agree that Type 5 package agency sales should be verified annually and the monitoring of production and inventories should be strengthened.

The Package Agency team is conducting annual audits with an emphasis on verifying sales, inventory transfers and storage, and ensuring that Type 5 Package Agencies remain in compliance with applicable rules and statutes. The Package Agency team will also confirm transfers, inventories, and monthly sales reports to confirm up to date reporting activities. The audit team also reviews past reporting activities to confirm accuracy of information and compliance.

Additionally, the DABC has begun the process of developing a web-based application for Type 5 PAs to report their sales. This would not only ensure that Type 5 PA sales data are reported in a more timely manner to the DABC, but also facilitate DABC monitoring of the type 5 PA inventory, and reporting process.

2. **Finding - Inadequate Inventory Control**

Recommendation: We recommend DABC improve its inventory control of Type 2 and Type 3 package agencies. We recommend DABC strengthen its supply chain with improved understanding of bottles sold, specifically as inventory flows into a package agency as well as when it is sold, whether via cash or credit/debit. We recommend DABC implement reporting that improves bottle-level reporting to help DABC and package agencies operate from common metrics

Response: We agree that improvements in inventory control, sales transaction transparency, and sales reporting are warranted.

Under current methods of operation, the DABC relies on the Package Agent to provide information on inventory, inventory purchases and adjustments, product sales, tender type and sales history. The DABC does not have access to the Package Agency owned POS systems. Consequently, we currently rely on units purchased by the Package Agent and not actual units sold to gauge performance and adequacy of inventory.

The department has invested in a new point of sale system (POS) - "Talech" - that will provide greater transparency with regard to sales transactions, improve understanding of bottles sold, and assist in rationalizing Type 2 and 3 PA inventories. The capabilities of the new POS system are broad and can assist the Package Agencies in their

daily operations by not only providing data on product sales performance; sales by time and day; and reorder points; but also notifications if the stock is running low and recommend reorder list for their next order. The POS system can provide greater understanding of inventory flows and supply chain needs on the basis of sales data.

The new POS system is currently being tested in three Package Agencies: Coalville, Tremonton and Bicknell. The test installations provide essential feedback on the system's functionality and ease of use. While the system is in test, the DABC, DTS and test PAs meet regularly to discuss issues and concerns arising from the daily use of the system. Problems found are then discussed with the manufacturer's product development group for resolution.

Feedback from the test PAs have primarily been positive. While some concerns regarding the need to learn the new processes needed to generate Talech reports, the automation or streamlining of processes such as: sale item pricing adjustments and receiving have been well received. The POS system was well received when compared with a competitor's POS system that is currently in use at a bigger Package Agency.

The POS system's capabilities provides many improvements to the methods currently in use. The system will not only allow the DABC to obtain information on PA purchases, sales and standing inventory - all essential to maintaining proper inventory levels, but it will also generate monthly sales reports, quarterly inventory reports, sales tax requirements, and licensee sales, which are currently created manually.

The Package Agency team will be installing a DABC approved POS system in all Type 2 and 3 Package Agencies over the next year.

For the bottle count reporting concerns the DABC is providing a monthly summary report that details the bottle count, credits, and includes monetary value of the orders. This report has been provided and available since August of 2019. Additional details are provided below.

3. Finding - Improper Compensation Errors

Recommendation: We recommend DABC ensure it reports accurate counts of bottles delivered to package agencies. We recommend

DABC review its contracts to properly compensate package agencies for contractual arrangements.

Response: The department agrees that more accurate counts are necessary and has taken the following steps to ensure accuracy in agency compensation and ensure that compensation is in accord with contract provisions.

