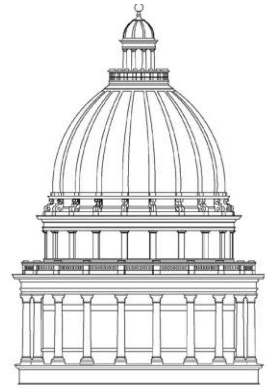
Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah



REPORT NUMBER 2011-13
October 2011

A Review of Allegations Regarding The Management of the DABC

We completed a review of allegations regarding the management of the Department of Alcoholic Beverage Control (DABC or department) and found significant and serious concerns in the department's administration. We were specifically asked to look at the relationship between the DABC and Flexpak, a company owned by the former DABC executive director's son. Our examination of the DABC's relationship with Flexpak revealed numerous other problems at the DABC.

Our review of allegations regarding the management of the DABC found significant and serious concerns.

We believe the DABC has been incompetently managed. This conclusion is based in part on years of bid rigging, falsifying financial documentation, and artificially splitting invoices in violation of state statute. The DABC has also done substantial business with Flexpak without competitively bidding or properly contracting, which was inappropriate and potentially illegal because of the familial relationship. We also found that DABC management failed to provide oversight of the department's financial affairs.

Due to the significant issues identified in this and other audit reports that extend over a period of time, we believe the DABC has been incompetently managed.

When looked at in total, a history of state and legislative audits further confirms a pattern of management incompetence. For example, poor purchasing practices had been identified in four past reports by the Office of the State Auditor, but DABC management failed to implement adequate controls. In this audit, we identified additional inappropriate and questionable management practices, including the unnecessary loss of $37,000 in liquor and questionable perks for the former director and deputy director. Also concerning were the failure of the department to adequately address budget cuts and the exclusive promotion of closing liquor stores and reducing employees' hours when other options were and are available.

We conclude that the DABC has been incompetently managed. Because of this demonstrated pattern of poor management, the Legislature may want to consider revising the current oversight structure of the department. With that being said, our limited review did not find concerns with the purchase of liquor for the state. We further acknowledge that, in the course of this audit, a number of DABC employees were helpful in addressing serious concerns about the management and operation of the department.

The DABC Has Been Incompetently Managed

The DABC has not been following state statute, policy, and best practices in the administration of the department. The DABC has not been properly procuring many of its supplies and has been falsifying financial data. Rather than follow state policy, management of the DABC allowed staff to purchase supplies or services without first obtaining competitive bids. After a purchase was made, staff contacted other vendors to obtain a higher bid price and then post-dated the bid to the actual purchase date, thus giving the appearance of validity to the purchase. This practice is commonly referred to as bid rigging and could be fraudulent if collusion exists between the buyer and seller. This practice certainly bypasses required competitive bidding and does not ensure that the state obtains the best possible price.

The DABC has not been following state statute, policy, and best practices in the administration of the department.

The DABC has also been artificially splitting invoices in order to avoid state-mandated purchasing requirements, which is a violation of state statute. In the last year alone, hundreds of invoices have been illegally separated to avoid the state requirement of seeking bids to ensure competition.

Since 2003, the DABC has spent hundreds of thousands of dollars with a company owned by the former executive director's son. Among other issues, business with Flexpak was conducted without following state procurement procedures, which has resulted in the DABC paying a premium to work with a member of the executive director's family. This is a possible violation of the Employee Ethics Act.

We also found that the DABC lacks crucial controls in their financial department to ensure that assets are safeguarded and payments are appropriate. Most importantly, the DABC does not have proper segregation of duties, fails to obtain documentation for invoices, and has a mother supervising her daughter (nepotism). We have concluded that members of management have not been attentive to their responsibilities to supervise employees and ensure adherence to state statute and policies.

The DABC Has Been Rigging Bids, Falsifying Reports and Artificially Separating Invoices

The DABC has been rigging bids and falsifying financial data for years in order to bypass procurement requirements. The DABC's routine practice has been to make purchases and then document higher bids after a purchase has already been made in order to pass financial audits conducted by the state. In addition to bid rigging and falsifying reports, the department has also been artificially splitting invoices in violation of state law to avoid purchasing requirements. As will later be discussed, the state has different procedures in place for purchases over $1,000 and $5,000; it is illegal to artificially split an invoice for a large purchase to stay below set purchasing restrictions. However, these inappropriate practices have been widespread within the DABC for purchases pertaining to office, warehouse, and store supplies.

The DABC has been rigging bids and falsifying financial data for years to bypass procurement requirements and to pass state financial audits.

The DABC Has Been Rigging Bids and Falsifying Financial Documentation. The DABC accounting technician responsible for documenting bids explained that staff were trained to find higher bids after receiving invoices for purchases already made and told to get verbal bids from vendors until a higher price was found. At times, these quotes were obtained weeks after a purchase was made, and quote sheets were back-dated to correspond to the day the purchase was made. The DABC accounting manager, a thirty-two year DABC employee, explained to us that the DABC has been documenting higher bids after purchases for over twenty years. When asked why the practice continued, she explained that nothing was said because of fear of losing her job.

The DABC practice has been to make purchases, find higher bids after the purchase has been made and then back-date bid records.

State procurement policies require bids for purchases over $1,000.

The state procurement policies for purchases from $1,001 up to $5,000 require bids in order to help ensure competitive prices. FIACCT 04-04.00(C) and (E) states:

> (C) Departments must obtain price quotes from at least two, and preferably three vendors for all purchases from $1,001 up to $5,000 that are not supplied by producing/distributing departments or divisions of the State and that are not included in a required-use master agreement. Price quotes must be obtained by phone, fax, email, or letter from a representative of an established, viable vendor and documented on a Telephone Quote Sheet.
>
> (E) Award must be made to the vendor submitting the lowest quote meeting minimum reasonable specifications and delivery date established by the ordering department.

As shown in Figure 1, the effects of these financial actions taken by the DABC have cost the state money. In some instances, items could have been purchased using state contracts already in place, ensuring that the best price was obtained.

All of the prices paid in column two of Figure 1 had higher price quotes obtained after the purchase was made and the invoice was received. The lower price found in column three was documented by the audit team with the accounting technician during the course of this audit. The DABC's practice of rigging bids and falsifying financial documentation is widespread, and Figure 1 provides only a few examples to illustrate the effect of these actions.

