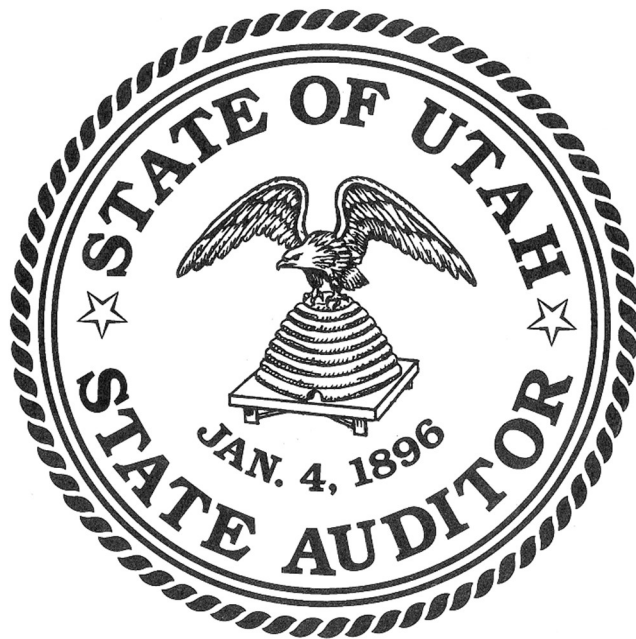


Department of Alcoholic Beverage Services

Agreed-Upon Procedures
For the Year Ended June 30, 2023

Report No. 23-01



**Office of the
State Auditor**

AUDIT LEADERSHIP:

John Dougall, State Auditor
Bertha Lui, CPA, Audit Director
Jordan Kattelman, CPA, Audit Supervisor

Department of Alcoholic Beverage Services

For the Year Ended June 30, 2023

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Office of the
State Auditor

July 21, 2023

Members of the Utah Alcoholic Beverage Services Commission
And

Ms. Tiffany Clason, Executive Director Department of Alcoholic Beverage Services

Commissioners and Ms. Clason:

We have performed various procedures on certain aspects of the Department of Alcoholic Beverage Services (DABS) relating to the audit scope and focus described in the “State Auditor Proposed Audit Plan for Fiscal Year 2023.” These procedures were performed in accordance with *Utah Code*, Section 32B-2-302, agreed to by the Alcoholic Beverage Services Commission.

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

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

Sincerely,

Bertha Lui, CPA
Audit Director
blui@utah.gov
801-808-0481

Findings and Recommendations

Finding 1. DABS Operations Are Not Accurately Recorded in the State's Accounting System

DABS is currently unable to accurately record financial data from its enterprise resource planning (ERP) system in the State's accounting general ledger system (FINET). Because of the complexity and nature of its operations, DABS uses an ERP system to track its financial activity. DABS then interfaces its ERP system with FINET to record this data. In October 2022, DABS deployed a new ERP system, Microsoft Dynamics 365 (D365). Since that deployment, DABS encountered interface issues between D365 and FINET. As a result, DABS's ERP System data has not been recorded in FINET since October 2022. DABS has not yet been able to resolve this issue.

DABS also encountered similar problems when it implemented its previous ERP system, Microsoft Dynamics AX (AX). DABS deployed AX in July 2016. After deployment, DABS's data from AX was not recorded in FINET accurately and the two systems did not reconcile. In two previous audit reports, we issued findings related to DABS's ERP system implementation and reconciliations with FINET.¹ Subsequent to these reports, DABS established a monthly reconciliation process to resolve the issues.

Because DABS is a part of the State, its financial activities should be accurately recorded in FINET to enable proper financial reporting and oversight. DABS's operations are significant to the State and DABS is considered a major fund for the State's Annual Comprehensive Financial Report (ACFR). The State cannot issue its ACFR if DABS data is not accurately recorded. If the issue is not resolved before the State fiscal yearend closeout, DABS runs the risk of delaying ACFR preparation and issuance, which could impact compliance with bond reporting requirements. The inability to record ERP system data in FINET also hinders oversight of DABS and increases the risk of undetected errors, misstatements, and fraud.

