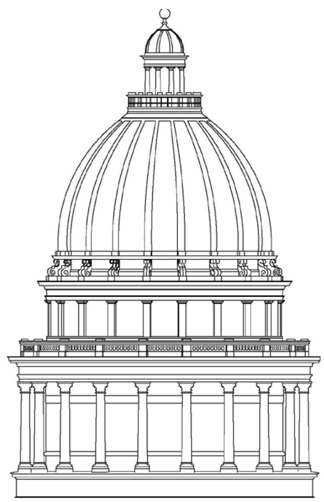
REPORT TO THE

UTAH LEGISLATURE

Number 2012-14



A Performance Audit Of DABC Operations

September 2012

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

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JOHN M. SCHAFF, CIA
AUDITOR GENERAL

September 11, 2012

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of DABC Operations** (Report #2012-14). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff

John M. Schaff, CIA
Auditor General

JMS/lm

Digest of
A Performance Audit
Of DABC Operations

Chapter I: Introduction

To regulate alcohol consumption in Utah, the Legislature established the Department of Alcoholic Beverage Control (DABC). This report examines the following components of DABC operations:

- Accounting of inventory
- Oversight and inventory controls of warehouse
- Oversight and inventory controls of retail stores
- Oversight of contracts and ethics training
- Ability of department to self-appropriate

Chapter II: DABC Needs to Improve their Accounting of Inventory

DABC Has Been Relying On Inaccurate Reports To Enter Physical Inventory Adjustments. DABC has been relying on flawed and inaccurate reports to enter physical inventory adjustments impacting the accuracy of overages monetized in several DABC reports. Significant errors were found in two DABC computer programs: the shipment management program and the licensee sales program. Both of these programs are used to generate the Monthly Inventory Adjustment Summary, which is used by the accounting department to compute the physical inventory adjustment. DABC has forced its account into balance each month with an artificial closing number which DABC officials have been unable to adequately explain.

DABC Needs to Continue to Address System Problems to Ensure Inventory Accuracy. The problems identified with the accuracy of the inventory data being reported can be directly attributed to poor programing. DABC needs to address programming problems with its operating systems to ensure inventory accuracy.

Chapter III: Oversight of Warehouse Operations Should Improve

DABC Should Improve Controls in the Warehouse to Ensure that Inventory is Safeguarded. We identified several problems that have weakened the efficiency and effectiveness of warehouse operations. Many processes that occur in the warehouse lack sufficient policies and procedures, including a lack of any control on the submission of variances in the receiving process, variances being undocumented and unexplained, and cycle counts not being performed on all limited products. In addition, oversight of warehouse operations needs to improve. Examples of poor oversight include end of year counts not being conducted properly, reported variances being manipulated, and warehouse management being unable to account for some equipment. We also found that DABC must improve controls in the warehouse to ensure that product is safeguarded. This includes not allowing vendors to have unsupervised access, not leaving doors open, and ensuring product is safeguarded while being delivered to stores. DABC should also consider several operational changes that may further increase efficiency.

Chapter IV: Control and Oversight of Retail Operations Can Improve

Inventory Controls in DABC Stores Can Improve. We found that enhanced policies and procedures for store operations would improve DABC control in stores. For example, we found that stores do not have a uniform receiving policy, which has resulted in poor practices being implemented by personnel. We also found that DABC lacks policies and procedures regarding the rotation of employees responsible for counting inventory. The personnel responsible for the oversight of stores have not been held accountable for ensuring that established policies are being followed. The efficiency and effectiveness of retail operations can be enhanced through the monitoring of measures such as percent of stock not moving and inventory turns. Finally, we found that the security of retail stores has been insufficient.

Chapter V: Increase Contract Oversight and Enhance Ethics Training

State Resources Have Not Been Protected As A Result of Poor Oversight of Service Contract. DABC has been overcharged for parts and labor since 2003. As a result, DABC paid its service vendor more than $2 million without adequate oversight. We also found that DABC and State Purchasing may have violated procurement laws in the formation of this contract.

DABC Needs to Enhance Employee Ethics Training. The former licensing and compliance director illegally accepting gifts and past audit findings highlight the need for enhanced ethics training for all DABC personnel.

Chapter VI: DABC Has Circumvented the Appropriations Process

DABC Has Been Self-Appropriating for Years by Covering Operating Expenses with Unappropriated Monies from the Liquor Control Fund. These operating expenditures should have come from DABC's budget appropriation overseen by the Legislature; instead the department has been using the Liquor Control Fund as a means to cover significant operating expenditures. In fiscal year 2011, these unappropriated operating expenses exceeded $6.6 million.

REPORT TO THE

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Report No. 2012-14

A Performance Audit
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September 2012

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Chapter I
Introduction

In order to regulate the consumption of alcohol in Utah, the Legislature has established the Department of Alcoholic Beverage Control (DABC). Utah has chosen a monopoly version of the control model to regulate the distribution and sale of alcohol. Under a commission structure, DABC regulates alcohol sales to the public from state liquor stores and package agencies, which are private entities under contract with DABC to sell alcohol. This audit examined the following elements of DABC operations:

- Accounting of inventory
- Oversight and inventory controls of the warehouse
- Oversight and inventory controls of retail stores
- Oversight of contracts and ethics training
- Ability of the department to self-appropriate

While we recognize that DABC administrators have greatly improved the oversight of the department's operations over the last year, this audit identifies a number of significant issues that need management attention.

While oversight of DABC's operations has improved over the last year, this audit identifies a number of significant issues that need management attention.

DABC Regulates the Distribution And Sale of Alcohol in Utah

DABC regulates the distribution and sale of alcohol in Utah. According to its mission statement, the purpose of DABC is to conduct, license, and regulate the sale of alcoholic products in a manner and at prices that:

> Reasonably satisfy the public demand and protect the public interest, including the rights of citizens who do not wish to be involved with alcoholic products; and
>
> Will promote the reduction of the harmful effects of:
>
> - Over-consumption of alcoholic products by adults,
> - Consumption of alcoholic products by minors, and

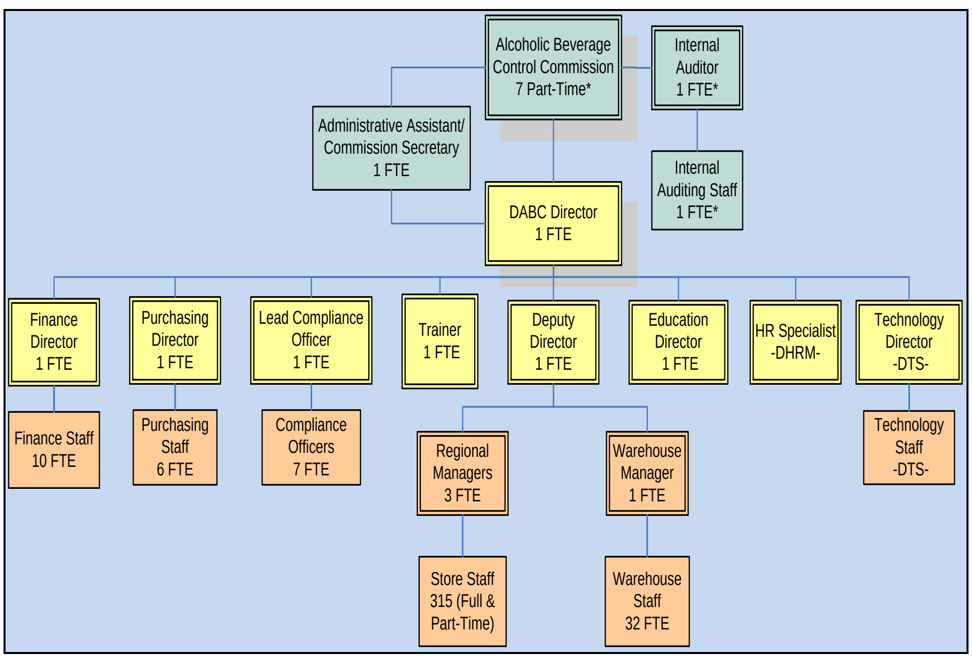
- Impaired driving; and

Promote the public interest by enforcing the Alcoholic Beverage Control Act in a way that is fair, impartial, consistent, and equitable.

In order to fulfill its purpose, DABC is an executive agency governed by a seven member part-time commission.

In order to fulfill its purpose, DABC is an executive branch agency governed by a seven-member part-time commission, the Alcoholic Beverage Control Commission. To help the commission in its oversight responsibilities, the Legislature authorized the creation of an internal audit division that reports directly to the commission. The executive director runs operations as directed by the commission. The executive director oversees eight administrative areas as illustrated in Figure 1.1.

Figure 1.1 DABC Organization Chart. DABC currently staffs nearly 400 full- and part-time positions.



****Authorized by Legislature during 2012 General Session, but not yet implemented.***

The deputy director oversees warehouse and retail operations, including store regional managers. Regional managers are responsible for all oversight of the individual store managers and store staff, including the club stores. The focus of this audit was on the warehouse and retail operations.

Process by Which Alcohol Becomes Available To Consumer Involves Several Steps

The process by which alcohol is brought into the state and made available to consumers involves many steps. First, the purchasing department is responsible for determining what products will be made available in liquor stores. There are several categories of product, but the focus of this audit was on general and limited distribution items. General distribution items are found in most state liquor stores/package agencies. Limited distribution products are typically rare or vintage products.

Once inventory has been ordered, the product arrives at DABC's warehouse through the receiving department. Receiving verifies the product delivered by counting and verifying against the purchased amount. If there is a mistake with the shipment, DABC must inform the vendor of the variance. Once the product is verified, it is entered into the system and assigned a location in the ASRS system (automatic racking system in DABC's warehouse). Product is stored in the ASRS until it is needed in the picking area of the warehouse (where store orders are picked and completed). When a product needs to be replenished, the replenishment crew pulls pallets from the ASRS and moves them to the picking area. In some cases, DABC uses drop shipment, a program the deputy director implemented during the past year, which is a direct shipment from the vendor to the store. This program is primarily used for beer delivered to stores along the Wasatch Front.

The process by which alcohol is made available to consumers involves purchasing, receiving, picking, and delivery to stores.

DABC's system generates a suggested order for each store, based on criteria entered in the system by the store manager. The store manager can adjust the suggested order if he or she feels it is necessary. Once the manager approves the order, it is transmitted to the warehouse for its approval. The order is then assigned by the picking manager. From there, orders are prepared on pallets by warehouse employees. Once the pallets are stacked, they are wrapped for delivery by a third-party trucking company, contracted with DABC (referred to in report as the common carrier) for delivery to stores within 3-6 days.

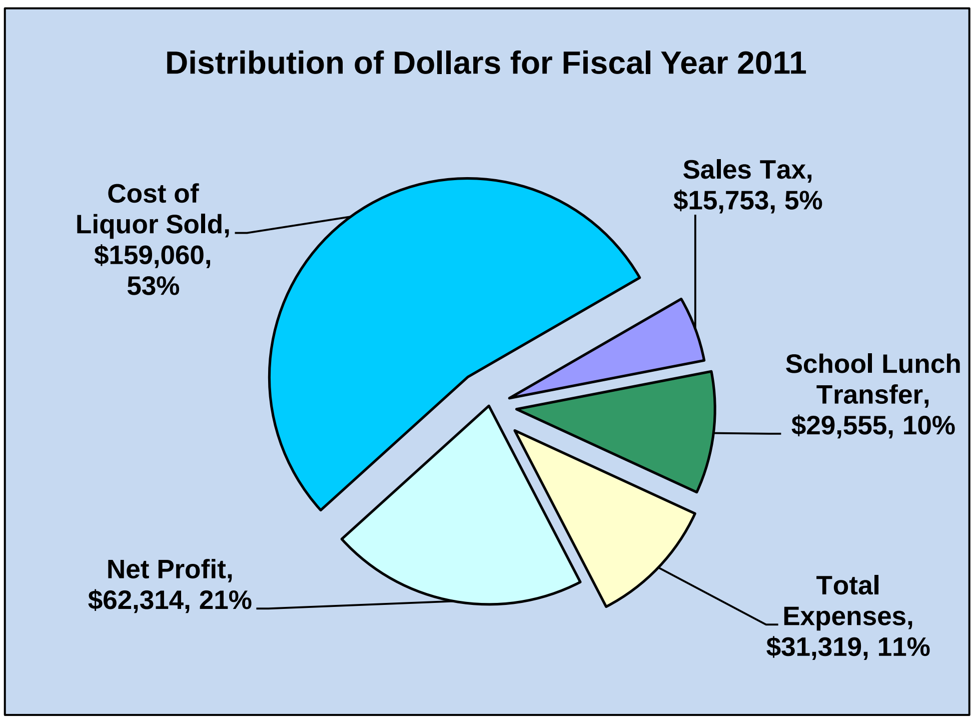
Once the orders arrive at the store, store employees must verify the products and quantities received. If there is a discrepancy, the store manager submits a variance report to the warehouse within 24 hours. The warehouse must then validate this variance.