Figure 1. Savings Would Be Realized by Following Procurement Rules. DABC employees have made purchases without properly obtaining competing bids for items over $1,000, resulting in excess costs to the state.

Item	Price Paid	Lower Price Found	Potential Savings	Percent Savings
Shelf Talker	$ 1,440	$ 720	$ 720	50 %
Warning Signs	2,650	1,918	732	28
Store Supplies	1,458	1,164	294	20
Receipt Paper	4,394	3,621	773	18

This figure shows examples of savings the state could have realized if procurement policies were followed.

While not every item purchased could have been purchased for a lower price through another vendor, Figure 1 shows that the DABC was overpaying for products as a direct result of not following state procurement rules. According to the accounting technician who obtains quotes, in December 2009 she notified DABC management that lower prices were available and that the process of getting quotes after the fact was backwards, but no actions were taken to fix the situation prior to our audit. As previously mentioned, the accounting manager also reported that the practice of bid rigging has been going on for over 20 years at the DABC.

Management was aware of the bid rigging and falsifying of records but did not correct these practices.

The DABC Has Been Artificially Splitting Invoices in Violation of State Law. The state has established purchasing guidelines to ensure competition and that the best price is obtained. When an entity artificially separates an order or invoice to bypass those requirements, they are violating the law. ***Utah Code*** 63G-6-409 states:

> Small purchases shall be defined in, and may be made in accordance with procedures established by, rules and regulations; except that the procurement requirement shall not be artificially divided so as to constitute a small purchase under this section.

The DABC has been artificially splitting invoices to come under certain spending thresholds, in violation of state law.

As previously discussed, purchases from $1,001 to $5,000 require the department to obtain bids. For purchases over $5,000, the Division of Purchasing, Department of Administrative Services (DAS-Purchasing) retains primary responsibility and control.

We found that the DABC has been artificially separating purchases and invoices to bypass purchasing policy requirements for obtaining bids. This is very concerning because, as will be discussed later in this report, the Office of the State Auditor had reported in several audits that the DABC had a habit of splitting invoices in the past. The current finance director of the DABC previously worked for 20 years in the state auditor's office and should have reviewed past reports and corrected control weaknesses.

Splitting invoices was especially noticeable with Flexpak purchases as well as store supplies purchased through various vendors. Figure 2 shows examples of split invoices.

Figure 2. Examples of Split Invoices from Flexpak and Other Vendors. ***Utah Code*** prohibits the artificial splitting of invoices to fall under certain limits. This is a common occurrence at the DABC, as shown in these examples.

Vendor	Item	Number of Invoices for One Purchase	Total Invoiced	Average Invoice
Flexpak*	Wrap	6	$ 5,936	$ 989
Flexpak*	Tape	4	3,492	873
Vendor 1**	Case Cutters	2	1,652	826
Vendor 2**	Carts	4	3,500	875
Vendor 2**	Coin Bags	2	1,520	760
Vendor 3**	Mops	2	1,819	909

** Wrap and tape purchases from Flexpak were often purchased on the same day, with separate invoices.*
*** Other vendors had recurring purchases of the same product often within a few days of each other.*

The Flexpak purchases are the most blatant example of split invoices, but invoices from other vendors were split as well.

The Flexpak purchases are the most blatant example of split invoices. The DABC purchases two main items from Flexpak: stretch wrap and tape. Stretch wrap comes in shipments of 40 rolls per pallet, which costs $1,978.80. Each reviewed pallet order was split into two invoices of 20 rolls, costing $989.40, in order to keep the invoices under $1,000. Figure 2 shows that three pallets of wrap were split into six invoices.

As illustrated in Figure 3, while pallets of stretch wrap are split into two invoices, the actual order is delivered on one pallet containing 40 rolls. Tape comes on pallets of 1,620 rolls, costing $1,765.80. These orders have also been split into multiple invoices to keep each invoice under $1,000. Figure 3 provides a picture of an order of stretch wrap from Flexpak.

Figure 3. A Picture of One Order of Stretch Wrap From Flexpak. A stretch wrap order from Flexpak comes on one pallet with 40 rolls, but invoices are consistently split or artificially separated into two invoices for 20 rolls each. However, the stretch wrap on the pallet is never physically split, as shown below.

An order for stretch wrap comes on one pallet containing 40 rolls, but the invoices are artificially split into two invoices of 20 rolls each. While Figure 2 shows examples of invoices being artificially split for orders made on the same day or within a few days of each other, the Division of Purchasing staff considers invoice splitting to have occurred when the same purchases are made on a recurring basis. Such recurring purchases were clearly occurring in many circumstances, including Flexpak purchases. Figure 4 shows the frequency that invoices were received from the same vendors shown in Figure 2 to illustrate how prevalent invoice splitting was.

Figure 4. Invoices Are Frequently Split at the DABC to Come Under the $1,000 Limit. Several companies had a large percent of their invoices split. Despite having several invoices per month, only one reached the $1,000 threshold that would have required bids, and this was purchased through the Division of Purchasing and not the DABC.

Vendor	FY11 Invoices	Invoices Per Month	Invoices Over $800	Invoices Over $1,000
Flexpak	182	15.2	82	1*
Vendor 1	117	9.8	63	0
Vendor 2	37	3.1	8	0
Vendor 3	35	2.9	24	0

**Invoice was for six stretch wrap machines that were procured through a Division of Purchasing bid.*

Invoices are frequently split at the DABC to come under the $1,000 limit.

All of the vendors shown in Figure 4 supply multiple products to the DABC, so having separate invoices may be appropriate in some circumstances. However, splitting of invoices is occurring frequently, with some purchased items totaling over $5,000, which should have gone through the Division of Purchasing. Using State Purchasing would clearly have been of benefit to the state, ensuring that the best prices and quantity discounts were received.

Orders Over $5,000 Were Improperly Handled by the DABC. In addition to items with split invoices, such as tape and stretch wrap with annual purchases over $5,000, several other items over $5,000 should have been handled by the Division of Purchasing through competitive bids. In fiscal year 2011, the DABC purchased $46,502 in stretch wrap and $41,093 in tape from Flexpak. Other identified items include a wine chiller in fiscal year 2011 and three orders of packing tape in fiscal year 2009. The chiller did not have any sort of bid or quote, and the tape had telephone quotes only, which were likely received after the purchase.

Some purchases clearly over $5,000 were not sent to the Division of Purchasing for procurement, this included about $88,000 in wrap and tape purchased from Flexpak in fiscal year 2011.