Recommendation:

We recommend that DABS resolve interface issues and ensure all ERP system data is accurately recorded in FINET before the State fiscal yearend closeout.

Finding 2. Challenges in Implementation Impaired DABS's ERP System Deployment

DABS's D365 implementation experienced challenges due to insufficient communication, incomplete understanding, and various circumstances at other State agencies.

DABS began the process of selecting a new ERP system in 2018 when it became aware that its previous ERP system, AX, was approaching end of life. DABS selected D365, which is a

¹ Office of the State Auditor Report No. 17-01, Findings #1 and #2, May 2017 and Office of the State Auditor Report No. 18-01, Finding #1, April 2018

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cloud-based version of AX. DABS selected a vendor in February 2020 and began the development process. DABS's implementation team included DABS personnel, its imbedded information technology team from the Department of Government Operations Division of Technology (DTS), and the vendor's support team. DABS had initially planned to deploy D365 in August 2022, but the project was delayed until September 2022, and then further delayed until October 2022 when D365 went live.

DABS's implementation timeline overlapped and conflicted with scheduled FINET downtime. While DABS was implementing D365, the Department of Government Operations Division of Finance (State Finance), which operates FINET, also deployed a new version of FINET. As part of the new FINET deployment, State Finance issued a moratorium on new interfaces with FINET from April 2022 until January 2023. State Finance informed DABS of the moratorium in March 2022, but due to the length of the moratorium and time constraints from AX's end of life, DABS did not feel that it could alter its deployment timeline. DTS personnel were involved with both the D365 and new FINET implementations. However, there was insufficient coordination and communication between the two DTS teams to avoid conflicting timelines. Better coordination between DTS teams earlier in the process could have helped proactively mitigate this issue.

By the time DABS was ready to begin testing system interface in September 2022, the FINET moratorium was still in effect. Because DABS would have incurred significant costs from further delayed implementation, State Finance made a special exception for DABS to perform limited interface testing. DABS's testing was unsuccessful. However, DABS still decided to deploy D365 in October 2022 despite the interface issues. Systems should be adequately tested prior to deployment. The decision to deploy at that time was the result of DABS's (including the imbedded DTS team) incomplete understanding of the problems and potential risks. Because of breakdowns in communication within the implementation team, DABS incorrectly assessed that it could quickly resolve the interface problems after deployment, so DABS deployed D365 to avoid additional delay costs. However, over seven months have passed, and the interface issues have still not been resolved. Improved communication between the various parties throughout the implementation process could have better informed decision makers and alleviated some of these challenges.

Recommendations:

We recommend that DABS:

- **Ensure systems are successfully tested prior to deployment.**
- **Ensure sufficient communication and complete understanding of issues to improve decision making.**
- **Improve communication among the members of the development team.**
- **Improve cross-agency communication.**

Finding 3. DABS Does Not Collect the Entire Statutorily Required Markups from Type 5 Package Agencies

DABS is not collecting statutorily required markups from liquor sales made by Type 5 Package Agencies (PAs). PAs are businesses that contract with DABS to sell liquor to the public for off premise consumption. PAs are classified into five types:²

- Type 1 – Resorts (e.g. ski lodge, hotel).
- Type 2 – Businesses authorized to sell liquor (e.g. rural grocery store).
- Type 3 – Privately owned liquor stores.
- Type 4 – Businesses that sell liquor directly to tenants (e.g. hotel room service).
- Type 5 – Liquor manufacturers that sell their own products directly to the public.

Statute³ mandates liquor prices that include set markup percentages. The intent is to provide DABS with resources to fulfill its statutory responsibilities. When DABS does not collect these markups, it limits its ability to fulfill its responsibilities and must divert funds from other sources. DABS collects the entire markup associated with liquor sales made by State liquor stores, licensees (i.e. bars, restaurants, etc.), and most PAs. DABS sets mandatory liquor retail prices for these PAs because statute⁴ requires that prices “are the same at all state stores [and] package agencies.” Statute⁵ also prescribes a formula to calculate those prices:

$$\text{Retail Price} = (\text{Cost of Liquor} + \text{Handling Costs}) * (1 + \text{Applicable Markup Percentage})^6$$

Type 1 through 4 PAs purchase liquor from DABS at the mandatory liquor retail price and generally sell it to the public for that same amount.⁷ As a result, Type 1 through 4 PAs do not retain revenue from liquor sales⁸ while DABS retains the sales revenue and thus the associated markups.