DABC Retail Sales Generate Significant State Revenues

In fiscal year 2011, retail sales generated more than $107 million for state and local governments.

Alcohol sales produce significant profit to the state. In fiscal year 2011, DABC's sales generated almost $107.6 million in revenue for state and local governments, which increased from $101 million in fiscal year 2010, a 6.6 percent increase. To generate these sales, DABC operates 44 state liquor stores and more than 100 package agencies. State liquor stores are owned and operated by the state, while package agencies are contract stores, owned and operated by private individuals. Figure 1.2 illustrates the distribution of dollars for fiscal year 2011 according to DABC's annual report.

Figure 1.2 DABC Distribution of Dollars for Fiscal Year 2011. Net profit, school lunch transfer, and sales tax all become state revenue. Values shown are rounded in thousands of dollars.



As shown in Figure 1.2, in fiscal year 2011, sales generated over $107.6 million in revenue to state and local governments. Monies deposited in the state's general fund exceeded $62 million and almost

$29.6 million went to the school lunch program and $15.8 million was generated in tax revenues. Total operating expenses for DABC exceeded $31.3 million in fiscal year 2011.

Audit Scope and Objectives

This audit was approved by the Legislative Audit Subcommittee based on concerns generated during the course of the audit report released in January 2012, *A Performance Audit of DABC Oversight of Package Agencies*. To address these concerns, we evaluated the following:

- Chapter II – The processes by which DABC accounts for inventory variances
- Chapter III – The oversight of DABC's warehouse operations
- Chapter IV – The oversight of DABC's retail operations
- Chapter V – The oversight of DABC's service contract and ethics training for employees
- Chapter VI – The practice of financing operating expenses through cost of goods sold

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Chapter II
DABC Needs to Improve Its Accounting of Inventory

Since 2007, DABC has sold over $834 million in alcohol and adjusted physical inventory by over $1.6 million. We are concerned that the correct inventory variances may not be reflected in this number because DABC has been relying on flawed and inaccurate reports to calculate inventory variances. At least one of the flaws identified in this chapter has been distorting these reported variance figures as far back as DABC can track. Tracking inventory variances is a form of inventory control. Because DABC cannot accurately report or explain inventory variances, the agency cannot sufficiently track how much pilferage is occurring.

DABC has been relying on inaccurate data to calculate inventory variances.

We also found that DABC has been forcing its account into balance each month with an artificial closing number that DABC officials have been unable to adequately explain. Until recently, the department has not tried to accurately balance the account. The cause of these problems can be partially, if not primarily, attributed to poor data programming in the systems that generate inventory reports. The Department of Technology Services (DTS) made significant changes to personnel assigned to DABC in October 2011. Since that time, DABC and DTS have been working together to identify and address DABC's accounting programs.

DABC officials need to ensure increased oversight and accountability over inventory in the future. We did not find any evidence to suggest that significant product is missing; our biggest concern rests with the fact that DABC does not have a system in place to accurately account for and address inventory variances.

DABC officials need to ensure increased oversight and accountability over inventory in the future.

Figure 2.1 shows the actual amount of inventory sold by year compared to the reported variances for the year. All figures are shown at cost.

Figure 2.1 Reported Inventory Variances Compared to Cost of Inventory Sold, But Accuracy of Variances Being Reported Are Inaccurate. While reported variances are small, we are concerned because of the significant inaccuracies in data being reported.

Year	Cost of Goods Sold	Variance
2007	$ 114,463,747	($ 264,467)
2008	128,445,081	(673,261)
2009	135,197,121	(1,322,332)
2010	142,280,733	547,504
2011	150,942,569	(99,652)
2012	162,828,047	187,201
Total	**$ 834,157,298**	**($ 1,625,007)**

While variances being reported are a small percentage of cost of goods sold, we are concerned that the variances are not accurate.

A variance is the monetary value of the difference between recorded and observed inventory. The initial recorded inventory is based on the cost of all alcohol purchased by the department minus the cost of all alcohol sold by the department. Inventory variances are intended to reflect occurrences such as pilferage and miscounts. Again, this is an important inventory control that should be in place. But because of inadequate accounting of inventory, additional problems are altering the physical inventory adjustment value and undermining the integrity of the control point.

A variance is the monetary value of the difference between recorded and observed inventory.

Inventory Variances Are Primarily Based on Two Components

There are two separate components that contribute to the variance that DABC reports: physical inventory adjustments and closing adjustments. The physical inventory adjustment is calculated based on the results of physical counts (cycle counts, or counts of select products on a daily basis, and year-end counts, or complete inventory counts at the end of the fiscal year). The closing adjustment is a forced number used to balance DABC's account (matching DABC's system with the state's financial system). Figure 2.2 shows the two components used by DABC to report its physical inventory variance for all stores and the warehouse at the end of each month of fiscal year 2012.

Physical inventory adjustments and closing adjustments help make up the inventory variance figure and both have problems.

Figure 2.2 Inventory Adjustments and Closing Adjustments Are Both Components of DABC's Physical Inventory Variance Reported at the End of Each Year. Significant problems with these two components highlight concerns with the accuracy of DABC reporting. Numbers reported are for fiscal year 2012.

Month	Inventory Adjustments	Closing Adjustments
July	$ 20,875	($ 33,012)
August	34,927	55,837
September	66,137	(106,938)
October	67,384	(225,435)
November	70,638	(25,664)
December	38,479	(35,518)
January	26,498	(66,545)
February	(34,416)	(2,585)
March	51,164	(45,358)
April	16,298	(3,035)
May	(7,067)	(22,512)
June	32,527	(5,173)
Total	**$ 383,444**	**($ 515,938)**

A negative physical inventory value indicates a shortage that must be reconciled. A positive physical inventory value indicates an overage that must be reconciled. The frequency of overages being reported is suspect since it is impossible for DABC to artificially grow its inventory. The closing adjustment is a forced number to balance DABC's account. While the errors feeding into the inventory adjustments help explain why DABC's account has not balanced, it is unclear if other problems are further affecting the data. Currently, DABC administrators do not know fully why their account is not balancing (matching the state's financial system). After further review, we determined that significant errors exist with the inventory adjustment numbers.

While the errors feeding into the inventory adjustments help explain why DABC's account has not balanced, it is unclear if other problems are further affecting the data.

As will be discussed in the next section of this chapter, DABC has been inaccurately calculating costs for adjustment purposes in its accounting system. For example, in fiscal year 2012, DABC's programming calculated an overage of $345,000 in the warehouse. We questioned this number as DABC cannot artificially grow its inventory. After working with DABC's DTS staff, we speculated that the correct variance for the warehouse for fiscal year 2012 was a shortage of ($97,793), but DTS staff was not confident in these numbers either. While the DTS staff believes they can fix the problems

For fiscal year 2012, DABC's programming erroneously calculated an overage of $345,000 in the warehouse, but upon further examination, it was then estimated to be a shortage of almost $98,000.

moving forward, there is some concern with fixing the problems for past numbers, as it may corrupt other data.

DABC Has Been Relying on Inaccurate Reports to Calculate Inventory Adjustments

Inventory adjustment figures have been inaccurate because of significant data errors that were found in the licensee sales program and the shipment management program.

We found that DABC's inventory adjustment figures are inaccurate. DABC must work to ensure that inventory adjustment figures are being accurately reported to the accounting department. Significant errors were found in two computer programs that DABC relies on for its reporting: the licensee sales program and the shipment management program.

The licensee sales program is used by the stores to create liquor orders for package agencies, clubs, restaurants, and private events. It is also used to receive orders made online. The shipment management program is used for store-to-store transfers of product, reporting variances on shipments from the warehouse, and creating shipping documents for shipments going from the warehouse to the stores. Both programs contribute to the Monthly Inventory Adjustment Summary report, which is used by the accounting department to compute the physical inventory adjustment.

Data errors have affected the accuracy of the Monthly Inventory Adjustment Summary, which is used by the accounting department to report variances.

The Monthly Inventory Adjustment Summary reports only the sum of all cycle counts by stores per month, as opposed to individual cycle count results for each product. Thus, the errors that were discovered and reported in this audit were only detectable through a review of the raw data that feeds into the report. The report also provides overages and shortages at cost (wholesale value), so the significant inflation of cost above retail was again only evident by reviewing the raw data that feeds into the report. Because of the errors identified in these reports, the true variances are unknown. We therefore recommend that DABC ensure that raw data is reviewed to ensure that numbers being reported are accurate.

Errors in Licensee Sales Program Have Led To Inaccurate Data Being Reported for Many Years

Problems with the licensee sales program have been occurring indefinitely. As previously mentioned, adjustments made through this program feed into the Monthly Inventory Adjustment Summary. When inventory adjustments to a product are entered in the system, it is supposed to calculate the value of one bottle at both cost and retail price. The programming error is only affecting overages and only for certain products. The retail calculation appears correct, however, the assigned cost is significantly inflated. This error affects the Monthly Inventory Adjustment Summary by inflating overages. Errors in this report are especially concerning because the accounting department uses this report to calculate the physical inventory adjustments.

DABC's DTS personnel now believe that an error in the program has caused it to calculate cost by full cases instead of per bottle. In addition, the program is multiplying the cost per case by the quantity of the overage entered into the system. Even so, many of the errors identified were inflated beyond what this explanation would produce. Therefore, it is clear that the programming errors were still not fully explained at the time of the audit. Figure 2.3 illustrates examples of the effect of these programming errors.

Figure 2.3 Recent Overages Entered into the System through the Licensee Sales Program. This figure demonstrates some of the largest errors caused by the licensee sales program in fiscal year 2012.

QTY	Incorrect Cost/Bottle	Correct Retail/Bottle	Incorrect Total Cost	Correct Total Retail
24	$ 152.50	$ 0.89	$ 3,660.00	$ 21.36
6	5,339.25	34.99	32,035.50	209.94
12	839.52	7.99	10,074.24	95.88
12	794.48	11.99	9,538.08	143.88
12	756.38	11.99	9,076.56	143.88
12	336.68	5.89	4,040.16	70.68
12	126.72	2.25	1,520.64	27.00
12	1,399.08	24.99	16,788.96	299.88
24	83.72	1.59	2,009.28	38.16
12	187.11	3.99	2,245.32	47.88
60	467.50	9.99	28,050.00	599.40
24	67.10	1.49	1,610.40	35.76

In FY 2012, there were over 100 instances when the cost of a product was significantly inflated above actual costs.

In fiscal year 2012 alone, there are over 100 instances when the cost of a product recorded through the licensee sales program was significantly higher than the retail price. Again, this programming error has significantly altered the figures reported in the Monthly

Inventory Adjustment Summary and artificially inflated the overages of physical inventory.

Problems with the Shipment Management Program Have Also Contributed to Recent Data Errors

Problems with shipment management have been occurring since the system was implemented in July 2011. When a store receives an overage of a specific product, it must enter the overage into the system so physical inventory at both the store and the warehouse will be accurate. The most substantial problem occurs when a store receives an overage and the warehouse has since run out of the product. The system was designed to cycle the product back in, even when the product was no longer physically present in the warehouse. This error occurred most often with limited products (only a limited amount of these products are purchased by the department). The limited location clean-up program compounded this problem because it automatically reassigns bin locations to new products once the old product has run out.

Since implementation around the start of fiscal year 2012, the shipment management program has been inflating the cost of products that are recorded as overages during store receiving.

While DABC's DTS personnel have recently corrected this error, it has impacted the accuracy of overages monetized in several DABC reports, again including the Monthly Inventory Adjustment Summary. In some instances, the errors caused by the shipment management program significantly inflated the cost per bottle used to calculate monthly variances. Figure 2.4 illustrates some examples of the shipment management program significantly inflating the cost per bottle.