Additionally, several items ordered from Flexpak in prior years met the $5,000 threshold. In 2008, $11,188 of stretch wrap was ordered. One of the invoices was for $6,716 and two invoices were received by the DABC one day apart. Clearly, this was a situation that should have been handled through the Division of Purchasing. In 2006, $8,942 of tape was purchased within two days, according to the Flexpak invoices. Again, this should have been purchased through a competitive bid to ensure the best prices and quantity discounts were received. As will be discussed, we documented multiple bids for Flexpak items that could have been obtained for less cost from other companies.

Business Done with Flexpak Was Inappropriate and Potentially Illegal

The DABC has spent $370,483 purchasing warehouse and store supplies from Flexpak, a company owned by the former executive director's son. The company was first used in 2003, when the former director was deputy director and in charge of warehouse operations. Other than the purchases of stretch wrap machines that were procured through the Division of Purchasing, DABC staff has been unable to provide us with any contracts signed with Flexpak, despite their becoming the only provider for the two main supplies used in the warehouse, stretch wrap and tape.

The DABC has spent $370,483 purchasing warehouse and store supplies from Flexpak, a company owned by the former executive director's son.

We found that the products supplied by Flexpak could have been purchased for less from other vendors. If the supplies had been purchased properly, the DABC would have obtained the best price available. Flexpak purchases have dramatically increased in the last two years because of the company being used exclusively for stretch wrap and tape.

It appears that the one contract that the DABC has with Flexpak (the stretch wrap machines) has not been handled properly. Flexpak has been charging the DABC thousands of dollars for service on these stretch wrap machines that are supposed to be under warranty. Management of the DABC was not aware this was happening until we questioned them about the many service calls in the year since the machines were placed into operation.

The DABC Commission did not know of the relationship between the former executive director and Flexpak, but employees of the DABC did know. Management of the DABC has not properly overseen the purchasing practices with Flexpak or acknowledged problems that have been occurring. The lack of oversight may be due to the relationship issue. Some employees have felt uncomfortable questioning what was happening with Flexpak, even if they did feel it was inappropriate. Because of all of these issues, the DABC relationship with Flexpak may be a violation of the law.

The DABC Paid a Premium for Flexpak Supplies and Allowed a Flexpak Employee to Place Orders. As discussed, Flexpak has been providing stretch wrap and tape, as well as store supplies, to the DABC without going through proper procurement channels.

Flexpak often did their own ordering of supplies for the DABC, which is unusual.

Additionally, warehouse employees reported to us that Flexpak often did their own ordering of supplies for the DABC warehouse (stretch wrap and tape), which is unusual. When the Flexpak salesman noticed a supply was getting low, he would simply place the order himself.

The warehouse general manager was not aware of the quantities being ordered and believed that Flexpak had a contract with the DABC for these supplies. Flexpak was the only vendor that we identified that did its own ordering, which could be seen as a special privilege or exemption. As will be discussed later, providing special privileges or exemptions could be a violation of the Employee Ethics Act.

Failing to obtain bids has also resulted in the DABC paying a premium for Flexpak items. We obtained multiple quotes for the same stretch wrap and tape provided by Flexpak. The results of our comparison between the lowest bids and the price paid to Flexpak are shown in Figure 5. Two of the three companies quoted several dollars less per roll of stretch wrap and one had a cheaper price for tape.

By not obtaining bids, the DABC paid a premium to do business with Flexpak.

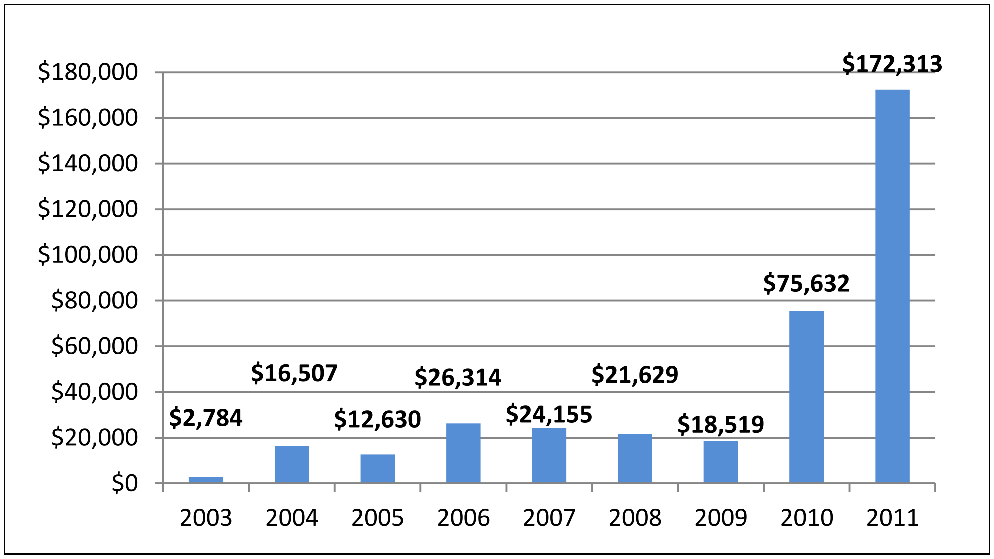
Figure 5. Savings Would Have Been Possible Through a Competitive Bid Process. Based on the approximate quantities used by the DABC in fiscal year 2011, the DABC could have saved over $7,800 if competitive bids had been obtained.

Item	Flexpak Unit Cost	Quote Unit Cost	Flexpak Yearly Cost	Quote Yearly Cost	Savings Potential
Wrap	$ 49.47	$ 45.54	$ 46,502	$ 42,808	$ 3,694
Tape	$ 1.09	$ 0.98	$ 41,093	$ 36,946	$ 4,147
Potential Savings					$ 7,841

The $7,800 in savings represents an almost nine percent reduction in spending on these two items for fiscal year 2011, not including a one percent discount the lowest bidder offered for prompt payment. Despite being the only vendor used by the DABC for tape and wrap, no quantity or other discounts were offered by Flexpak. Greater savings will be possible by requesting bids through the Division of Purchasing to get a greater variety of options and ensuring these discounts.

Business Done with Flexpak Increased Substantially Over the Last Two Years. As shown in Figure 6, Flexpak has done business with the DABC beginning in 2003, but purchases from Flexpak substantially increased in fiscal year 2010.