Type 5 PAs do not purchase liquor from DABS and instead sell their own manufactured products at prices mandated by DABS. Currently, DABS requires Type 5 PAs to remit some funds, but it allows Type 5 PAs to retain a significant portion of the markups. We see no indication in statute that markup should be treated differently for Type 5 PAs. Figure 1

² Utah Administrative Rule R82-2-301

³ UCA 32B-2-304

⁴ UCA 32B-2-202(1)(i)

⁵ UCA 32B-2-304

⁶ Applicable Markup percentages are listed in UCA 32B-2-304

Wine, spirituous liquor, and flavored malt beverage: 88%

Heavy beer: 66.5%

Small manufacturer wine and spirituous liquor: 49%

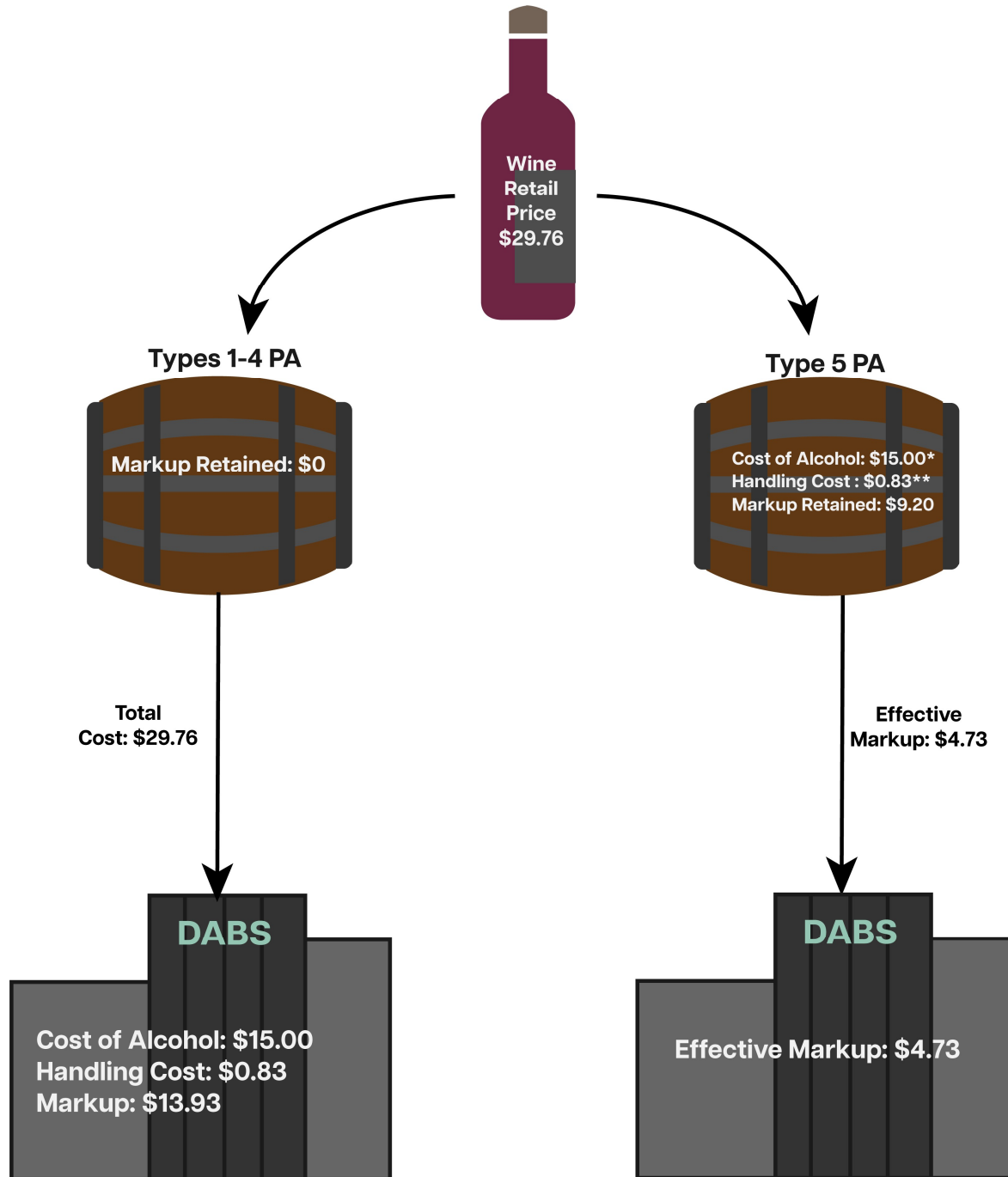
Small manufacturer heavy beer: 32%

⁷ Occasional variances may occur if DABS changes the mandatory retail price between when a PA purchases a product and when it sells that product.

⁸ Type 2 and 3 PAs receive a monthly contract payment from DABS to sell liquor. Type 1 and 4 PAs sell liquor as a benefit to their customers.

illustrates the collection and distribution of the markup from the sale of an example bottle of wine by Type 5 PAs compared to Type 1 through 4 PAs.

Figure 1 – Type 5 PAs Retain a Significant Portion of the Statutory Markup



* Type 5 PA cost of alcohol includes manufacturing profit. Costs are calculated as if product was sold to DABS.

** Liquor prices are required to include handling costs as if DABS shipped and stored the product. Because DABS does not incur handling costs, Type 5 PAs retain this revenue.

In this example, the retail price of a bottle of wine is \$29.76 which includes the associated markup of \$13.93. As shown on the left side of Figure 1, the Type 1 through 4 PA purchases a bottle of wine from DABS for \$29.76 and sells it to the public at the same price. DABS pays the liquor supplier \$15.00 and incurs \$0.83 in handling costs. After these costs, DABS retains \$13.93, which is the entire markup.