Figure 2.4 Examples of Products with Inflated Costs that Affect Inventory Variances Being Reported. The shipment management program artificially inflated the cost of numerous products throughout fiscal year 2012.

QTY	Incorrect Cost/Bottle	Correct Retail/Bottle	Incorrect Total Cost	Correct Total Retail
6	$ 763.75	$ 21.99	$ 4,582.50	$ 131.94
24	60.80	4.29	1,459.20	102.96
12	59.50	4.49	714.00	53.88
12	97.66	9.97	1,171.92	119.64
36	41.60	4.29	1,497.60	154.44
12	123.21	18.99	1,478.52	227.88
12	22.00	3.65	264.00	43.80
48	23.48	5.47	1,127.04	262.56
24	8.00	1.90	192.00	45.60
96	12.00	4.29	1,152.00	411.84
12	165.00	61.77	1,980.00	741.24
24	3.52	1.67	84.48	40.08

Figure 2.4 shows inflated costs generated by the shipment management program in fiscal year 2012. Since it is against state law to sell a product for lower than the vendor's currently listed cost for the product, these discrepancies are clearly errors. These errors contribute to the inaccuracy of the physical inventory adjustment figure.

DABC Administrators Do Not Fully Know Why Their Account Does Not Balance

The errors in the physical inventory adjustment figure have a direct effect on the closing variance figure calculated by DABC accounting personnel. As previously mentioned, DABC has been creating this number to forcibly balance its account instead of identifying why the account was not balancing (matching the state's financial system). In short, total inventory owned by DABC at the warehouse, stores, and package agencies should equal all purchases minus all sales, plus/minus the physical inventory adjustment. Because these two figures do not match, DABC calculates and enters the closing adjustment. The closing adjustment is the difference between these two figures.

The closing adjustment is an unexplained number computed by DABC in order to make its account balance.

Currently, DABC administrators cannot fully explain why their account is not balancing. We believe that the problems identified in this audit with the shipment management and licensee sales programs contribute significantly to the account not balancing, but it is unclear if other programming errors are causing problems with the data as well. We therefore recommend that DABC administrators work towards ensuring the accuracy in reported data to eliminate the need to have a closing variance which is used to force their account into balance.

Currently, DABC administrators cannot fully explain why their account is not balancing.

DABC Needs to Continue to Address System Problems to Ensure Inventory Accuracy

The problems identified with the accuracy of the inventory data being reported by DABC can be directly attributed to poor programming by DABC's DTS personnel. According to current DABC DTS personnel, it appears that past programmers were not using software development best practices when creating the custom software programs to make the various DABC systems work together. These problems included:

Because former programmers did not follow best practices, data integrity was compromised.

- Not following programming standards
- Not following software development life cycle processes
- Not documenting any of their programs
- Not using a software repository
- Not including the business stakeholders when designing a solution
- Not tracking any software programming bugs

Since none of the standards listed above were followed, data integrity has been compromised. DTS employees are working on fixing the system to ensure data integrity. It should be noted that the employees who were responsible for these problems are no longer working at DABC.

In order for DABC to run its retail and warehouse operations, the agency currently uses three different software systems. Having three programs interact with each other is difficult because software modifications have to be made in order for these programs to work correctly together. The DABC systems used to operate the warehouse and retail operations include:

1. Escalate – This is the main computer system that keeps track of the inventory.

2. Pick to Voice – This system is responsible for directing the warehouse workers to the inventory that must be picked for each store order.

3. ASRS – This is the system that keeps track of all inventories in the automatic racking system, which is used to house excess inventory.

Using three different programs is a challenge because software modifications must be made to have these programs work together correctly.

According to current DABC DTS staff, the custom software programs that were created by past software programmers were poorly designed, written, and implemented. These flaws have wasted a great deal of time and resources for maintenance and support of the custom programs that were created to interface with the DABC operating systems. The following are examples of the many problems that were caused by the poor software programming:

According to current DABC DTS staff, the custom software programs that were created by past software programmers were poorly designed, written, and implemented.

- Doubling product quantity counts when a Short-On-Load (SOL) variance is processed. When a variance is reported as an SOL scenario, the warehouse quantities for a product are incorrectly doubled.

- Poor detail on error reporting. When an error happens, the detail that is provided is often of no use to either the user who reports the issue or the developers who will address it.

- No transactional processing support. Grouped/related data should all succeed or fail together, which is not currently happening. The application is allowing partial processing, but since the processing is failing, the users are attempting to adjust data over and over, further impacting data integrity when it comes to variances and transferred inventory. This issue has the potential to get worse over time.

- Improper evaluation of available inventory when trying to adjust inventory values for a variance or transfer. The application should be considering all available stock of a specific product on a transfer/variance, but it does not. In the reported issues that we investigated, it appears to be handling the

FIFO/LIFO (first in, first out/last in, first out) layering rules improperly.

Programming errors have led to errors in reports generated for use by DABC administrators, store managers, regional managers, warehouse management, and the accounting department. These errors have affected the physical inventory adjustments reported by DABC. Because of the time required to fix the programming errors described throughout this chapter, we did not request DABC DTS staff to go back and fix the problems for past numbers being reported, but do recommend that the problems be addressed moving forward.

Recommendations

1. We recommend that DABC's DTS staff work to ensure the accuracy of data being reported.

2. We recommend that DABC administrators periodically review raw data feeding into management reports to ensure its accuracy.

3. We recommend that DABC work with its DTS staff to ensure that IT best practices are being followed.

Chapter III
Oversight of Warehouse Operations Should Improve

We identified several problems that have weakened the efficiency and effectiveness of warehouse operations. Many processes that occur in the warehouse lack sufficient policies and procedures. Examples of this include a lack of any control on the submission of variances in the receiving process, variances being undocumented and unexplained, and cycle counts not being performed on all limited products. In addition, warehouse management and department administration have not provided adequate oversight to ensure that policies already in place are being followed and efficient practices are being employed. Examples of this lack of oversight include end of year counts not being conducted properly, reported variances being manipulated, and warehouse management being unable to account for some equipment. We also found that DABC must improve controls in the warehouse to ensure that product is safeguarded. This includes not allowing vendors to have unsupervised access, not leaving doors open, and ensuring product is safeguarded while being delivered to stores. Finally, DABC should consider several operational changes that may further increase efficiency.

Warehouse Operations Lack Policies and Procedures

During the course of the audit, we found that several processes in the warehouse either lacked policies and procedures or the policies and procedures that were in place were simply ignored. Specifically:

Several processes in the warehouse either lacked policies and procedures or what was in place was simply ignored.

- Process for receiving all products in the warehouse was not directed by any policies or procedures and DABC lacks any control on the submission of variances in the receiving process.

- Variances in warehouse cycle counts of the general inventory were undocumented and unexplained.

- Variances from stores were being accepted by the warehouse without validation and in violation of policy.

- Cycle counts of limited inventory were not being completed in the warehouse.

- Warehouse lacked policies and procedures for handling product breakage.

Addressing these issues would help ensure enhanced oversight over warehouse operations for DABC.

Receiving Process Lacked Policies and Procedures, And Controls for Variances Need to Improve

Before the start of this audit, DABC lacked any policies or procedures regarding the receiving of product in the warehouse. Since that time, DABC has implemented new policies and procedures to direct this process. While the new policies and procedures are a clear step in the right direction, we are concerned that the current receiving process lacks any control over product variances being recorded by employees.

The current receiving process lacks control over the employees who enter product variances.

When products are received at the warehouse, a warehouse worker verifies that the products and quantities in the order match what was purchased by the department as the shipment is unloaded by warehouse forklift drivers. All variances between what was purchased by the department and what is received are documented in the computer. The current computer log-in system at receiving has one log-in username and password, making it difficult to identify the warehouse employee who enters these variances. Consequently, an individual employee cannot be held accountable for product that is lost, stolen, or miscounted during the receiving process.

Variances in Warehouse Cycle Counts of The General Inventory Were Undocumented

Only physical variances over nine cases required an investigation to determine the reason for the error.

The person in charge of completing the cycle counts for the general warehouse inventory was adjusting the inventory system and found a discrepancy between what the system reported and what was actually counted. This person was told by the warehouse manager to make a change to the system anytime there was a difference in the count of nine cases or lower. If any count was above nine cases, the employee was to alert the warehouse manager of the differences. We were told that only a difference above nine cases was investigated to determine the reason for the error. This practice is concerning because for higher-end products, one or two cases can represent a significant amount of money for DABC. We recommend that DABC consider instituting a policy that lowers this threshold or bases the threshold on dollar value as opposed to quantity.

When asked to produce the documentation for previous errors above nine cases, the warehouse manager was unable to produce any documentation. We then gave him a sample of 37 instances of product discrepancies that resulted from cycle counts over nine cases and asked him to show us the reasons for the errors. The manager took over two weeks to produce the needed documentation, but was unable to explain the cause for eight of the errors. Figure 3.1 shows the results of the 37 cycle-count errors that needed further documentation.

The warehouse manager was unable to provide documentation for a number of errors greater than nine cases.

Figure 3.1 Thirty-Seven Instances of Product Discrepancies Resulted from Cycle Counts. The warehouse manager was not able to determine the cause for some inventory errors from the cycle counts in the warehouse.

Type of Error	Count	Reason for Error	Value of Error
Data Problem	17	IT Issue	$ 24,661
Warehouse – Wrong Product Picked	12	Warehouse Error	31,517
Warehouse	8	Unknown	31,909

We worked through the discrepancies and discovered the causes for 29 of the 37 errors. We are particularly concerned about the eight errors for $31,909 with unknown causes because warehouse management had not followed up on the discrepancies at the time they were discovered. The warehouse manager has not documented warehouse inventory variances, nor has this person attempted to determine the cause of the inventory problems.

DABC needs to have a policy that outlines the warehouse manager's responsibility regarding the accounting of variances in the warehouse and must hold warehouse personnel accountable for these variances.

DABC needs to have a policy that outlines the warehouse manager's responsibility regarding the accounting of variances in the warehouse and must hold warehouse personnel accountable for these variances. According to *Inventory Best Practices, Second Edition*:

> Whatever the cause, negative inventory balances are a clear indicator of inadequate warehouse management. . .

> The solution is to immediately investigate all negative balances. Investigation means not just correcting the book balance to match the on-hand balance, but also reviewing all underlying transactions to find the reason for the negative balance and following through to ensure that the problem does not happen again.

We therefore recommend that DABC establish a policy that requires variances in the warehouse to be researched and documented in an attempt to reduce the problems that caused the variance.

Variances from Stores Were Being Accepted by the Warehouse without Validation and in Violation of Policy

We found that the warehouse was accepting reports of inventory variances from stores without first verifying product quantities in the warehouse to confirm that an error had actually occurred. When stores have an inventory variance due to an incorrect shipment, they are required to report the variance to the warehouse within 24 hours. Before the start of this audit, warehouse personnel were simply accepting all variances without first counting the inventory on hand in the warehouse to verify whether an incorrect shipment had occurred.

Variances reported by stores were being accepted by warehouse managers without verification.

Since the start of this audit, the warehouse manager implemented a practice that requires warehouse personnel to verify the error against the physical inventory in the warehouse, if the variance is over three cases. The problem with not verifying the physical inventory is that, historically, stores were manipulating the system through shipping variances. If a store's cycle counts showed missing product, a store would not report the cycle count variance and instead report the variance incorrectly as a shipping variance, thus charging the variance to the warehouse and masking where the variance occurred. This practice made the store's variances look better than they were and inflated the warehouse's variances. An example of how this manipulation was done is illustrated in Chapter IV of this report.

We tested to determine whether the new practice of verifying variances was being followed by tracking a variance submitted. Warehouse personnel failed the test by accepting the variance without doing any sort of verification. DABC administrators need to develop a policy that addresses variances being accepted by the warehouse. This policy should establish a minimum threshold which would require a warehouse employee to recount the product to verify that an incorrect shipment did occur before the variance is accepted. This threshold should be based on dollar value and not on the number of cases. For example, three cases of beer could be valued at $50 while one case of vintage wine might be valued at $500. Under the current practice, only the first variance (three cases of beer) would be investigated.

We also found that warehouse employees were not following the policy that variances must be accepted or declined within 24 hours of the shipment being received at the store. We were told by the warehouse manager that even though the policy says that the variance needs to be submitted to the warehouse within 24 hours of delivery, the warehouse will still accept the variance if a store submitted it late.