Figure 6. The DABC Order History with Flexpak Shows Significant Increases Over the Last Two Fiscal Years. The DABC has ordered over $370,000 in products from Flexpak dating back to fiscal year 2003.



Over the time shown in the figure, the DABC paid over $370,000 to Flexpak for supplies, equipment, and services. Flexpak purchases increased dramatically in fiscal year 2010. In the first six months of that year, the DABC purchased $24,137 from Flexpak. In the second half of the year, $51,495 in purchases was made from Flexpak. In fiscal year 2011, the DABC again averaged over $50,000 in purchases every six months, and spent $59,716 on wrapping machines.

Since 2003, the DABC paid over $370,000 to Flexpak for supplies, equipment, and services. Business done between the DABC and Flexpak substantially increased in fiscal year 2010.

According to warehouse personnel, the need for wrap increased during the recent remodel of the warehouse. During this time, products were shipped from an off-site location and had to be wrapped securely for shipment. We found that wrap and tape had been previously purchased through multiple vendors. Our review found that some of these purchases were over $1,000 and the bidding records had price quotes from Flexpak that were higher than the quote received from the winning bidder. Despite this evidence of less costly materials, in 2009, the DABC began using Flexpak exclusively and without properly obtaining bids.

The DABC Contracted to Purchase Wrapping Machines from Flexpak without Disclosing Conflicts of Interest. In addition to the regular purchases of wrap, tape, and store supplies that have been made from Flexpak, there have also been two purchases of wrapping machines, both of which were procured through the Division of Purchasing with a competitive bid. The most recent purchase occurred in 2010 when the DABC bought six wrapping machines for just under $60,000. Flexpak was the lowest bidder and was therefore awarded the contract.

In 2004, a $7,500 film wrapper was purchased from Flexpak, which was not the lowest bidder. The lower bids were discarded by the former executive director when he was deputy director for not meeting specifications.

In 2004, a $7,500 film wrapper was also purchased through a bidding process. In this bid, another vendor submitted two proposals, each priced lower than the winning Flexpak bid. The lowest bid was nearly $1,000 less. However, in January 2004, the former executive director (deputy director at the time) sent a memo to the state's purchasing agent. In the memo, he said the two lowest bids did not meet the required specifications and indicated that the bid was to be awarded to Flexpak. This memo did not disclose his relationship with Flexpak.

We attempted to contact the lowest bidder to determine if the company felt the bid was handled in an appropriate manner, but were unable to get in contact with him. It is possible that the other bids did not, in fact, meet specifications. However, it is inappropriate for the deputy director to make the decision and send the memo to bypass the two lowest bidders for a contract with his son's company. We could find no evidence that the Division of Purchasing was aware of the relationship between the then deputy director and Flexpak.

The DABC paid Flexpak $4,684 in repairs on machines that are under warranty.

Flexpak Charged for Service Repairs of Items Under Warranty. When Flexpak won the bid on the six wrapping machines purchased by the DABC in 2010, the company included a three year warranty on the machines. Despite this warranty, Flexpak charged the DABC for service labor and/or travel time 33 times from August 2010 to July 2011. Most of these charges appear inappropriate given the warranty included in the bid; the DABC requested a refund of $4,684 in September, 2011. In addition, Flexpak also charged the DABC for multiple machine parts that may have been covered under the warranty.

When we questioned the warehouse general manager about the many service calls on the machines, he said that the machines were under warranty but when employees broke the machines due to negligence, the warranty did not cover repairs. However, he had no documentation to show why any of the service calls were made and did not seem aware of exactly how often service had been performed. We requested the documentation from the DABC accounting office, which in turn requested it of Flexpak.

DABC management was not even aware of what the service charges from Flexpak were for.

After reviewing the documentation and discussing this issue with warehouse employees responsible for working the machines and making calls for service, we confirmed that most service calls were made because the machinery was not working as it was supposed to, not because it had been broken by employees. It was not until we questioned these charges that the DABC checked on the warranty status and requested a refund of repair charges.

The DABC Commission Did Not Know of the Relationship Between Flexpak and the Former Director, But Employees Knew. The relationship between Flexpak and the executive director was not known to the commission. The former chair of the DABC Commission told us that in 2007, when he was first appointed, the chair asked the former executive director if the DABC did business with Flexpak. According to the former commission chair, the former executive director told him they did not and said it would be unethical if they did. The current chair of the commission also did not know of the relationships between Flexpak and the former executive director.

The past and current DABC Commission chairs were not aware of the relationship between the former director of the DABC and the Flexpak owner, even though employees knew.

In discussions with members of management, as well as members in the finance department and the warehouse, we found that employees knew of the relationship between the former executive director and Flexpak. One employee claimed his life was made much easier once he started ordering from Flexpak and he was afraid of repercussions if he had problems with them. Another employee commented that nothing would come of complaints about Flexpak because of the relationship. The perception of special treatment was apparent in some employees. While none said they were specifically told to give Flexpak special treatment, we believe it is likely that an employee would be uncomfortable with upsetting a company with such close relations to the department head. This conclusion of employees feeling uncomfortable questioning management was also reached by the Office of the State Auditor in 2004 when he stated, "it is very concerning to us that various employees were aware of certain procedures that we determined to be improper, but either did not recognize them as improper or did not feel comfortable questioning them."

After the resignation of the former executive director, we were told by management that the director had been very open about the relationship with Flexpak. While it is true that most employees seemed to know of this relationship, we did not find this same openness when we questioned management about it. It should be noted that this questioning occurred with several members of management present, including the former executive director. These members of management were not forthcoming about the DABC doing business with Flexpak when we questioned them about contracting with companies who employed their relatives. The former director instead questioned what we meant by contracting. Management eventually did divulge the relationship, but it was far from an attitude of openness.

We believe that the Attorney General's Office should consider whether it should pursue appropriate charges.

The DABC Relationship with Flexpak May Be a Violation of the Law. Because of the business dealings outlined in this report between Flexpak and the DABC, and because the owner of Flexpak is the son of the former executive director of the DABC, a possible violation of the Employee Ethics Act (***Utah Code*** 67-16-4) may have occurred. We believe that the Attorney General's Office should consider whether it should pursue appropriate charges. The act states that a public employee may not "use or attempt to use his official position to . . . secure special privileges or exemptions for himself or others." Because the value of compensation exceeded $1,000, this violation could be a felony of the second degree.

DABC Management Failed to Ensure Oversight of Financial Affairs

The DABC does not have proper segregation of duties, fails to obtain documentation for invoices, and has a mother supervising her daughter (nepotism).