On the right side of the Figure 1, a Type 5 PA manufactures a bottle of wine and sells it to the public at the DABS mandatory price of \$29.76. The Type 5 PA covers its liquor manufacturing costs and retains the handling costs. The Type 5 PA then remits a limited portion of the markup to DABS. In this case, DABS retains only \$4.73 while the Type 5 PA retains \$9.20 of the markup. This example illustrates that DABS does not uniformly collect the markup from all PAs.

As a result, DABS did not collect an estimated \$3.95M of statutory markups from Type 5 PAs during fiscal year 2022.

Recommendation:

We recommend that DABS collect the entire statutory liquor markups from Type 5 Package Agency liquor sales.

Finding 4. DABS Charged Type 5 Package Agencies An Administrative Fee Not Established According to Statute

DABS charges Type 5 PAs a 5% administrative fee. DABS has not established this fee in accordance with statute. Statute⁹ allows DABS to establish fees, provided that it adopts a fee schedule¹⁰ and submits that schedule to the Legislature for approval.¹¹ DABS has a fee schedule, however the administrative fee is not included in the fee schedule. Therefore, DABS is charging a fee that has not been approved by the Legislature. Statute¹² further requires that fees:

- “Be reasonable and fair”
- “Reflect and be based on the agency’s cost for the fee; and”
- “Be established according to a cost formula determined by the Executive Director of the Governor’s Office of Planning and Budget and the Director of [State Finance] in conjunction with the fee agency.”

The current administrative fee is not based on DABS’s costs and was not established using the required cost formula. DABS personnel do not know how or when the fee originated.