The warehouse was not following its own policy, which requires that variances from stores be accepted or declined within 24 hours.

We took our concerns to the deputy director who indicated that this practice was unacceptable and the warehouse needed to follow the policy. Adhering to this policy forces the stores to complete the receiving of their inventory in a timely manner. Further, it becomes more difficult to verify inventory as time passes. We therefore recommend that DABC management enforce the 24-hour limit for shipping variances to be accepted and create a policy for warehouse personnel regarding verification of variances before acceptance.

Cycle Counts of Limited Inventory Were Not Being Completed In the Warehouse

In addition to variances of general distribution products not being investigated, we also found that warehouse personnel have not been cycle counting the limited alcohol inventory. Limited alcohol that is warehoused by DABC is high-end alcohol that is already owned by DABC. The current value of this inventory is $3.4 million. Warehouse personnel responsible for overseeing the limited inventory have never conducted cycle counts on these products. We were told that warehouse staff only does a year-end inventory count on the limited alcohol and that no cycle counts on the limited inventory have been done in the last nine years. According to best practices for warehouse inventory, the entire inventory should be cycle counted six times a year.

Limited products, which are often high-end products, were not being cycle counted.

We alerted the warehouse manager about the lack of cycle counts in the limited alcohol area. Three months later, we checked to see if the cycle counts were being performed, but found that the manager had not created a policy for completing the cycle counts and had not even informed the staff responsible for limited inventory to perform these duties. DABC needs to do regular cycle counts on all its products in the warehouse and determine the causes of inventory variances if it is to reduce these variances.

Warehouse Lacked Policies and Procedures for Handling Breakage

The warehouse employee who broke product was often responsible for documenting and disposing of it, creating an opportunity for potential pilferage.

We found that the warehouse lacked policies and procedures for handling product that was broken in the warehouse. When inventory breakage occurred in the warehouse, the person who broke the product was often in charge of taking it to the breakage room and accounting for it. This practice opens the door to potential pilferage. A second employee should be required to verify that the breakage actually occurred. DABC has since changed this practice and developed a policy in which one person, not handling the broken product, is in charge of documenting all breakage. The person also ensures that all broken, non-saleable containers are destroyed and the contents emptied down the drain.

Oversight of Warehouse Operations Has Been Insufficient

We found that there has been insufficient oversight of warehouse operations. Specifically:

- End-of-year counts have not been conducted correctly.
- Reported variances have been manipulated by a warehouse employee circumventing policy.
- Product was being stored off-site (unnecessarily) at a significant cost to the department.
- Warehouse management has been unable to account for several pieces of equipment totaling over $110,000 (value at time of purchase).

Improved oversight of warehouse operations would prevent issues such as the ones listed here from happening in the future.

End-of-Year Inventory Counts Were Not Being Conducted Properly

Ever since DABC implemented the current computer system in 1997, the warehouse has not been using the correct process for completing a full warehouse inventory. Year-end inventories were being calculated by using a combination of cycle counts and a report that shows how many cases were adjusted through the cycle count process.

The problem with using a cycle count to conduct a full inventory is that as soon as an employee enters the observed quantity of the product, the system immediately updates the inventory quantity. Quantities should not be immediately adjusted because year-end physical counts should be re-counted, with all discrepancies between recorded and actual inventory documented before quantity adjustments are made in the system.

Quantities should not be immediately adjusted because year-end physical counts should be re-counted, with all discrepancies between recorded and actual inventory documented first.

In addition, when the warehouse makes a mistake on the cycle count that must be corrected, the correction automatically adjusts the cost of the product to the currently listed cost. The cost assigned to a single item is based on its cost the day it was purchased. Because vendors often change the cost of a product, it is possible to have several items of the same product, purchased at different times, assigned different costs. (Retail price, however, is always set at the current cost of the product, plus the required mark-up, regardless of when the item was purchased.)

As a hypothetical example, DABC purchases 500 bottles of wine for the wholesale cost of $5 per bottle in January 2012. DABC pays the distributor $2,500 for the purchase. In March, the distributor changes the wholesale cost to $6 per bottle (if DABC were to purchase another 500 bottles in March, the agency would have to pay the distributor $3,000). If a correction to a cycle count occurs in or after March and the cost of the wine purchased in January is incorrectly adjusted to the current cost of $6 per bottle, the system will register that DABC paid $3,000 for the wine. This incorrect adjustment would create an unexplained overage of $500.

DABC DTS employees are in the process of writing a program which will allow the warehouse to use the current computer system to conduct a full inventory. A physical count of the warehouse will be performed, along with a snapshot of what the system shows in the inventory. The physical count and the snapshot (inventory at a specific point in time) will then be compared before any adjustments are made. That way, all costs associated with individual items will remain intact and quantities will only be adjusted once the adjustments are deemed necessary and appropriate. This new program will create a clearer picture of inventory for auditing and review purposes. According to DABC administrators, the fiscal year 2012 year-end count conducted in the warehouse in June 2012 was the first time that DABC conducted a correct year-end count in the warehouse.

Variance Numbers Have Been Affected by a Warehouse Employee Circumventing the Process

Shipping variances have been inflated because a warehouse employee has been ignoring policy and adding additional items to shipments without documentation.

We also found that inventory variances have been affected by a warehouse employee circumventing the ordering process. DABC has a policy for adding additional items to store shipments. We found that an employee would automatically add cases to a shipment if it was requested by a store, without recording the addition into the warehouse inventory system. This action inflates the shipping variance reports generated by the stores.

Variance reports are an important measure that the warehouse uses to help evaluate the accuracy of shipments from the warehouse. If the process is circumvented to fill an order in a hurry, the rush order reduces the accuracy and effectiveness of the variance reports. An employee told us that they do not have time to fill out the required paperwork and that it is just easier to add the cases and have the store fix the problem on its end. However, DABC employees need to follow implemented policies and procedures, and if they do not, they should be held accountable for the policy violation.

Over $188,000 in State Resources Were Wasted Because of Unnecessary Storage Fees

One example of an inefficient practice with no oversight is the use of off-site storage after the completion of the warehouse renovation. DABC began renovations on its main warehouse in 2010. The warehouse redesign increased its capacity from about 600,000 cases to about 820,000 cases. As a contingency, DABC added a section to the common carrier contract to address the potential need for additional, off-site storage during construction. The common carrier is a private company under contract with DABC to pick up product from DABC's warehouse and deliver it to stores and package agencies throughout the state. After the warehouse renovation was completed in the summer of 2010, DABC continued to pay the common carrier to store pallets of alcohol off-site through January 2012. Between August 2010 and January 2012, DABC paid the common carrier over $188,000 in storage fees, even though the warehouse renovation had been completed and additional free space for inventory had been created. Warehouse management took no action to end this wasteful practice and it was not until we brought the issue to the deputy director's attention that the use of off-site storage was eliminated.

DABC spent over $188,000 to store product at an off-site location when it could have used space available in its warehouse.

Warehouse Management Cannot Account for Missing Equipment

During the course of the audit, warehouse management was asked to compile a list of all motorized equipment currently in use in the warehouse and club store. Auditors then attempted to identify each piece of equipment based on the serial numbers provided. Auditors were unable to locate 5 of the 70 pieces of equipment on the list. Warehouse management was also unable to find the missing equipment. The five pieces of equipment are shown in Figure 3.2.

Warehouse management cannot account for over $110,000 (purchase value) worth of equipment.

Figure 3.2 Equipment Purchased for the Warehouse that Is Unaccounted for. While this equipment was possibly surplused, it is concerning to us that DABC warehouse management is unable to document what happened to over $110,000 (value at time of purchase) in equipment.

Equipment	Year Purchased	Purchase Value
Forklift	2005	$ 33,609
Forklift	2005	33,609
Electric Pallet Jack	1999	8,331
Electric Pallet Jack	1996	7,975
Rider Reach Truck	1999	27,220
Total		**$ 110,744**

Note: We did not depreciate the equipment because our concern is that the equipment is unaccounted for.

As shown in Figure 3.2, the value of the unaccounted for equipment is over $110,000 (value at time of purchase). While we have no evidence to indicate that any of this equipment has been misappropriated by DABC employees, it is concerning that warehouse management cannot locate expensive pieces of equipment. Management presumes that this equipment has been sent to state surplus, but because of poor record keeping, we were unable to validate this assumption. There were originally six pieces of equipment that were unaccounted for that DABC managers assumed were surplused, but, just prior to the release of this audit, a forklift was discovered still in DABC possession. This causes us to question what has happened to the rest of the missing equipment. DABC should be accountable for recording all movements of fixed-assets in its possession.

DABC Needs to Improve Controls in the Warehouse

DABC needs to ensure that adequate controls are in place to safeguard product. We found that vendors have unsupervised access to the warehouse. At least one door in the warehouse has been left open for long periods of time. We also found that employees of the common carrier could easily remove product from the top of wrapped pallets (if they chose to do so). Additional warehouse security measures that address these concerns need to be implemented.

Staging and Delivery Process Lacks Control Over Common Carrier Handling of Product

DABC has no system in place to prevent a person from removing cases from the top of pallets during the staging and delivery process.

We found that the staging and delivery process lacks any control over the common carrier handling of DABC inventory. Once orders have been picked and staged, the common carrier wraps the pallets and loads the product on the truck for delivery to the stores. We are concerned that DABC has no system in place to prevent employees of the common carrier from stealing product. The pallets are wrapped on the sides, leaving products exposed on the top and easily removable. We recommend that DABC management reassess their wrapping procedures to see if items on the top of the pallets can be covered or packed more securely.

Warehouse Security Needs To Be Strengthened

We found that warehouse security needs to be strengthened. Vendors have been given unsupervised access to areas of the club store and warehouse. The warehouse staff has allowed its common carrier vendor and its maintenance vendor unfettered access to the warehouse.

The maintenance vendor also had unrestricted access to a workshop that is connected to the club store. It is very concerning that an outside vendor could enter DABC buildings whenever he or she wanted, without any supervision. The door between the workshop and the club store only locked on the workshop side. Thus, the vendor could enter the club store through the workshop without having a key or an access badge. This easy access is especially concerning because the club store does not yet have adequate security camera coverage. DABC has recently improved in this area so that the door locks from both sides. In addition, they are increasing camera coverage in the club store as well as the workshop. However, we recommend that DABC consider putting an additional control in place that would limit the maintenance vendor's access to only areas and times necessary to complete all required work.

At the start of the audit, vendors were being given unrestricted and unsupervised access to the warehouse, creating an opportunity for theft.

The vendor that has the intrastate shipping contract (common carrier) with DABC has at times been left alone and unsupervised in the DABC warehouse. Non-DABC employees should not be allowed unsupervised access to the warehouse, because they could easily steal product. DABC needs to ensure that all vendors, while on the premise, are under supervision.

We also found that at least one door in the warehouse was left unlocked and open. To test the sufficiency of warehouse security, we arranged for an auditor, who was unknown to warehouse personnel, to enter the warehouse through the doors that were left open and attempt to walk out with product. The auditor entered the warehouse and walked out with about $200 worth of product without being challenged by any warehouse employees. We recommend that DABC develop and enforce policies and procedures pertaining to warehouse security.

A warehouse door was left unlocked and open, allowing an auditor to remove about $200 worth of product without being questioned by any warehouse employees.

DABC Administrators Should Consider Additional Steps to Help Improve Warehouse Operations

The following is a list of issues that DABC administrators should consider to help improve the efficiency and effectiveness of warehouse operations. While not exhaustive, these changes could help DABC increase revenues and decrease costs.

To improve the efficiency and effectiveness of operations, DABC should consider instituting a bailment fee, expanding the use of drop shipping and requiring vendors to deliver product on pallets that meet warehouse specifications.

1. **Bailment Fee:** the DABC warehouse contains both state-owned product and vendor-owned product (bailment). The department does not purchase inventory on bailment until it is moved from the ASRS to the picking area. This practice is beneficial to DABC because it provides an inventory "buffer" and allows the department to easily purchase products in bulk when they go on sale. The vendor benefits through free warehousing and the ability to deliver product in full truckloads. While both parties receive some benefit, it seems reasonable for DABC to consider a bailment fee. We have been told that other states have used bailment fees; DABC should study the cost and benefits associated with the use of a bailment fee.
2. **Expanded Drop Shipping:** drop shipments are shipments delivered directly from the distributor to the store, bypassing the warehouse. DABC currently uses drop shipments for much of the beer sold in state stores along the Wasatch Front. DABC should consider expanding the drop shipment program, as it will reduce warehousing costs.
3. **Requiring Vendors to Deliver Product on DABC Pallets that Meet Warehouse Specifications:** in order for product to be prepared and entered into the ASRS (automatic racking system), the product must be on a special pallet and meet certain specifications. If vendors were required (when feasible) to deliver the product on DABC pallets already meeting specifications, it would save significant man-hours in the warehouse.