The problems discussed so far in this report are a direct result of management's failure to provide oversight of the financial affairs of the department. The DABC is missing crucial controls in the financial department to ensure that assets are safeguarded and payments are appropriate. Most importantly, the DABC does not have proper segregation of duties, fails to obtain documentation for invoices, and has a mother supervising her daughter (nepotism).

According to the American Institute of Certified Professional Accountants (AICPA), the opportunity for fraud related to misappropriation of assets is enhanced when there is inadequate separation of duties. The proper segregation of duties prevents an individual employee from both perpetuating and concealing fraud. To safeguard assets, three main functions must be segregated:

- Authorization of transactions (ordering)
- Custody of assets (receiving)
- Recordkeeping of transactions (payment/recording)

These financial functions have not been separated at the DABC. For supplies being purchased at the warehouse and liquor stores, both the authorization of the purchase and the custody of the assets often involved the same employees. In these instances, a single employee would both order goods and receive them. They would also sign off on the invoice to have it paid. It would have been difficult for the DABC to be aware if this employee was stealing assets. Ideally, one employee would place orders, another would receive them, and a separate employee should record the transactions after obtaining proper documentation of the purchase.

The DABC had one employee responsible for both ordering and receiving supplies.

In addition to the lack of segregation of duties, we also found that accounting did not always receive proper documentation that invoiced items were actually received. The accounting technician responsible for entering the data said that one employee in particular was often missing supporting documentation such as a purchase order or packing slip to verify the invoiced items were ordered and received. While the technician had invoices for supplies signed by the responsible party, they sometimes were paid without documentation. Additionally, invoices for service on Flexpak machines were paid without any sort of authorization or supporting documentation. The accounting technician acknowledged that there was no control for incorrect invoices, meaning that accounting often had no way to verify receivables.

The accounting technician who handles payments to vendors for administrative, warehouse, and store supplies has these payments approved by her supervisor, who is the accounting manager. While this is an important control to ensure that improper payments are not made, the manager is the mother of the technician. This relationship raises serious concerns since the potential for collusion is greatly enhanced. While we did not find any collusion or fraudulent activity because of this nepotism, the opportunity exists.

The DABC overspent their operating budget in fiscal year 2011 by over $56,000.

We also found that the DABC overspent their operating budget for fiscal year 2011 by over $56,000. This error was the result of some expenditures not being properly accounted for. We are concerned that DABC management believes that they can cover this shortfall with funding provided by the Governor's Office and the Legislature to keep liquor stores open until February 2012.

Limited Review of Liquor Purchases Did Not Raise Any Concerns

Our limited review of the DABC process for purchasing liquor did not raise any concerns.

Our limited review of the DABC process for purchasing liquor did not raise any concerns. Our review here was limited because we did not find any inappropriate relationships between DABC officials and alcohol vendors. We also did not find the same lack of controls that was found in other procurement areas of the DABC.

For alcohol product selection, the DABC has a submission, tasting, listing, and decision-making process. They also have a process for distributing the product in select geographic regions to determine demand. We also found that the personnel responsible for ordering the products do not receive the products, which is a control that other procurement areas of the DABC lack.

DABC Management Has Exhibited a Pattern of Incompetence and Questionable Practices

DABC management has exhibited a pattern of incompetence and questionable practices. This pattern is highlighted by a series of past state and legislative audits of the DABC. We also found some other current management practices to be questionable and inappropriate. Because this pattern has been ongoing, we recommend that the Legislature consider whether it is time to revisit the current oversight structure of the DABC.

Past State and Legislative Audits Have Identified Significant Concerns

Past state and legislative audits have demonstrated a pattern of poor management over the DABC, which, when considered in totality, have contributed to our conclusion that the department has been incompetently managed. State audits from 2002 and 2004 found a number of inappropriate and some illegal activities by DABC employees. A legislative audit found that the DABC's poor management contributed to state losses from a now-closed package agency and that the department did not report those issues to their commission or the attorney general. Other legislative audits identified that the DABC has inadequately planned for growth in retail space and has not adequately considered alternatives to addressing past budget reductions.

Financial audits of the DABC by the Office of the State Auditor demonstrate a concerning pattern of financial problems.

Past State Audits Demonstrate a Pattern of Financial Problems at the DABC. The following audits of the DABC, released by the Office of the State Auditor in 2002 and 2004, demonstrate a concerning pattern of financial problems.

- **Management Letter No. 03-616B:** This audit was a review of fraud to which the DABC employee pled guilty to second-degree felony charges. Regarding this audit, the State Auditor wrote,

> The control environment over cash receipting, clothing purchases, the petty cash account, and various other procedures at DABC were inadequate, which allowed the misappropriation and manipulation of funds to go undetected. We found that controls were either lacking in these areas or were not followed. It is very concerning to us that various employees were aware of certain procedures that we determined to be improper, but either did not recognize them as improper or did not feel comfortable questioning them. Management needs to create a strong control environment where good internal controls are established and followed. Management should communicate to the employees the importance of following internal controls to maintain a good control environment and should insist that established internal controls are followed. Management should also encourage their

A 2004 state audit found that the DABC lacked a strong control environment and employees did not feel comfortable questioning management.

employees to question procedures they believe are improper without fear of reprisal.

- **Report No. 02-616:** This audit found significant weaknesses relating to purchasing, including the splitting of invoices. It also identified inadequate controls over a checking account and noncompliance with state fixed asset policies. With regards to the splitting of invoices or artificial separation, the State Auditor wrote,

> Artificially dividing purchases into smaller amounts to avert purchasing requirements could allow noncompetitive and unreasonable expenditures to be made. We are particularly concerned about the Department's apparent disregard of this State law and these State accounting policies since the same problem was also noted during the last two reviews we performed of Department controls in 1995 and 1999.

A 2002 state audit found that the DABC has an apparent disregard of state law and accounting policies in that they were found to be splitting invoices in 2002, 1999, and 1995.

It is particularly concerning to us that artificially dividing purchases has been reported on three other occasions (2002, 1999, and 1995) and is still occurring at the DABC.

Past Legislative Audits Demonstrate a Pattern of Poor Management. The following audits regarding the DABC were released by the Office of the Legislative Auditor General from 2006 through 2011.

- **A Review of DABC Actions Regarding a $300,000 Loss from a Package Agency (May 2011):** This audit reported that poor management decisions of the DABC contributed to state losses. The audit also found that the DABC failed to report the issues surrounding this package agency to the attorney general and their own commission.