⁹ UCA 32B-2-202(1)(h)

¹⁰ UCA 63J-1-504(2)(a)

¹¹ UCA 63J-1-504(6)(a)

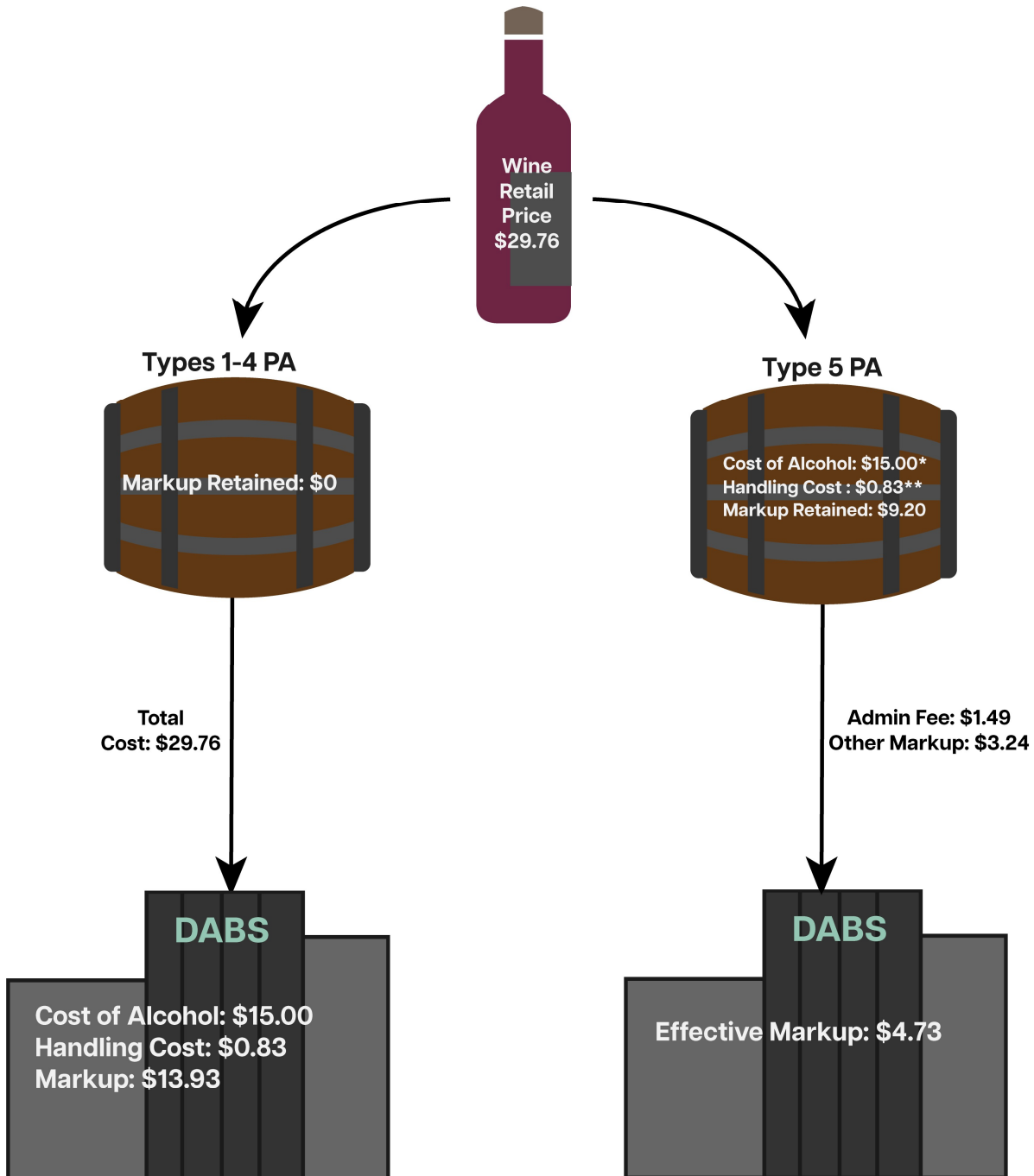
¹² UCA 63J-1-504(2)(b)

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Figure 2 illustrates how DABS charges the administrative fee for the sale of an example bottle of wine.

Figure 2 – DABS Only Charges an Administrative Fee to Type 5 PAs



* Type 5 PA cost of alcohol includes manufacturing profit. Costs are calculated as if product was sold to DABS.

** Liquor prices are required to include handling costs as if DABS shipped and stored the product. Because DABS does not incur handling costs, Type 5 PAs retain this revenue.