Recommendations

1. We recommend that DABC work to improve controls by ensuring that any product variances entered into the system by receiving staff require unique log-ins in order to monitor who alters inventory in the system.

2. We recommend that DABC develop a policy for investigating and documenting the cause of large variances.

3. We recommend that DABC develop a policy for cycle counts of both general and limited alcohol in the warehouse.

4. We recommend that DABC management create a policy for the verification of shipping variances and enforce current policies pertaining to the submission of shipping variances.

5. We recommend that DABC improve oversight of warehouse operations to ensure that costs are controlled and equipment is managed.

6. We recommend that DABC implement wrapping procedures so that products located on the top of pallets are more secure and less susceptible to pilferage.

7. We recommend that DABC review warehouse security policies and procedures to ensure that the warehouse provides adequate protection to state inventory.

8. We recommend that DABC consider the following in order to help improve the efficiency and effectiveness of operations:

    - Bailment fees
    - Expanded drop shipments
    - Requiring vendors (when feasible) to deliver product on DABC pallets, according to warehouse specifications

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Chapter IV
Control and Oversight of Retail Operations Can Improve

The control and oversight of retail operations can improve. We found that enhanced policies and procedures for store operations would improve DABC control in stores, specifically with receiving, counting, and selling product. For example, we found that stores do not have a uniform receiving policy, which has resulted in poor practices being implemented by store personnel. We also found that DABC needs to develop policies and procedures regarding the rotation of employees responsible for counting inventory. Additionally, the personnel responsible for the oversight of stores have not been held accountable for ensuring that established policies are being followed. The efficiency and effectiveness of retail operations can be enhanced through the monitoring of specific measures such as percent of stock not moving and inventory turns. Finally, we found that the security of retail stores has been insufficient, especially concerning the alarms and activity that occurs through the back doors.

Enhanced Policies and Procedures for Store Operations Would Improve DABC Control

We identified several store operational practices that require sufficient policies and procedures that have been lacking.

We identified several store operational practices in need of sufficient policies and procedures previously lacking. Specifically, we found that stores do not have a uniform receiving policy, which has resulted in poor practices being implemented by store personnel. We also found that DABC needs to develop policies and procedures regarding the rotation of employees responsible for counting inventory. Store operations would also benefit from the development of procedures for using the quantity key when selling product to ensure that inventory is properly sold and accounted for.

Stores Lack Receiving Policy Resulting In Poor Practices

Stores have developed inconsistent and poor receiving practices because DABC has failed to establish a standardized policy for all stores to follow.

Our review of operations found that DABC lacks policies and procedures for receiving product at state stores and package agencies. Without a store receiving policy, stores have developed inconsistent receiving practices. In the absence of policies and procedures for receiving product, we also found that stores have manipulated shipment variances to account for cycle count shortages (resulting in store shortages being erroneously charged back to the warehouse).

The club store tried to mask missing product by improperly charging shipping variances back to the warehouse.

An example of this occurred when the club store (Store 33) submitted an intentionally incorrect shipping variance for 13 cases of Sierra Nevada Pale Ale. The club store found it was short 13 cases of this product and then tried to correct its inventory by shifting the mistake to the warehouse. During the audit, we discovered that the club store submitted the incorrect variance in hopes that the warehouse would accept it without question. This practice is alarming because it masks the true origin of the inventory variance. When brought to their attention, DABC administrators took personnel action to address this issue.

Variances in a store's inventory can be caused by employees not accounting for inventory correctly when it is received at the stores. We found that DABC does not have a policy providing direction on the correct procedures to follow when receiving inventory shipments. Thus, we found that many stores receive and account for inventory differently.

To determine stores' accuracy when receiving inventory, we devised an audit test for all stores and some package agencies. Shipments to stores were purposely altered by adding or subtracting a case from two different product lines in the store's shipment. If the stores were receiving product correctly, employees would have accounted for this disparity and submitted a shipping variance report to the warehouse within 24 hours of receiving the product.

A lack of checks and balances for product receiving in stores could conceal theft.

Figure 4.1 shows the results of our test of inventory shipments to stores and package agencies. For some stores, the test was run multiple times in order to make sure all stores were included. In some cases, a stored failed the test more than once. We found that in some stores, the person who received the inventory was also recording variances and submitting the information into the system. This lack of separation of duties could conceal theft.

Figure 4.1 Inventory Test Found that a Significant Number of Stores and Package Agencies Are Not Correctly Receiving Product. Auditors intentionally manipulated shipments to liquor stores to test if stores would correctly account for incoming shipments of liquor.

	Number of Tests	Tests Passed	Percentage Passed	Tests Failed	Percentage Failed
Stores	52	33	63.5 %	19	36.5 %
Package Agencies*	8	3	37.5	5	62.5

***** *After testing was complete, we informed DABC staff of all products altered to package agencies to ensure that the package agencies' audits were not affected.*

An audit of test of stores' and package agencies' receiving practices found that 36.5 percent of stores and 62.5 percent of package agencies are not properly receiving product.

We found that stores that did not account for inventory variances during receiving did account for the variances when cycle counts were performed. We credit store employees for protecting inventory through the cycle count process. To help ensure that inventory is properly received in the future, DABC administrators are in the process of developing a receiving policy for all stores. The policy will describe exactly how stores are to receive and account for products shipped to them from the warehouse.

There is currently no policy that places a time restriction on package agencies for the submission of variances.

We are also concerned that package agencies have no policy dictating when their shipment variances have to be submitted. Stores are required to submit variances within 24 hours, but package agencies have no requirements. Thus, most package agencies submit variances at their convenience. It becomes more difficult to reconcile a variance as time passes, so we recommend that DABC implement a policy for package agencies that includes a time requirement to submit shipping variances as well.

DABC Should Implement Policies and Procedures for Counting and Selling Inventory

Stores lack policies concerning the rotation of employees counting products. We found that some stores always use the same employees to count the same inventory, which could conceal theft. Our review of the system also found that product variances, entered into the system from either shipping or cycle counts, cannot be traced back to individual employees due to the lack of unique employee log-ins. Unlike the warehouse system in which handheld computers require a username when performing cycle counts, store employees performing cycle counts use the same log-in store-wide. Thus, individual store employees cannot be held accountable for discrepancies in cycle count entries.

Stores do not have policies regarding the rotation of employees conducting cycle counts and also do not have unique employee log-ins to allow a manager to determine which employee conducted the count.

We also found that store employees would benefit from either the development of a standard procedure or enhanced training for the use of the quantity key when selling product. Because customers can mix cases of product, it is important for cashiers to scan each individual product being purchased. Errors can lead to store inventory discrepancies as well as monetary losses to the department. Some store managers have reported this error as being a significant operational problem for stores.

Personnel Responsible for the Oversight of Stores Have Lacked Accountability

The personnel responsible for the oversight of stores have lacked accountability. We found that policies regarding inventory controls have not been monitored or enforced. We also found that store activity has not been sufficiently monitored, though monitoring has improved. The efficiency and effectiveness of retail operations can be enhanced through the monitoring of specific measures such as percent of stock not moving and inventory turns.

DABC Has Had Poor Oversight and Lacked Accountability of Inventory in Retail Stores

DABC has not held managers and employees accountable for inventory cycle counts and wall-to-wall counts, despite documented policies and procedures. Monthly cycle counts of the stores are required on a minimum of 1,200 products per month, but most stores were not complying with this policy. Additionally, DABC has not enforced policies and procedures, or held managers accountable, for monthly inventory variances greater than 1/15th of 1 percent.

Stores are not cycle-counting the minimum number of products each month as required in policy, yet no enforcement of the policy has occurred.

Stores have anywhere from 868 products to 4,461 products at any given time. Therefore, the smallest store should be counting its entire inventory monthly and the largest store should be counting its entire inventory about three times a year. Figure 4.2 shows the percentage of the stores' inventories counted during fiscal year 2011.

Figure 4.2 Percentage of Inventory Counted In Liquor Stores for Fiscal Year 2011. The largest liquor store should be counting its entire inventory about three times a year or 300 percent.

Percentage of Inventory Counted	Number of Stores
0 – 10	0
11 – 20	2
21 – 30	3
31 – 40	0
41 – 50	3
51 – 60	3
61 – 70	4
71 – 80	5
81 – 90	2
91 – 100	11
> 100	11
Total	**44**

Figure 4.2 shows that only 11 stores counted more than 100 percent of their inventory for fiscal year 2011, thus most stores did not ever count their entire inventory that year. The highest percentage reached by a store was 255 percent; however, according to the policy, even the largest store should reach about 300 percent in a given year. So clearly, store managers were not being held accountable for compliance with the policy.

Stores were not being held accountable for variances greater than 1/15th of 1 percent as was required by DABC policy.

Additionally, DABC had a policy for the stores that was in place to help monitor variances that may occur in stores when they completed their cycle counts. The policy stated, "If a store's variance exceeds 1/15th of 1 percent of monthly gross sales, it may necessitate a full inventory count." However, we did not see any evidence of this percentage being measured or the policy being enforced. In fact, regional managers told us that they only verify that cycle counts are being done, but do not really look at the results of the counts.

As shown in Figure 4.3, no store was in compliance with DABC's variance threshold policy (threshold for variances was 1/15 of one percent) for all 10 months reviewed. A sample of stores from July 2011 through April 2012 found that 14 stores were not in compliance with the threshold for 5 of the 10 months reviewed, and all stores failed at least one or more months. During our review of this issue, we found no evidence to show that store managers were ever held accountable for not complying with this policy.

Figure 4.3 All Reviewed Stores Failed to Meet the Threshold Established in Policy for Acceptable Cycle Count Variances; 14 of 21 reviewed stores failed half the time. We also found no evidence of store managers being held accountable to DABC policy.

Months Failed	Number of Stores
1	2
2	2
3	0
4	3
5	2
6	1
7	6
8	1
9	4
10	0

All reviewed stores failed the acceptable cycle count variance policy at least one out of ten months reviewed and most failed half of the time.

While this policy specified potential consequences for stores exceeding the variance threshold of $1/15^{th}$ of 1 percent, we found no evidence that these consequences were ever implemented. The policy stated that if a store falls below the threshold, then it may have to do a full inventory count. Regional managers were unable to provide any documentation of full inventory counts being conducted in stores with variances greater than $1/15^{th}$ of 1 percent.

DABC has recently modified the policy, but administrators have to ensure that the policy is enforced.

DABC has since altered this policy by making it less stringent, but now requiring that a full inventory be conducted when a store is in violation. The current policy states that cycle count variances cannot be above $1/10^{th}$ of 1 percent 2 months in a row. The consequence for exceeding this threshold is that the store will have to do a full inventory count every month until the reported variances fall below the acceptable threshold. This policy modification is an improvement over the old policy only if the regional managers who oversee the stores enforce it.

Store managers need to be held accountable for the inventory they oversee. By doing so, managers will likely be motivated to reduce variances and determine the cause of the inventory fluctuations.

According to the United States General Accounting Office (GAO), "The inventory count process is an integral component of an organization's internal control environment." GAO goes on to state, "Setting high goals for inventory record accuracy rates is one way of establishing accountability for the physical inventory count. High goals "stretch" the organization and personnel to perform inventory counts with increasingly superior precision."

Inventory control best practices recommend the following practices for negative inventories.

Best practices dictate that all negative inventory balances and the underlying transactions should be investigated.

- Immediately investigate all negative inventory balances.
- Review all underlying transactions to find the reason for the negative balances.
- Have the cycle counters correct and investigate the negative balances as part of their daily cycle-counting routines.

Stores are required to perform cycle counts but staff is not held accountable for the accuracy of the inventory counts nor does it try to determine the causes for the inaccuracies that occur. Until recently, DABC has not held employees accountable for inventory variances and as a result, there is no way to determine the cause of past variances. In the future, by following up on inventory variances, DABC administrators can work towards holding inventory variances to a minimum.