Four legislative audits recently released establish a pattern of poor management.

- **A Performance Audit of the Department of Alcoholic Beverage Control (October 2010):** This audit reported, among other issues, that the DABC has not adequately analyzed alternatives to building new stores or expanding existing stores even though the DABC spent over $41 million in the previous five years. The audit also found that the DABC failed to adequately consider the long-term impact of construction and expansion.

- **A Limited Review of the Effects of DABC Budget Cuts on State Revenue (May 2010):** This audit found that the DABC did not adequately examine alternatives to addressing budget cuts. Instead, the DABC primarily considered reducing the hours at 12-hour stores and eliminating part-time employees.

- **A Performance Audit of Post-Retirement Re-employment (December 2006):** This audit found that the DABC bypassed the intent of the post-retirement re-employment restrictions. The report stated, "the fact that so many management employees of this agency have been allowed to retire, work part-time for six-months, and then immediately return to full-time employment gives the appearance that the agency is attempting to manipulate the intent of the law."

Audit findings concerning the DABC, from both the Utah State Auditor and our office, the Legislative Auditor General, have contributed to our conclusion that DABC management has demonstrated a pattern of incompetency and questionable practices.

Other Current Management Practices of the DABC Are Inappropriate and Questionable

While reviewing the financial practices of the DABC and working with the current executive director, inappropriate and questionable management practices and actions were identified. These practices included:

- Negligence in allowing liquor to be taken when unpaid for and failure to report the issue to the commission
- Inappropriate and questionable executive perks
- Failure to adequately address their budget in tight economic times

These inappropriate and questionable management practices and actions further support our conclusion concerning DABC management.

The DABC allowed over $37,000 in liquor to leave their premises without being paid for and failed to report this incident to their commission.

Thirty-Seven Thousand Dollars in Liquor Went Unpaid for and the DABC Demonstrated Negligence Throughout. On January 24, 2011, $37,122 in liquor was picked up from the DABC and never paid for in violation of DABC Commission rule. The former commission chair was not made aware of this incident at all and the current commission chair was not informed until after the resignation of the former executive director. We are concerned that this incident is very similar to the $300,000 lost from the now-closed package agency in Eden, Utah. In the Eden incident, the DABC exercised poor management throughout and tried to not bring attention to their apparent lack of oversight, which is similar to the $37,122 lost in January 2011.

In the Legislature's Business and Labor Interim Committee meeting on July 20, 2011, the committee co-chair asked the former executive director if staff misled the commission with regards to Eden. The former executive director responded, "the staff has never, never, in 37 years misled the commission." While staff did not inform the commission of the Eden problems, at the time of this response, the DABC had known for about six months about the $37,000 in unpaid liquor and failed to report this issue to their commission as well.

On September 19, 2011 the current executive director sent a letter to the co-founders of ChefDance and those involved from the Hotel on Rivington in New York demanding payment of $37,122.13 plus 10 percent annual interest. The director also stated that if payment is not received, criminal charges will be pursued.

Executive Perks Are Inappropriate and Questionable. In the course of our review, three inappropriate and questionable executive perks for the former executive director and deputy director were identified. These perks included (1) custom furniture for the former deputy director, which was paid for with bond monies intended for the DABC warehouse, (2) expensive iMac computers and iPads for the former executive director and deputy director, and (3) the purchase of what can be viewed as an executive vehicle. These management perks are further explained below. While these purchases may be inappropriate and questionable in good economic times, the fact that they were made in a time of budget cuts and the DABC recommending eliminating jobs and closing stores further supports our concerns with the management of the department.

(1) In March 2011, the DABC ordered custom furniture for the former deputy director's office costing $4,630. DABC officials informed us that this furniture was purchased with bond monies for the warehouse expansion. The plan was to give the former deputy director new furniture and put his old office furniture in a warehouse office. While some of the furniture was delivered on May 16, 2011, the desk and conference table (which were paid for) was being held by the seller at the request of the DABC. The person responsible for seeing that the furniture was held informed us that the ultimate purpose for holding the furniture was to not bring it to the attention of auditors.

The DABC inappropriately purchased $4,630 in custom furniture for the deputy director from bond monies for the warehouse. The DABC also tried to conceal this purchase.

We contacted the Division of Facilities Construction and Management (DFCM) about this purchase with warehouse bond monies and were informed that the DFCM did not approve this purchase, that the purchase was irregular, and that the DFCM would not have funded new furniture for the deputy director's office with bond monies for the warehouse. The fact that the DABC tried to hide this purchase and did not seek proper authorization highlights the fact that DABC management knew it was inappropriate, but did it anyway.

(2) In October 2010, the DABC purchased three twenty-seven inch iMacs with applications at a cost of $5,271. Both the former DABC executive director and deputy director got iMacs and the third was purchased so computer staff could support the former executive director and deputy director's computers. The Executive Director/Chief Information Officer for the Department of Technology Services (DTS) told us that their policy is to support the purchase of PCs and not iMacs. In order to purchase this brand of computer, the DTS requires justification, and the DABC failed to provide justification. The DTS informed the DABC that they could not buy these computers, but the former executive director of the DABC told the DTS that they had the money and there was nothing the DTS could do about it. PCs cost about a third the cost of the iMacs.

The DABC purchased $5,271 in iMacs for the former director and deputy director despite inadequate justification for these purchases.

Similar to the iMacs, the DABC also purchased five iPads, two for the former executive director and deputy director, one for another member of management, one for a commissioner, and the fifth for computer staff so they could support management's devices. The cost for these devices was $3,760. Like the custom furniture, we believe DABC management tried to conceal these purchases.

The former director of the DABC illegally gifted an iPad to a former commissioner and we believe the DABC tried to conceal the iPad purchases.

One commissioner was gifted an iPad at the conclusion of his term. The commissioner offered to purchase the iPad, but was told by the former executive director to keep it as a gift. On September 28, 2011, the current executive director sent a letter to the former commissioner to inform him that this gift violated state law, asking that the iPad and case be returned to the department. Two other former commissioners were also illegally gifted two netbooks that have also been requested for immediate return.