In this example, the total retail price is \$29.76. As shown on the left side of Figure 2, the Type 1 through 4 PA purchases the liquor from DABS for \$29.76 and sells it to the public at the same price. DABS does not charge the Type 1 through 4 PA an administrative fee. On the right side of Figure 2, the Type 5 PA manufactures a bottle of wine and sells it to the public at the DABS mandatory price of \$29.76. The Type 5 PA then remits funds to DABS that include the administrative fee of \$1.49, which is 5% of the total retail price of \$29.76.

Although Type 5 PAs contractually agree to pay this fee to DABS, any DABS fee should be properly established in accordance with statute.

DABS charged Type 5 PAs \$829,060 in administrative fees during fiscal year 2022.

Recommendations:

We recommend:

- **DABS either eliminate the administrative fee or ensure the fee has been properly established according to State statute.**
- **If DABS retains the administrative fee, it should consistently apply treatment of the administrative fee to PAs.**

Finding 5. DABS Does Not Consistently Collect All Statutorily Required Earmarks from Type 5 Package Agencies

DABS does not consistently collect all statutorily required earmarks from PA liquor sales. DABS is required by statute to set aside a portion of proceeds from liquor sales for the following statutory earmarks:

- Uniform School Fund (School Lunch): 10%¹³
- Public Safety: 0.875%¹⁴
- Underage Drinking Prevention: 0.6%¹⁵

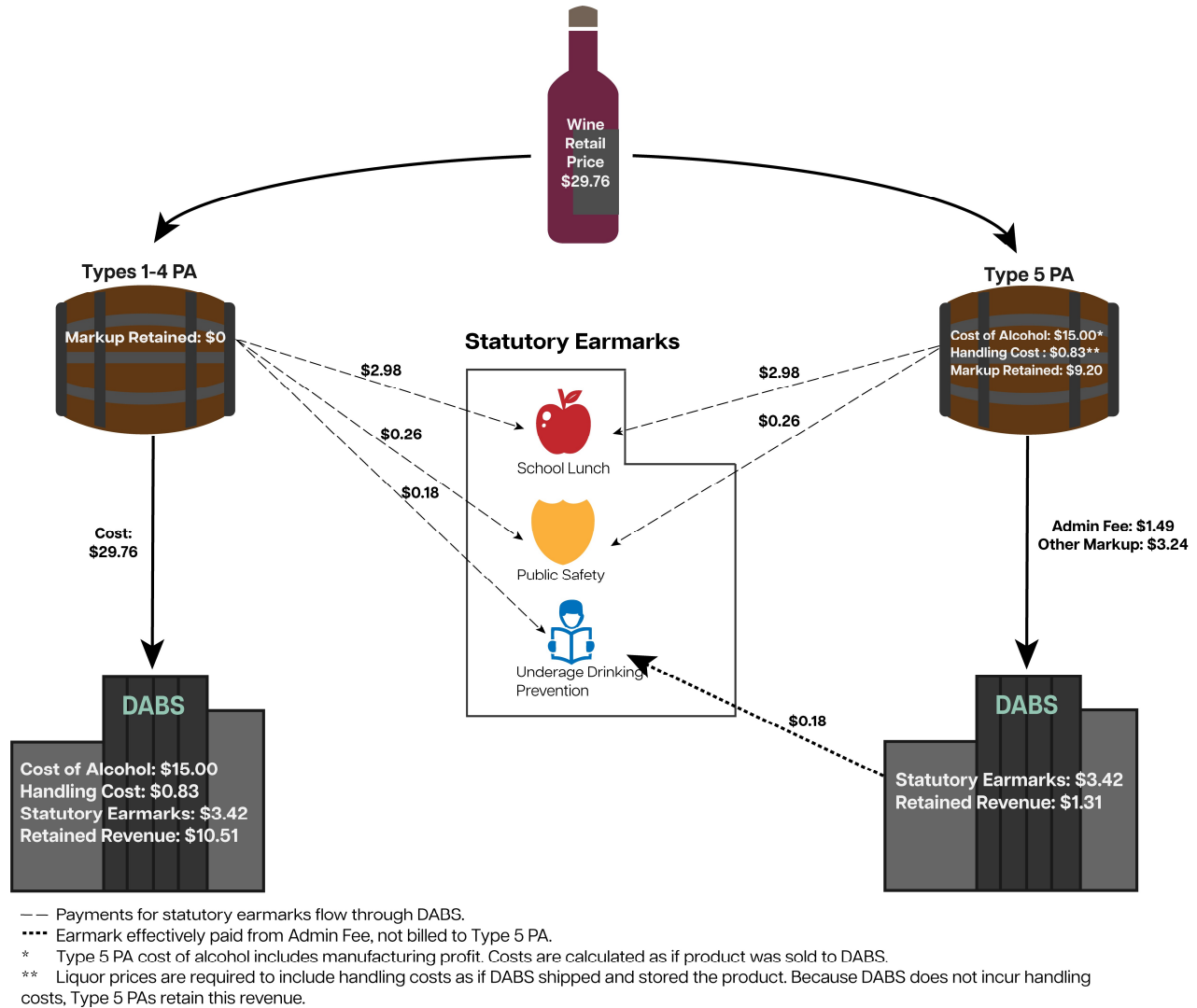
When Type 1 through 4 PAs purchase liquor from DABS, DABS pays these earmarks from statutory markups. However, DABS directly bills Type 5 PAs for the Uniform School Fund and Public Safety earmarks. But DABS does not directly bill Type 5 PAs for the Underage Drinking Prevention earmark, and instead effectively uses a portion of the Type 5 PA administrative fee to pay that earmark. Figure 3 shows how earmarks are paid from the sale of an example bottle of wine by Type 1 through 4 PAs compared with Type 5 PAs.