DABC would benefit by holding employees accountable for the inventory in their care.

Store Activity Has Not Been Adequately Monitored

DABC has 3 regional managers who oversee and supervise 44 state liquor stores. In the past, these regional managers have not been adequately monitoring and supervising the stores they were assigned. Several store managers we spoke with told us that they saw their regional managers only once or twice a year.

In the past, some stores were only visited by regional managers once or twice per year.

In November 2011, DABC created a manager checklist that the regional manager must complete at each store visit. This list has made it possible to track whether a store has been visited or not. The managers are required to submit the checklist to the deputy director every month. This list also helps store managers know what is expected of them when the regional manager visits their stores. This document is a living document, meaning that DABC will continue to change and update it when needed.

Regional managers currently use many reports to help them monitor store activity. We recommend that some additional information should be monitored to help measure the efficiency and effectiveness of store operations. This information includes:

- Percent of stock not moving
- Safety stock
- Inventory turns

DABC has the capability to measure all of these items, but has not been doing so.

DABC can and should measure and report the percent of stock not moving, safety stock levels, and inventory turns for each store.

DABC Should Continually Monitor the Percent of Stock Not Moving in Each Store. Managing the percent of stock not moving is important to the efficiency of store operations. Stock that is not moving, but left in a store, is taking up space and not producing any return on investment. To illustrate how this would be useful, one store we visited had 87 products that were not even on display because there was no room. In addition, there were 124 products that had not sold at this store between January and April 2012.

DABC Needs to Monitor and Evaluate the Safety Stock Levels of Each Store. Safety stock is the stock of inventory above sales that stores carry to avoid running out of product. DABC needs to reevaluate the amount of safety stock that is necessary at each store. It should also consider the cost associated with excess stock beyond what is necessary to avoid stock-outs. DABC should determine what balance of reductions in safety stock is most efficient.

Stores have anywhere from six to forty-nine days of safety stock, but DABC administrators were unaware of this.

State liquor stores are allowed to order as much product as they would like. The system does have a ceiling that allows stores to order as many as 999 bottles of any product on a single order. We are concerned that stores are carrying too much inventory. We were told that the standard practice for stores was to have a minimum of two weeks of safety stock, in order to minimize stock-outs. DABC administrators did not know how much inventory the stores had been ordering.

We found that stores have safety stock levels of anywhere from six to forty-nine days. As shown in Figure 4.4, the stores appear to be unaware of how much safety stock the department would like them to carry and what level of safety stock is necessary to avoid stock-outs.

Figure 4.4 Number of Days' Worth of Inventory that Stores Are Ordering. Many stores are ordering more product than is needed even though they receive shipments every week.

Number of Days of Safety Stock	Number of Stores
6	1
7	6
(DABC Standard) 14	15
18	1
21	9
28	10
42	1
49	1

Half of all DABC stores have more safety stock than DABC's standard.

DABC does not have a policy for safety stock levels for the stores to follow and these levels are not being monitored by regional managers. We are concerned about the amount of safety stock that the stores have on hand and DABC's apparent lack of monitoring of this process. As mentioned, the standard practice for DABC is to have two weeks of safety stock, but as shown in Figure 4.4, half of all DABC stores (22 stores) have their ordering set out to 18 or more days.

Figure 4.5 shows the cost of excess inventory being carried in nine randomly selected stores. In these nine stores, the excess inventory exceeded $1.7 million.

Figure 4.5 Nine Randomly Selected Stores Had $1.7 Million of Excessive Inventory. These totals are from May 2012. The total amounts were determined by calculating the items in inventory minus the items that were sold over a two-week period.

Store #	Cost of Overstock
1	$ 284,819
5	183,887
10	155,531
16	218,757
19	132,066
24	203,447
32	108,611
42	218,719
45	233,132
Total Amount	**$ 1,738,969**

Carrying excess inventory leads to additional costs associated with increased man-hours and unnecessary shipments.

Some stores are packed so high with extra inventory that it is difficult for employees to walk behind the store shelves. DABC needs to establish safety stock guidelines to help ensure that stores are operating as efficiently as possible. Additional costs associated with excess inventory that DABC needs to consider include increased man-hours and unnecessary shipments which cause increased shipping costs.

Receiving days typically require the highest number of employee man-hours. Employees must be available to not only receive new product, but also move existing product to make room for new product. Thus, any reasonable reductions in the quantity of product ordered or the frequency of store deliveries should decrease DABC's personnel expenditures and diminish the problems associated with overstocking. DABC should evaluate potential savings that could be generated through a reduction in safety stock.

Half of all DABC stores are not turning over their inventory in a month's time.

DABC Should Evaluate Inventory Turns and Safety Stock Levels to Determine if Shipping Schedules Could Be Reduced. As shown in Figure 4.6, some stores do not sell their average inventory in less than a month. For example, the Hurricane store turns over its inventory, on average, 0.24 times per month, or about once every four months. However, the store still receives shipments once every week. Since the store's average inventory turns are so low, DABC should reevaluate if weekly shipments are necessary or consider reducing the amount of inventory the store orders. Reducing the number of shipments or the amount of inventory ordered to certain stores would help reduce the overall man-hours needed to operate the stores and potentially decrease DABC shipping costs.

Figure 4.6 Average Number of Inventory Turns per Month for State Liquor Stores. Average inventory turns measures the average number of times a store turns over its inventory in a month. Some liquor stores take longer than a month to turn over inventory.

Average Inventory Turns per Month	Number of Stores
0.10 - 0.31	1
0.32 - 0.52	3
0.53 - 0.74	10
0.75 - 0.95	9
0.96 – 1.17	7
1.18 – 1.38	8
1.39 – 1.60	1
1.61 – 1.81	2
1.82 – 2.03	0
2.04 – 2.25	1

Note: 42 stores included in analysis. Store 33 (club store) and Store 45 not included because of incomplete data.

DABC needs to assess inventory turns at each store to determine if they can reduce the number of times certain stores receive shipments or the amount of inventory stores receive. DABC should perform a cost/benefit analysis to determine if it is optimal for stores to order increased inventory and receive fewer shipments or if stores should order less product under the current delivery schedule (weekly). Improved monitoring of store activity, specifically looking at issues such as inventory turns, percent of stock not moving, and stores' ordering levels would help retail stores operate more efficiently and effectively.

DABC should conduct a cost/benefit analysis to determine the optimal level of inventory and desired frequency of shipments for each store.

Security of Retail Stores Has Been Insufficient

Security policy regarding stores' back doors needs to be improved. Many of the stores allow employees to enter and exit by the back door without supervision. It appears that many alarms on the stores' back doors have been disabled, allowing employees to keep the door open.

While visiting many stores throughout Utah, we observed the following:

- Stores' back doors are left open.
- Some stores had levers installed to keep the back doors open.
- Employees enter and exit through the back door.
- Door alarms are disarmed.
- Employees park next to the back door.

DABC needs to revisit their policies and procedures concerning the back doors of stores.

At some stores, we observed the back door being left open while employees were on break. Liquor stores are retail operations and need to have increased security for the safety of the employees as well as the safeguarding of the liquor, which is state owned.

We are also concerned that at some stores, when licensees pick up their orders, they use the back door. DABC should reexamine this practice and consider having licensees enter and exit through the front door. In a number of stores, licensee sales are handled from the back door. This past year, DABC had an incident in which a store employee prepared a licensee order for pickup and at the same time put an order together for himself and walked out the back door with it. While the employee was identified and caught on security camera, we believe that eliminating all back door access would help reduce the potential for theft in the future.

Activity occurring around back doors needs to be reconsidered.

According to an assistant manager at a private liquor store in Nevada, under no circumstance is anyone allowed to use the back door unless accompanied by the manager. Also, their employees are not allowed to park behind the store. Employees park in the main parking lot, along with the customers. DABC needs to create a security policy concerning appropriate uses of stores' back doors.

Improved camera coverage is needed at some of the retail stores to enhance security measures.

The security cameras in stores and the warehouse appear to be adequate in some cases, but improved camera coverage is needed for some stores, like the club store. DABC is currently moving to an improved camera system that will enhance security in their stores.

Recommendations

1. We recommend that DABC establish a receiving policy for retail stores and package agencies and monitor compliance with that policy.

2. We recommend that DABC establish a policy requiring rotation of store employees performing cycle counts.

3. We recommend that DABC develop a standard procedure or enhance training for the use of the quantity key when selling product.

4. We recommend that DABC work to improve controls by ensuring that any product variances entered into the system by store employees require unique log-ins to enable monitoring of who is altering inventory in the system.

5. We recommend that DABC ensure that policies relating to inventory counts are enforced.

6. We recommend that DABC establish ordering policies and procedures for stores.

7. We recommend that DABC review the checklist for regional managers and add pertinent measures such as inventory turns, percent of stock not moving, and safety stock to help ensure that the efficiency of store operations is being measured.

8. We recommend that DABC review store security policies and procedures to ensure adequate protection for state inventory and employees.

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Chapter V
Increase Contract Oversight And Enhance Ethics Training

DABC needs to increase its oversight of contracts and enhance ethics training for employees. We found that state resources have not been protected because of poor oversight of the department's service contract. For one contract we examined, DABC has been overcharged for parts and labor. Since 2003, DABC has paid the service vendor over $2 million without adequate oversight. We also found that DABC and State Purchasing may have violated procurement laws in the formation of this contract. Finally, DABC needs to enhance ethics training for all employees. This conclusion was reached based on the illegal acceptance of gifts by the former licensing and compliance director, past audit findings, and other inappropriate actions by DABC employees.

State Resources Have Not Been Protected as A Result of Poor Oversight of Service Contract

Since 2003, DABC has spent over $2 million for the maintenance of warehouse and store equipment. During that time, DABC warehouse management failed to adequately monitor this service and maintenance contract. As a result:

DABC failed to adequately monitor consecutive contracts with a vendor that amounted to over $2 million.

- DABC was overcharged for the costs of labor and parts.
- Contract terms were violated due to a lack of monitoring and understanding of contract terms.

We also found that DABC and State Purchasing may have violated the state procurement statute in the formation of this contract. To address the uncertainty surrounding cost-plus-a-percentage-of-cost contracts, the Legislature should consider revisiting the procurement code to determine if cost-plus-a-percentage provisions contained in contracts are allowed.

DABC has used the same vendor for warehouse maintenance since 2003, although this vendor has been doing business with the department for over 30 years. Since 2003, DABC has signed two five-year contracts with this vendor. Before 2003, the vendor worked for DABC without a contract. This vendor was responsible for maintenance on most warehouse equipment; including forklifts, reach trucks, pallet jacks, cherry pickers, scissor lifts, and box crushers. He also performed occasional maintenance on warehouse doors and dock levers.

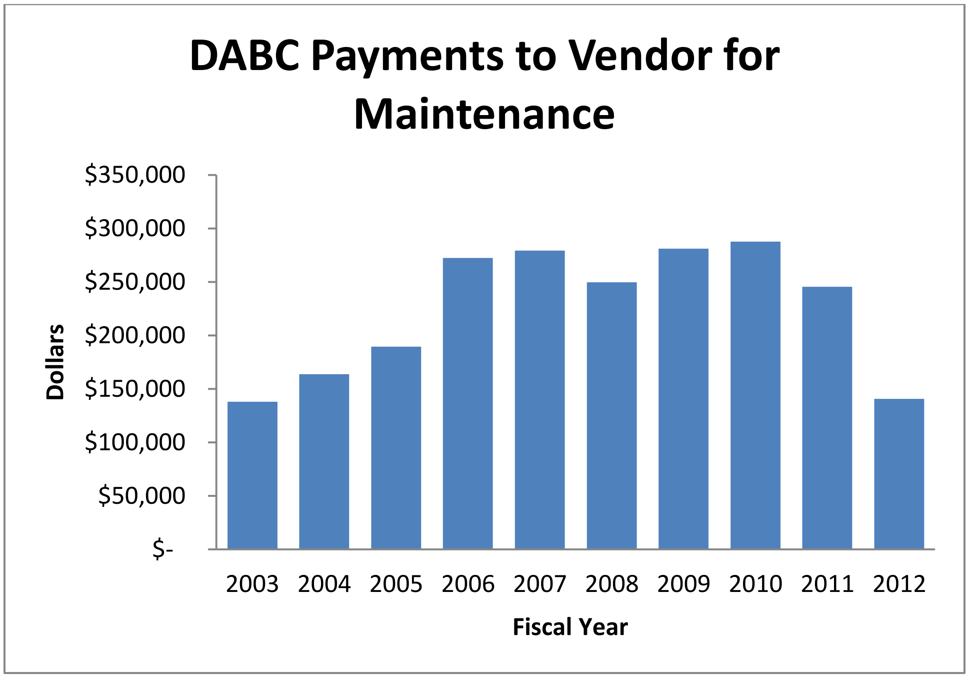
The most recent contract stipulated that the vendor would be paid $30 per hour and could charge a 15 percent mark-up on parts, which may violate state procurement laws.