(3) On May 01, 2011, the DABC purchased a Jeep Liberty that cost $20,216. While we do not question the cost of the vehicle, this vehicle was clearly treated differently from other DABC fleet vehicles. The keys for the Jeep were kept in the former executive director and deputy director's office. Other employees were not allowed to use the Jeep unless no other car was available and then only if the former executive director or deputy director did not need it. In fact, one employee had to use their own vehicle for a long road trip because the former executive director needed the vehicle the next day to drive to the capitol (from the DABC to the capitol is about nine miles roundtrip). Other DABC vehicles are listed on a sign-out sheet, but the Jeep did not appear on this sign-out sheet until so ordered by the new executive director.

Despite a legislative audit recommending they do so, the DABC has failed to adequately examine alternatives in addressing budget cuts, which included a review of administrative and warehouse costs.

The New Director of the DABC Has Identified Significant Cost Savings In Administrative and Warehouse Overhead. In working with the DABC's new executive director, it is clear that the DABC has failed to adequately address their budget in tight economic times, despite our legislative audit identifying these concerns. As previously mentioned, a legislative audit report titled, *A Limited Review of the Effects of DABC Budgets Cuts on State Revenue (May 2010),* found that DABC administrators failed to adequately examine alternatives in addressing budget cuts. The audit found that reducing retail hours was the primary option considered. This audit was critical of the DABC for failing to consider the possibility of closing a lower performing store in close proximity to another state liquor store and/or reducing administrative and warehouse costs. In recent discussions with two DABC administrators, it is clear that for years, the DABC model used to address significant budget cuts has been only to reduce hours or close stores.

The new DABC executive director has identified several potential budget savings in the administration and warehouse operations. Some have been implemented, some are in process, and some are still being contemplated. If all were fully implemented and made permanent, annual savings could be as much as $707,340; however, since the changes have been made during the current fiscal year, the savings would be lower for this fiscal year. This savings can be realized by taking actions such as turning administrative office and warehouse maintenance responsibilities over to DFCM and eliminating some nonessential positions in administration and the warehouse. This potential savings could generate more than half of the $1,158,408 needed to keep open the five liquor stores that the DABC has proposed closing.

The new DABC executive director has identified a potential savings of $707,340 (not all potential savings would be recognized this fiscal year). This is more than half the amount needed to keep open the five proposed liquor store closures.

Current Oversight Structure of the DABC May Need to Be Reviewed Further

Although weak management is the primary cause of the ongoing problems at the DABC, we believe these issues are exacerbated by the DABC Commission's tenuous oversight of the department. These oversight weaknesses have been caused by the commission's charge to establish general policies and oversee the day-to-day activities of the department while still being a part-time commission. Issues involving a lack of communication between the commission and department management can be partially attributed to the fact that the commission is only required to meet once a month and consequently is not aware of the department's day-to-day activities. This structure has also caused disagreements between the commission and DABC management over what has and has not been communicated. Because of the resultant problems, we recommend the Legislature consider whether the current oversight structure at the DABC is sufficient.

The DABC is governed by a five-member, part-time commission that meets at least once per month to act as the policymaking body for alcoholic product control. Duties include issuing alcohol licenses, determining the location of stores and package agencies, fixing the price of alcohol, and supporting and overseeing the department in the performance of their duties. The commission also appoints the director of the DABC, with the approval of the governor and the

We recommend the Legislature consider whether the current oversight structure at the DABC is sufficient.

consent of the Senate. According to ***Utah Code*** 32B-2-202(1)(k), the commission is charged to "require periodic reporting from the director to ensure that sound management principles are being followed and policies established by the commission are being observed." Because of this charge, the commission is completely dependent on information provided by the director and department.

From 1969 to 1976, the commission was composed of a three member full-time commission. During this time, there were allegations of malfeasance and misuse of government property and two of the three commissioners were indicted. Because of these problems, the commission was re-established with its current structure of five part-time members.

Due to recent events discussed in this report, we question whether the structure or duties of the commission should be revised. Some of the potential restructuring areas could include any of the following:

If the Legislature decided to revisit the oversight responsibilities of the DABC Commission, a number of alternatives are available.

- Reducing some responsibilities over the day-to-day operations of the department
- Moving appointment authority of the director from the commission to the Governor
- Changing from part- to full-time

Other control states, as well as other commissions within the state of Utah, range broadly in the spectrum of these issues. We examined the applicable alcohol statute for Alabama, Idaho, New Hampshire, Oregon, Pennsylvania, and Virginia, and discovered that while they operate in similar ways to Utah, their oversight structure is diverse. For example, Idaho does not use a commission at all, but reports directly to the governor. Three of the states' commissions are full-time, while the other two are part-time, similar to Utah. If the states use commissions or boards, that is the body that awards licenses and oversees the operation of their respective departments.

Within Utah's boards and commissions, there is even more variety in operational structure. The Tax and Public Service commissions are both full-time, with the director appointed by the commission. These commissions also oversee the day-to-day operations of their departments. All of the commissions or boards within the Department of Commerce are part-time, appointed by the Director of Commerce or the Governor. We looked at seven commissions or boards within Commerce: the Real Estate, Securities, and Construction Services commissions, the Physicians Licensing Board, the Board of Nursing, the Committee of Consumer Services, and the Land Use/Eminent Domain Advisory Board. The majority of these boards or commissions make decisions about licensing, maintain only advisory status over other rulemaking policy, and have no responsibility for day-to-day operations.

Because of this broad spectrum of structures and authorities, there is no clear consensus on best practice for how commissions, and in particular alcoholic beverage control commissions, should operate. We recommend that the Legislature consider whether the DABC and its commission would be better served by revisiting the oversight structure at the DABC.

Recommendations

1) We recommend that the Attorney General's Office consider investigating whether charges should be brought against the former executive director of the DABC for potentially violating the Employee Ethics Act.

2) We recommend that the current DABC executive director work to address the pattern of inappropriate and incompetent management and oversight of the DABC, including addressing the financial operations of the department.

3) We recommend that the Legislature consider whether the oversight structure of the DABC should be revisited.

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Agency Response

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GARY R. HERBERT
Governor

GREG BELL
Lieutenant Governor

State of Utah

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October 11, 2011

John M. Schaff, CIA
Auditor General
Office of the Legislative Auditor General
W315 Utah State Capitol Complex
Salt Lake City, Utah 84114

Re: Report No. 2011-13, A Review of Allegations Regarding the Management of the DABC

Dear Mr. Schaff:

I want to thank you and your audit team for the professional way they have performed this audit. I believe the Department of Alcoholic Beverage Control ("DABC") should operate as a public trust to carry out Utah's alcohol policies and to safeguard the associated revenues. Unfortunately, some within the DABC have violated that trust. I appreciate the way your audit team has helped identify the DABC culture that caused the problems and established a foundation to change it.