¹³ UCA 32B-2-304(5)

¹⁴ UCA 32B-2-305(4)

¹⁵ UCA 32B-2-306(3)

Figure 3 - DABS Inconsistently Handles Statutory Earmarks



In this example, the retail price is \$29.76. As shown on the left side of Figure 3, a Type 1 through 4 PA purchases a bottle of wine from DABS for \$29.76 and sells it to the public at the same price. DABS uses funds collected from the Type 1 through 4 PA to cover the \$15.00 cost of alcohol purchased from the supplier, the \$0.83 handling cost incurred, and pays \$3.42 for all three earmarks. Because DABS used markup funds collected from the Type 1 through 4 PA to pay the earmarks, it is essentially the Type 1 through 4 PA that is paying for the earmarks.

On the right side of Figure 3, a Type 5 PA manufactures a bottle of wine and sells it to the public at the DABS mandatory price of \$29.76. The Type 5 PA remits \$3.24 to DABS for the School Lunch and Public Safety earmarks. DABS acts as a pass through agent to use the funds to pay for these two earmarks. On the other hand, DABS uses a portion of the administrative fee to cover the remaining \$0.18 for the Underage Drinking Prevention earmark.

DABS does not have a justification as to why it does not require Type 5 PAs to pay the Underage Drinking Prevention earmark in the same manner as the other earmarks. DABS should consistently apply the statutory markup and pay each statutory earmark.

DABS is effectively going to use \$99,487 from administrative fees charged to Type 5 PAs to pay the Underage Drinking Prevention Earmark for fiscal year 2022 liquor sales in fiscal year 2024. This earmark is paid two fiscal years after liquor sales occur, unlike the other earmarks that are paid in the same fiscal year as when the liquor sales occur.¹⁶

Recommendations:

We recommend that DABS:

- **Ensure consistent handling of all statutory earmarks.¹⁷**
- **Consider recommending to the Legislature that they remove the delay between liquor sales and payment for the Underage Drinking Prevention earmark to be consistent with the other earmarks.**

Finding 6. DABS Does Not Issue Notices of Agency Action for Violations in a Timely Manner

The time DABS takes to review a violation and issue a formal Notice of Agency Action Letter (NOAA) increased significantly from last year. Issuing a NOAA formally allows DABS to take action to correct the violation. In our previous audit report,¹⁸ we recommended DABS reduce the time between initially notifying violators and issuing a NOAA. Last year, DABS took 11 business days to issue a NOAA. We recommended that the time could be reduced to within a week with improved processes. We reviewed 16 violations in the current year, and on average DABS took 27 business days to issue a NOAA. This is an increase of 145% from the previous year.