The most recent contract, formulated in 2008, stipulated that this vendor would be paid $30 per hour for equipment maintenance in the warehouse and stores. In addition, the vendor was authorized to charge the department a 15 percent mark-up on purchased parts (cost-plus-a-percentage), which may violate state procurement statute. The contract also placed a $1,000,000 cap on the amount that the vendor could charge during the five-year period.

DABC Has Paid Over $2 Million To One Service Vendor

Since 2003, DABC has paid this service vendor over $2 million. Under the first contract, DABC paid this vendor just under $1.2 million in five years. The vendor exceeded the cap on the first contract in 2007, at which time DABC amended the contract to increase the cap by almost $441,000. Under the second contract, between fiscal year 2009 and fiscal year 2012, the vendor charged DABC $1,000,000 in repairs, with one year remaining on his contract. Figure 5.1 shows DABC payments to this service vendor for maintenance.

Figure 5.1 Payments to this DABC Service Vendor Have Increased Over Time. Charges only began to decrease when the warehouse purchased new equipment that was covered under the warranty of a different vendor.



Over the past 10 years, this vendor has charged DABC increasing amounts almost every year.

Over the past 10 years, this vendor has charged DABC increasing amounts almost every year. It was not until the warehouse purchased 25 pieces of new equipment near the middle of fiscal year 2011 (representing over 35 percent of their fleet) that the maintenance charges began to decrease. This new equipment was covered under warranty by a different vendor and thus was not the responsibility of the vendor in question. Around the same time, DABC put 21 pieces of equipment into surplus. Figure 5.2 shows a breakdown of charges for the most recent complete fiscal year from DABC's service vendor in question.

Figure 5.2 DABC Paid $245,390 for Maintenance in FY 2011. In fiscal year 2011, the service vendor charged DABC for almost 3,000 man hours of labor and about $157,000 in materials.

Month	Materials	Labor	Man Hours
July	$ 17,199	$ 9,875	329
August	16,673	7,575	253
September	12,760	7,900	263
October	16,041	8,350	278
November	15,874	8,630	288
December	10,146	6,550	218
January	15,688	6,040	201
February	5,878	5,600	187
March	12,290	8,510	284
April	10,184	7,170	239
May	11,010	6,130	204
June	12,842	6,475	216
Totals	**$ 156,585**	**$ 88,805**	**2,960**
Total – Materials and Labor	**$ 245,390**		

The vendor often brought an additional person with him to complete maintenance.

As shown in Figure 5.2, the vendor charged DABC more than $245,000 in fiscal year 2011. While the figure is likely inflated due to the fact that the vendor often brought an additional person to perform maintenance, it still raises questions about the precision of the vendor's billing practices. As previously stated, DABC's costs for fiscal year 2011 should have been somewhat lower given the fact that over 35 percent of the drivable equipment was new and under warranty by the eighth month of the year.

DABC Was Overcharged for The Cost of Labor and Parts

Several of the submitted invoices appear fraudulent.

The vendor submitted several invoices that may contain fraudulent charges. On one occasion, the vendor charged DABC for 20 hours of labor at a Utah County liquor store. While it has been established that these charges contained travel time (which the contract prohibits) and time charged for an additional employee, the charges are still questionable. This particular store is only open eight hours per day (11 AM – 7 PM) and the vendor does not have access to the store when it is closed to the public. In addition, DABC security records indicate that the vendor accessed the main warehouse in Salt Lake City at 11:51 AM, 2:29 PM, and 2:38 PM on the same day the vendor was billing hours to a Utah County store. Similar occurrences were identified for at least two additional stores. On all three occasions, a member of warehouse management signed the invoice, even though he was not present at the location where the repair occurred.

After we identified this issue, DABC administrators compared store security videos to invoices submitted by the vendor for store maintenance. They found that on two recent occasions, the vendor charged DABC for the time that he was at the stores plus an additional 10.5 hours on one day and 4.5 hours on the other. These recent invoices (combined with a few other invoices) totaled about $1,700. At the time of the submission, there was only about $800 left on the contract. DABC decided to pay the vendor only what remained under the contract and terminate the business relationship. In their letter to the vendor, DABC administrators stated:

After it was brought to their attention, DABC administrators discontinued their business with this vendor.

> Based on these findings and the agreed-upon amount that could be billed under this contract, this final payment is, in our view, sufficient to cover any additional work that has been done. The fact that the two invoices where we could verify your time were so clearly and extremely inflated leads me to believe that these were not isolated instances but rather your standard billing practice. Combined with the other issues highlighted in this letter, we have reason to believe that the amounts charged over the life of this contract were inflated by tens of thousands of dollars.

We credit DABC administrators for taking steps to rectify the problem once it was brought to their attention.

We also found that the vendor was charging DABC based on the price of new parts when he was actually installing used parts that he purchased at a discount. In discussing the identified issues with the vendor, he admitted to purchasing used parts and charging DABC based on the retail value of the part, plus 15 percent. Management had no knowledge of this practice because they did not require the vendor to submit receipts for parts. While it is clear that some charges were inappropriate, it is unknown exactly which charges are legitimate and which ones are not because of inadequate documentation.

The vendor charged DABC based on the cost of new parts, plus a 15 percent mark-up even though he admitted to often utilizing used parts.

Warehouse Management Has Failed to Adequately Monitor Service Contract

DABC warehouse management failed to monitor and enforce several portions of this contract, due in part to a lack of understanding of what the signed contract contained. The contract required that all service be scheduled by warehouse management. Both the vendor and members of DABC warehouse management informed us that few repairs were actually scheduled and the vendor, at times, completed maintenance without the full knowledge of management. The vendor was able to perform maintenance without the full knowledge of management because, as discussed in Chapter III of this report, he had his own DABC-issued badge which allowed unrestricted access to the warehouse.

Despite what was specified in the contract, the vendor negotiated an increased rate for certain services and rarely scheduled work with warehouse management.

Service to equipment located in state stores was also included in the contract, at the same rate as service to equipment in the warehouse. All stores and pieces of equipment within stores were specified in the bid and incorporated into the contract through a clause located directly above the signature lines on the first page of the contract. Lack of knowledge on the part of the vendor was evident based on the vendor's disclosure that he negotiated an increased rate for service and preventative maintenance on equipment at the stores with the former executive director of the department. This agreement, never formalized in writing, violated the contract terms and amounted to at least $8,000 in charges in fiscal year 2011 alone.

Because of poor oversight, warehouse management was unaware that they were often being charged labor for two people.

The service vendor often held invoices for several days to a couple of weeks and submitted them in bulk; these invoices were signed with very little, if any, scrutiny by DABC warehouse management. DABC warehouse management was unaware that the vendor often brought an additional person to the warehouse or stores. In these instances, the vendor charged an additional $30 dollars per hour for the second laborer. DABC warehouse management was unaware that it was paying for the work of two individuals until it was brought to its attention when the audit team questioned numerous invoices in which the vendor charged 20 or more hours for a job that was completed in one day.

The contract specifically states that "no additional fee [would be] incurred for travel from portal to portal." The vendor admitted charging for travel to stores, but did not seem to have knowledge that the contract contained this provision. Warehouse management knew that the vendor was charging extra for travel, but did not know that the contract prohibited payment for travel time.

Neither warehouse management nor the vendor was aware that the contract had a $1,000,000 ceiling. Both parties were also unaware that the total cost of maintenance since the implementation of the contract was close to exceeding that cap. At the time of questioning, the vendor was $817 from the $1,000,000 cap, with a full year left on the contract. It was surprising to us that the individuals responsible for overseeing this contract had such little knowledge of the contract's content.

DABC and State Purchasing May Have Violated State Procurement Law

DABC and State Purchasing may have violated state procurement law in the formation of this contract. ***Utah Code*** 63G-6-416, which deals with procurement, prohibits cost-plus-a-percentage-of-cost contracts. The warehouse and store maintenance contract includes a cost-plus-a-percentage-of-cost element, which allowed the vendor to mark the cost of parts up by 15 percent. As previously mentioned, in some instances, the mark-up was even higher because the vendor bought used parts and charged DABC the full retail value plus 15 percent. The statutory prohibition of cost-plus-a-percentage charges was in effect prior to the formation of this contract.

The contract includes a cost-plus-a-percentage element, which may violate state procurement law.

This issue was brought to the attention of the Division of Purchasing and the State Attorney General's Office. It is currently unclear as to whether this contract violates state procurement statute because in this instance, the cost-plus-a-percentage-of-cost is merely a component of the contract and not the full contract. However, this review of state procurement statute could have implications for other state agencies that use similar terms in their contracts. According to the Director of Purchasing, "it is unclear whether statute prohibits a cost-plus-a-percentage-of-cost component within a contract. It is a common practice for contracts within certain industries to contain a cost-plus-a-percentage-of-cost component." We therefore recommend that the Legislature consider clarifying this statute in order to either allow or prohibit cost-plus components of a contract. We further recommend that DABC administrators be much more diligent in monitoring and enforcing the terms of their own contracts.

The director of purchasing concurs that a cost-plus-a-percentage component may be illegal based on the language of the statute.

DABC Needs to Emphasize Employee Ethics Training

DABC needs to improve the ethics training that employees receive to help establish a culture of rules and adherence to rules. We found that the former licensing and compliance director of DABC accepted gifts in violation of state law. This issue coupled with past audit findings and other employee problems, in our opinion, highlights the need to emphasize ethics training for all DABC employees.

Former Licensing and Compliance Director Accepted Gifts

The former director of licensing and compliance accepted gifts from a licensee, in violation of state liquor laws and state ethic laws.

The former director of licensing and compliance for DABC accepted gifts that exceeded $50 from a licensee, in violation of state liquor laws and state ethics laws. In our discussions with him, it was discovered that he accepted free meals and gift cards to restaurants from a licensee who was an old friend. Even though these gifts were described as gifts from a friend, they still violated state laws. The friend of the former licensing and compliance director owns eight establishments which each hold a different liquor license.

When asked how many gifts he received, the former licensing and compliance director could not remember. He said, "at least half a dozen or more over the years. They were usually in the form of dinners or gift cards for meals." He also informed us that he may have received other gifts over the years that were not in the form of meals or gift cards, but he could not remember.

Utah Liquor Laws Prohibit the Type of Gifts that Were Received. ***Utah Code*** 32B-2-209, "Prohibited interests, relationships, and actions", states:

> (2) In addition to being subject to Title 67, Chapter 16, Utah Public Officers' and Employees' Ethics Act, an individual who is a commissioner, the director, or an applicable department employee may not:
>
> (e) accept a gift, emolument, or employment from:

(i) a person who applies for or holds a package agency, license, or permit under this tile; or

(ii) an officer, agent, or employee of a person who applies for or holds a package agency, license, or permit under this title, except that a commissioner, the director, or an applicable department employee may accept a gift from an officer, agent, or employee if the gift is equal to or less than $50.

This statute defines an applicable department employee as someone designated as a deputy or assistant director, compliance officer, or an employee directly performing licensing and compliance functions. Thus, the director of licensing and compliance for DABC is clearly prohibited from accepting inappropriate gifts, according to the state's liquor laws. While this current language was enacted in 2011 and amended in 2012, prior language also prohibited the receipt of gifts.

The director of licensing and compliance for the DABC is clearly prohibited from accepting inappropriate gifts, according to the state's liquor and ethics laws.

Utah Ethics Laws Also Prohibit Gifts that the Former Licensing and Compliance Director Was Receiving. As stated previously, the act of receiving these gifts not only violated state liquor laws, but also violated state ethics laws. ***Utah Code*** 67-16-5 (2) states:

(2) It is an offense for a public officer or public employee. . .to knowingly receive, accept, take, seek, or solicit, directly or indirectly for himself or another a gift of substantial value or a substantial benefit tantamount to a gift:

(a) that would tend improperly to influence a reasonable person in the person's position to depart from the faithful and impartial discharge of the person's public duties;

(c) if the public officer or public employee recently has been, is now, or in the near future may be involved in any governmental action directly affecting the donor or lender. . . .