When I began my temporary assignment at DABC in August 2011, while this audit was underway, it did not take long to recognize the inappropriate culture that exists among some within DABC. A line from a "talking-points" card the former executive director carried demonstrates that culture: "Why Utah's DABC is the BEST state agency! . . . *Run enterprise like a business and not agency." While I agree that government agencies should learn all we can from the private sector about good management and business practices, agencies must never forget that they fulfill a public trust and must remain transparent and accountable to that public.

The misconduct uncovered by this audit was appalling. Much of it also could have been avoided, prevented, or repaired, had previous management instituted recommendations from previous legislative and state audits. The record indicates a history of audits the DABC management apparently ignored. I do not believe that is appropriate or acceptable behavior for any state agency.

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I am committed to doing everything I can while I have oversight over the agency to ensure that this audit marks the beginning of a new chapter in DABC operations. During my short time I have met some outstanding, talented, and ethical DABC employees. The agency has the tools in place to learn from this audit and move forward.

I agree with all the recommendations of this audit. With respect to recommendation #1, I am committed to full cooperation with the Attorney General's Office on whatever type of action or further investigation they determine to be appropriate.

For recommendation #2, I have made some obvious changes to stop the most egregious examples of the DABC's mismanagement, but I recognize it will take continued time and work to change the underlying agency culture. Some examples of the steps I have taken so far include:

- On my first day at DABC I immediately ended all DABC purchases from Flexpak until the audit and further internal review are completed.
- On my second day at DABC when I realized a new Jeep Liberty appeared to have been purchased by the agency solely for use by the executive director and deputy director, I directed that it immediately be placed within the DABC fleet pool. DABC employees immediately began using the vehicle for work related travel.
- I have directed the DABC to ask Flexpak to recognize the repair work previously done that the auditors identified should have been covered under the machinery's warranty. While Flexpak has indicated it is looking into the matter, it invoiced the DABC on September 30 for finance charges on the repair bills that should have been covered under warranty.
- I have modified work duties, reassigning office supply purchasing away from the warehouse worker who previously had been overseeing most of the Flexpak purchases.
- I have had multiple meetings with staff, particularly the financial and accounting staff, to stress that they must follow the rules of the Division of Finance, especially the rules relating to bids and invoicing.
- I instituted written weekly reports to the Alcoholic Beverage Control Commission in addition to the extensive materials the commissioners were previously receiving at monthly commission meetings. I did this to address what I perceived to have been an inappropriate pattern of the DABC management selectively communicating about some day-to-day items with individual commissioners, but not with all commission members.
- I have made arrangements for the Division of Facilities and Construction Management to take over management of the DABC administrative offices and warehouse beginning November 1. This will be a significant cost savings but more importantly, it is a recognition that DABC should operate like every other state agency.
- With respect to the approximately $37,000 of unpaid liquor from January, when I learned of the situation I immediately took personnel action against the DABC employees who did not follow procedure, directed that signage be installed at the club warehouses to remind employees of proper procedure, and contacted representatives of the two entities who organized the event that took and used the unpaid liquor: ChefDance (of Park City, Utah) and Hotel on Rivington (of New York City). I have let them both know that until the amount is paid with interest, I do not intend to allow the DABC to sell any future product to events associated with those organizations. An

attorney representing the parties has recently indicated to me that he expects the past due amount to be paid within two weeks.

- I have discovered the DABC has an extensive history of paying *per diem* to Commissioners for numerous events, informal meetings, and conference calls that did not qualify as meetings under *per diem* statutes and rules. I have stopped that practice.
- After discovering that the former executive director gave inappropriate gifts (two netbook computers and an iPad) to three former commissioners, I asked those former commissioners to return the gifts. One has made arrangements to do so, the other two have not responded.

I recognize that these steps are a starting point, not a completed project. Recommendation #2 from the audit has far-reaching implications. I believe complete implementation of that recommendation will require a change in culture. Making that change will require some further personnel changes, but then it will require establishing two simple principles I have lived by in my other assignments in state government: (1) employees are expected to follow the rules; and (2) employees who don't follow the rules will face consequences.

Utah's Division of Finance has rules and guidelines that cover all of the financial mismanagement at DABC. Those rules and guidelines, if followed, could have prevented most of the problems in this audit, and they must be the basis for correction going forward. I have instructed DABC's financial staff to ensure they have Division of Finance personnel on their speed-dial, engage as necessary, and communicate more frequently. We will undertake to train and re-train as necessary to ensure all employees with duties in these areas understand the rules. The new culture DABC needs must include viewing the Division of Finance as a partner. Changing the culture will take time, but it is the only way to make real changes.

For recommendation #3, I am committed to providing whatever feedback or information the legislature finds helpful as it evaluates the DABC's oversight structure. From my experience with the Department of Commerce, I have worked extensively with over 80 different boards and commissions, all with varying levels of responsibility and authority. I have never experienced anything quite like the unique governance structure at DABC. When I first arrived there, I had the impression of a homeowner whose house was on fire but was arguing with the fire truck operators about whether they had authority to save his house. I agree that the legislature needs to take a fresh look at the oversight structure of DABC. I recognize that issue is ultimately out of my hands, but I will participate in the process to the extent I can. In the meanwhile I will be working with the Commission to enlist their help in appropriate and meaningful oversight as much as possible.

I will institute systematic review of audit recommendations from this audit and from the October 2010 audit, and ensure recommendations are tracked and progress is regularly reported. I will institute a system so recommendations from future audits, whether financial or performance audits, will be tracked and instituted, and the DABC held accountable.

I sincerely appreciate the work of this audit team. The problems they uncovered are not pleasant, but the audit obviously was necessary to bring the DABC into a new culture of open and transparent operation. While the problems are real, I have also discovered many dedicated DABC employees who are in a perfect position to help the agency move forward appropriately. I am honestly optimistic about the DABC's future.

Sincerely,

Francine A. Giani

FRANCINE A. GIANI, EXECUTIVE DIRECTOR
DEPT. OF ALCOHOLIC BEVERAGE CONTROL

cc: Commission Chair Richard J. Sperry
Commission Vice-Chair Jeffrey Wright
Commissioner Kathleen McConkie Collinwood
Commissioner David L. Gladwell
Commissioner Constance White