- A. Monthly distribution to each Package Agency of an individualized sales order summary report which details bottle count for their review and feedback if adjustment is needed. The reports are sent to the Package Agencies by the 15th of each month, and each includes clear information regarding bottles sold and total compensation by agency. (See example email below in blue). This allows the package agencies and the DABC to discover and address discrepancies in a timely manner.
- B. Detailed review of the sales order summary report on a monthly basis. The DABC Package Agency Team reviews and compares the monthly bottle count summary report against a detailed Sales Order report that provides invoice number, date ordered, units ordered, and dollar amounts of order. This process is double checked to confirm accuracy between bottle count summary report and actuals. This report will also include credits for items returned and LQ9's for shipping errors (over/under quantities) or broken in transit. The Package Agency is then given a reasonable amount of time to review and reply to the DABC for any perceived discrepancies.

Sample monthly email below

The internal generated report is directly below, which is for confirmation of the AX report in blue (below). The total of the fourth column, 105809.37 is dollars spent and the total of the fifth column is units purchased during fiscal period 10.

PAO			105809.37	10760
03/30/2020	CUI456922	SOO483860	401.06	62
03/31/2020	CUI456994	SOO483838	27910	2700
04/01/2020	CUI457088	SOO484114	72.18	-18
04/07/2020	CUI457386	SOO484578	15720.9	1538
04/10/2020	CUI457599	SOO485052	159.92	8
04/13/2020	CUI457739	SOO485260	13343.48	1036
04/20/2020	CUI458123	SOO485937	204.95	5
04/21/2020	CUI458194	SOO485928	28133.41	3063
04/25/2020	SCN103094	SOO486387	-492.24	-48
04/25/2020	SCN103095	SOO486388	-1.65	-2
04/25/2020	SCN103096	SOO486389	-35.98	-2
04/25/2020	SCN103097	SOO486390	-14.25	-15
04/27/2020	CUI458537	SOO486457	20407.59	2433

Package Agency: PAO

Fiscal Year 2021 Compensation based on Fiscal Year 2019 purchases

Our records show that your average monthly purchase in the 2019 fiscal year was: 12,404 bottles.

Based on the above, your compensation for fiscal year 2021 (July 1, 2020 - June 30, 2021) will be \$12,308.22 per month.

See tiered schedule below:

PAY LEVEL	UNITS PER MONTH	MONTHLY PAY	YEARLY PAY	PAY LEVEL	UNITS PER MONTH	MONTHLY PAY	YEARLY PAY
1	1 to 999	\$2,382.22	\$28,586.64	33	15,490 to 15,989	\$15,087.50	\$181,050.00
2	1,000 to 1,239	\$2,779.26	\$33,351.12	34	15,990 to 16,489	\$15,484.54	\$185,814.48
3	1,240 to 1,489	\$3,176.30	\$38,115.60	35	16,490 to 16,989	\$15,881.58	\$190,578.96
4	1,490 to 1,739	\$3,573.34	\$42,880.08	36	16,990 to 17,489	\$16,278.62	\$195,343.44
5	1,740 to 1,989	\$3,970.38	\$47,644.56	37	17,490 to 17,989	\$16,675.66	\$200,107.92
6	1,990 to 2,489	\$4,367.42	\$52,409.04	38	17,990 to 18,489	\$17,072.70	\$204,872.40
7	2,490 to 2,989	\$4,764.46	\$57,173.52	39	18,490 to 18,989	\$17,469.74	\$209,636.88
8	2,990 to 3,489	\$5,161.50	\$61,938.00	40	18,990 to 19,489	\$17,866.78	\$214,401.36
9	3,490 to 3,989	\$5,558.54	\$66,702.48	41	19,490 to 19,989	\$18,263.82	\$219,165.84
10	3,990 to 4,489	\$5,955.58	\$71,466.96	42	19,990 to 20,489	\$18,660.86	\$223,930.32
11	4,490 to 4,989	\$6,352.62	\$76,231.44	43	20,490 to 20,989	\$19,057.90	\$228,694.80
12	4,990 to 5,489	\$6,749.66	\$80,995.92	44	20,990 to 21,489	\$19,454.94	\$233,459.28
13	5,490 to 5,989	\$7,146.70	\$85,760.40	45	21,490 to 21,989	\$19,851.98	\$238,223.76
14	5,990 to 6,489	\$7,543.74	\$90,524.88	46	21,990 to 22,489	\$20,249.02	\$242,988.24
15	6,490 to 6,989	\$7,940.78	\$95,289.36	47	22,490 to 22,989	\$20,646.06	\$247,752.72
16	6,990 to 7,489	\$8,337.82	\$100,053.84	48	22,990 to 23,489	\$21,043.10	\$252,517.20
17	7,490 to 7,989	\$8,734.86	\$104,818.32	49	23,490 to 23,989	\$21,440.14	\$257,281.68
18	7,990 to 8,489	\$9,131.90	\$109,582.80	50	23,990 to 24,489	\$21,837.18	\$262,046.16
19	8,490 to 8,989	\$9,528.94	\$114,347.28	51	24,490 to 24,989	\$22,234.22	\$266,810.64
20	8,990 to 9,489	\$9,925.98	\$119,111.76	52	24,990 to 25,489	\$22,631.26	\$271,575.12
21	9,490 to 9,989	\$10,323.02	\$123,876.24	53	25,490 to 25,989	\$23,028.30	\$276,339.60
22	9,990 to 10,489	\$10,720.06	\$128,640.72	54	25,990 to 26,489	\$23,425.34	\$281,104.08
23	10,490 to 10,989	\$11,117.10	\$133,405.20	55	26,490 to 26,989	\$23,822.38	\$285,868.56
24	10,990 to 11,489	\$11,514.14	\$138,169.68	56	26,990 to 27,489	\$24,219.42	\$290,633.04
25	11,490 to 11,989	\$11,911.18	\$142,934.16	57	27,490 to 27,989	\$24,616.46	\$295,397.52
26	11,990 to 12,489	\$12,308.22	\$147,698.64	58	27,990 to 28,489	\$25,013.50	\$300,162.00
27	12,490 to 12,989	\$12,705.26	\$152,463.12	59	28,490 to 28,989	\$25,410.54	\$304,926.48
28	12,990 to 13,489	\$13,102.30	\$157,227.60	60	28,990 to 29,489	\$25,807.58	\$309,690.96
29	13,490 to 13,989	\$13,499.34	\$161,992.08	61	29,490 to 29,989	\$26,204.62	\$314,455.44
30	13,990 to 14,489	\$13,896.38	\$166,756.56	62	29,990 to 30,489	\$26,601.66	\$319,219.92

31 14,490 to 14,989 \$14,293.42 \$171,521.04 63 30,490 to 30,989 \$26,998.70 \$323,984.40
32 14,990 to 15,489 \$14,690.46 \$176,285.52
Current year-to-date Fiscal Year 2020

According to our records, you purchased **10,760** bottles from us during period **10** of fiscal year **2020**.
Your fiscal year-to-date purchases total: **124,421** bottles.

Your current monthly running average is: **12,442** bottles. This will determine your compensation for fiscal year **2022**.

Kindly review and reach out as soon as possible with any questions or concerns.
Thanks,

C. As previously indicated, the department has invested in a new point of sale (POS) that allows for both the department and agency to reconcile on a daily basis if necessary. The new POS allows for greater accuracy of bottle counts and increased reporting capabilities. All type 2 and 3 PA will be required to use this POS system in future contracts.

4. Finding - Sales Tax collection.

Recommendation: We recommend DABC revise its practices in regards to package agency sales tax collection.

Response: The department adjusted this practice to allow all Type 2 and 3 Package Agencies the option to receive a monthly check for tax reimbursement or continue the practice of receiving a credit against future purchases.

All type 2 and 3 Package Agencies are given the option to receive a reimbursement for the monthly sales tax collected or have a credit issued on their account.

I wish to thank your staff for their efforts in conducting this audit and look forward to working with your office in the future.

Sincerely,



Salvador D. Petilos, Director
Dept. of Alcoholic Beverage Control