Like state liquor laws, employee ethics laws allow an occasional non-pecuniary gift if the value of such gift does not exceed $50.

A Criminal Investigation Should Be Considered. State ethics laws clarify penalties for violations and we believe the Utah Attorney

General's Office should investigate. The Employee Ethics Act states penalties for violation of the law. ***Utah Code*** 67-16-12 states:

> (1) Any public officer or public employee who knowingly and intentionally violates this chapter, shall be dismissed from employment or removed from office as provided by law, rule, or policy within the agency.

The state's ethics law defines the penalties for violations as follows:

- Felony of the second degree if the value of compensation exceeds $1,000
- Felony of the third degree if the value of compensation is more than $250 but not more than $1,000
- Class A misdemeanor if the value of compensation is more than $100 but does not exceed $250
- Class B misdemeanor if the value of compensation is less than $100

When confronted with these allegations and the prescribed penalties codified in state law, the former licensing and compliance officer resigned.

When confronted with this information, the former licensing and compliance director resigned. In his letter of resignation dated March 15, 2012, he stated:

> "I am hereby submitting this letter of resignation from the department for the reason that I received gifts from a licensee."

As stated previously, the former licensing and compliance director could not remember how many gifts he received. He did say that he received "at least half a dozen or more over the years. They were usually in the form of dinners or gift cards for meals." He also informed us that he may have received other gifts over the years that were not in the form of meals or gift cards, but he could not remember. We were able to obtain a photocopy of one gift card to the former licensing and compliance director for $250 from December 2007. He verified that he spent this gift card, which, coupled with the other gifts, leads us to believe that a felony of either the third or second degree may have been committed. We have referred this issue to the Utah Attorney General's Office to investigate further.

Past Audit Findings Support the Need for Enhanced Ethics Training

Past audit findings and other employee problems further illustrate the need for DABC to be more proactive in ensuring employees receive proper ethics training. Past legislative audit findings include:

Past audits have revealed multiple examples of unethical behavior by DABC employees.

- Staff concealing issues and facts from the commission (the Eden Package Agency failure, business done between DABC and Flexpak)

- Inappropriate and illegal purchasing practices (rigging bids, falsifying reports, artificially splitting invoices)

- Inappropriate gifts to former commissioners

We also found other examples of inappropriate behavior by DABC employees during the course of this audit. For example, an assistant manager at one retail store was receiving free meals from restaurants that hold liquor licenses, in exchange for restaurant and wine reviews. Another store employee asked for and received apparel from a liquor vendor.

We also found other examples of inappropriate behavior by DABC employees during the course of this audit.

In October 2011, DABC administrators instituted a new ethics policy that states, in part:

> Employees shall avoid all appearance of impropriety, and may not accept any gifts or gratuities, regardless of value.
>
> Employees may not participate in, condone, conceal, or be associated with dishonesty, fraud, misrepresentation, or theft.

Under violations of this policy it clearly states that, "employees shall immediately report suspected violations of this policy to both their immediate supervisor and the Executive Director." The policy also clearly states the corrective actions that may be taken for violating the policy. We credit DABC administrators for creating an ethics policy, but recommend that they strengthen this policy by ensuring that all DABC employees are sufficiently trained on these ethics requirements.

Recommendations

1. We recommend that DABC maintain better oversight of all contracts.

2. We recommend that management require vendors to submit appropriate documentation immediately when services are rendered or product received.

3. We recommend that the Legislature review procurement law and clarify ***Utah Code*** 63G-6-416 in order to either allow or prohibit cost-plus components of a contract.

4. We recommend that DABC administrators ensure that ethics training is emphasized to all employees.

Chapter VI
DABC Has Circumvented The Appropriations Process

DABC has been self-appropriating for years by covering operating expenses with unappropriated monies from the Liquor Control Fund. In fiscal year 2011 alone, these unappropriated operating expenses exceeded $6.6 million. Our concern is that these operating expenditures should have come out of DABC's budget appropriation, which is overseen by the Legislature, but instead, the department has been using unappropriated monies from the Liquor Control Fund as a means to cover significant operating expenditures. This ability to operate beyond the approved budget has allowed DABC to operate inefficiently without budgetary constraints. When this audit finding was brought to DABC's attention, the interim director took the issue to the Legislature and to the Governor during the 2012 Legislative General Session, at which point the problem was rectified. However, this issue could resurface again in the future unless controls are put in place.

DABC Has Been Self-Appropriating For Years Without Oversight

DABC has been self-appropriating for years without legislative oversight. The department had the ability to use unappropriated funds, generated by the sale of alcohol, to cover operational expenses. This access to unappropriated funds limits accountability for the department and reduces incentives to operate in the most efficient manner possible.

DABC has had the ability to use non-appropriated funds, generated by the sale of alcohol, to cover operational expenses.

DABC is allocated funds through a single line-item appropriation each year. These funds are intended to cover the agency's operating expenses. In addition to the appropriated funds, DABC also has authority over the balance of the Liquor Control Fund, after local taxes have been withdrawn and a percentage of revenue has been transferred to the school lunch program and general fund as required by law. The Liquor Control Fund contains all funds generated by the sale of alcohol and issuance of permits and licenses in Utah; revenue to the fund surpassed $136 million in fiscal year 2011.

Funds transferred to the Liquor Control Fund, as well as retail liquor prices in general, are determined based on "landed case cost." Landed case cost is defined as the cost of the product (liquor inventory) plus the cost of inbound shipping incurred by the department.

Unappropriated Expenses Should Be Controlled

The Liquor Control Fund is used to cover the appropriated operating budget of DABC. Unappropriated expenses from this fund include, but are not limited to, the purchase of alcohol and inbound shipping costs. Money from the fund is also used to offset variances between recorded and physical inventory caused by shrinkage, inventory miscounts, and, as previously discussed in Chapter II, other problems such as system errors resulting in inaccurate reporting of inventory.

Legitimate unappropriated expenses from this fund include the purchase of alcohol and inbound shipping costs.

The cost of liquor and inbound shipping (landed case cost) and the variance between recorded and physical inventory are items not funded by the Legislature because the department cannot fully control or predict these costs. Figure 6.1 shows the cost of product, the cost of inbound shipping and the amount of variance reported by DABC between fiscal years 2007 and 2011.

Figure 6.1 Five-Year Totals for DABC's Cost of Product, Inbound Shipping, and Recorded Inventory Variances. These expenditures are not appropriated by the Legislature.

Activity	2007	2008	2009	2010	2011
Cost of Goods Sold	$ 114,463,747	$ 128,445,081	$ 135,197,121	$ 142,280,733	$ 150,942,569
Freight In	622,459	678,693	808,229	864,652	802,863
Inventory Variance	(264,467)	(673,261)	(1,322,332)	547,504	(99,652)
Total	**$ 114,821,739**	**$ 128,450,513**	**$ 134,683,018**	**$ 143,692,890**	**$ 151,645,780**

As shown in Figure 6.1, the price of the product (cost of goods sold) makes up the vast majority of landed case cost and the funds that are taken out of the Liquor Control Fund for use by the department. Cost of goods sold has increased from over $114 million to about $151 million in the past five years. This change amounts to an increase of about 32 percent. Freight in has increased by about $180,000 or about 29 percent. There is no apparent trend with regard to the reported inventory variances. Issues related to inventory variances were discussed in detail in Chapter II of this report.

Significant Amounts of Unappropriated Liquor Control Funds Have Been Used to Cover Operating Expenses

Since fiscal year 2007, operating expenses that have not been appropriated by the Legislature have increased from almost $3.7 million to over $6.6 million. While this increase can be largely explained by increases in items such as the cost of delivery and credit card fees, we are still concerned that these operational expenses should have been authorized by the Legislature. Because DABC did not budget these items for approval by the Legislature, there was no oversight for a sizeable part of DABC expenditures. Thus, these expenditures were unconstrained. Figure 6.2 displays the total monetary amount of operational activities financed through the Liquor Control Fund that were not appropriated by the Legislature.

Operational expenditures outside the department's allocated budget are not monitored by the Legislature or the Division of Finance.

Figure 6.2 Five-Year Totals for DABC Operational Costs which Were Not Appropriated by the Legislature. These expenditures were clearly operational expenditures that DABC self-appropriated from the Liquor Control Fund.

Activity	2007	2008	2009	2010	2011
Salaries	$ 279,440	$ 635,383	$ 331,962	$ 260,605	$ 232,833
Maintenance	291,125	285,303	270,142	314,312	294,740
Liquor Bags	174,035	177,911	211,895	234,221	204,195
Delivery to Stores	740,252	912,627	1,131,889	1,843,010	2,111,955
Credit Card Fees	2,008,026	2,420,419	2,775,241	3,073,261	3,513,190
Other	194,723	100,895	225,660	311,025	273,553
Total	**$ 3,687,601**	**$ 4,532,539**	**$ 4,946,790**	**$ 6,036,434**	**$ 6,630,466**

The total amount of additional expenditures financed through the Liquor Control Fund from fiscal year 2007 through 2011 ranged from almost $3.7 million in fiscal year 2007 to over $6.6 million in fiscal year 2011.

The total amount of operating expenditures financed through the Liquor Control Fund from fiscal year 2007 through 2011 ranged from almost $3.7 million in fiscal year 2007 to over $6.6 million in fiscal year 2011.

During this time period, DABC's appropriated budget remained fairly flat. However, DABC was able to endure this lack of a budget increase in part due to the unrestricted availability of funds in the

Liquor Control Fund. By maintaining some operational expenses in this fund, DABC was able to use its budgeted funds elsewhere, with fewer constraints.

DABC Had Little Incentive to Operate Efficiently Because of Unrestrained Access to the Liquor Control Fund

Because of limited budgetary constraints, DABC administrators had little incentive to seek opportunities to reduce costs or increase productivity.

DABC has not been constrained by the budget set by the Legislature because it has had almost unlimited access to revenues generated through the sale of alcohol in the Liquor Control Fund. Operational expenditures that could not be made within DABC's budgetary limits could be shifted to the Liquor Control Fund. Thus, past DABC administrators had little incentive to seek ways to reduce costs or increase productivity. Two examples of the results of these inefficiencies are cited below:

- DABC wasted over $188,000 to pay a third party to store alcohol after the warehouse renovations were completed.

- DABC failed to adequately monitor and enforce a service maintenance contract for equipment in the warehouse. As a result, the department was significantly overcharged for the cost of parts and labor.

Legislature Addressed Budgetary Issue but Controls Still Needed

In an effort to establish greater oversight of DABC's operational expenditures, the Legislature amended HB 354 during the 2012 Legislative Session. HB 354 "modifies the Alcoholic Beverage Control Act, the Public Safety Code, and revenue and taxation provisions to address the tracking of the effects of the abuse of alcoholic products and collection and use of certain markups and taxes." The amended version of the bill also increased DABC's annual budget for fiscal year 2013 by $6,377,800. The fiscal note attached to the bill stipulates that "the net impact of the provision would be zero." The additional appropriations are meant to fund operational expenditures that had been unappropriated and financed by the Liquor Control Fund. DABC administration confirmed that all expenditures not included in the landed case cost or the variance amount would be shifted to the department's budget starting July 1, 2012.

While DABC and the Division of Finance agree that the Liquor Control Fund should only be used to fund the cost of alcohol and inbound shipping and to offset variances, currently, no provision in the Alcoholic Beverage Control Act prevents DABC from shifting expenses from the budget to the Liquor Control Fund in the future. We therefore recommend that the Legislature stipulate in statute what expenses the department can legally withdraw from the Liquor Control Fund. The Legislature could consider allowing only the following unappropriated expenses to be charged to the Liquor Control Fund: cost of the product, associated costs of inbound shipping of the product, and variances between recorded and physical inventory.

Though the Legislature amended HB 354 to budget for operational expenses that had been covered with unappropriated funds, there is still no control to prevent DABC from shifting operating expenses in the future.

Recommendation

1. We recommend that the Legislature stipulate in statute that unappropriated operating expenses should not be withdrawn from the Liquor Control Fund.

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