Issuing a NOAA is a key step in the violation resolution process and allows DABS and the Office of the Attorney General to begin working with the violator to take corrective action. DABS' inability to determine agency action in a timely manner limits its ability to correct violations in a timely manner.

Recommendation:

We recommend that DABS evaluate and improve the violation review process to increase efficiency and to decrease the time taken to issue a Notice of Agency Action.

¹⁷ Earmark payments would be included as part of the markup collected by DABS (see Finding #3).

¹⁸ Office of the State Auditor Report No.22-01, Finding #1, July 2022

Finding 7. DABS Allows Certain Package Agency Contracts to Exist in Perpetuity

Type 1, 4, and 5 PA contracts do not have set time limits. Once issued, these contracts may exist in perpetuity. Type 2 and 3 PA contracts, however, are limited to three years. Historically, PA contracts were not time-limited, but recently DABS set time limits for Type 2 and 3 PA contracts. Issuing contracts that are not time-limited is not a concern when the allowable number of contracts is unlimited. However, statute¹⁹ limits the total number of PA contracts that DABS can issue. While DABS has not hit this cap, when the limit is reached, qualified potential PAs could be denied contracts. Because there is a limited number of contracts, DABS should establish a periodic review process to ensure that the “best” providers receive contracts.

Recommendations:

We recommend that DABS:

- **Establish time limits for Package Agency contracts.**
- **Establish criteria to select Package Agencies when the number of Package Agency applicants exceeds available contracts.**

Finding 8. DABS’s Governance Structure Could Be Simplified

DABS is governed by a Commission that is appointed by, and reports to, the Governor.²⁰ The Commission has rulemaking authority²¹ and regulatory responsibilities, such as licensing. The Commission also oversees the DABS Executive Director²² and DABS operations. But the Executive Director is appointed by the Governor²³ and is a member of the Governor’s Cabinet. So the Executive Director reports directly to both the Governor and the Commission. This structure creates potential conflicts and redundancies in reporting, although in practice, the Commission does not regularly report to the Governor and defers to the Executive Director. Figure 4 is a visual representation of the current reporting structure.

¹⁹ UCA 32B-2-601(2)(a)

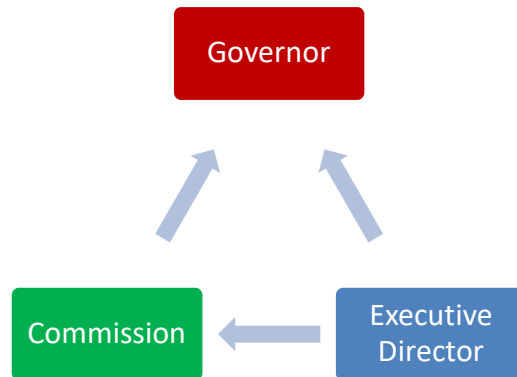
²⁰ UCA 32B-2-201(2)

²¹ UCA 32B-2-202(4)

²² UCA 32B-2-202(1)(k) & 32B-2-205(3)(c)

²³ UCA 32B-2-205(1)(a)

Figure 4 – DABS Reporting Structure



DABS’s governance structure has evolved over time. Historically, the Commission appointed the Executive Director, with the Governor’s consent.²⁴ Now, the Commission only nominates potential Executive Director candidates to the Governor.²⁵ This change gave the Governor more direct control over DABS, similar to control over most other State agencies. Of the 23 agencies represented in the Governor’s Cabinet, 19 are governed solely by an Executive Director.²⁶ A few other agencies have both a Commission and an Executive Director, such as the Utah State Tax Commission (USTC) and the Utah Department of Transportation (UDOT). USTC and UDOT have different reporting structures, however, they both have a clearly defined hierarchy and reporting chain, unlike DABS.

The USTC Executive Director directs day-to-day operations and reports directly to the Tax Commission. The Tax Commission provides oversight and the Tax Commission Chair reports to the Governor as a member of the Cabinet.

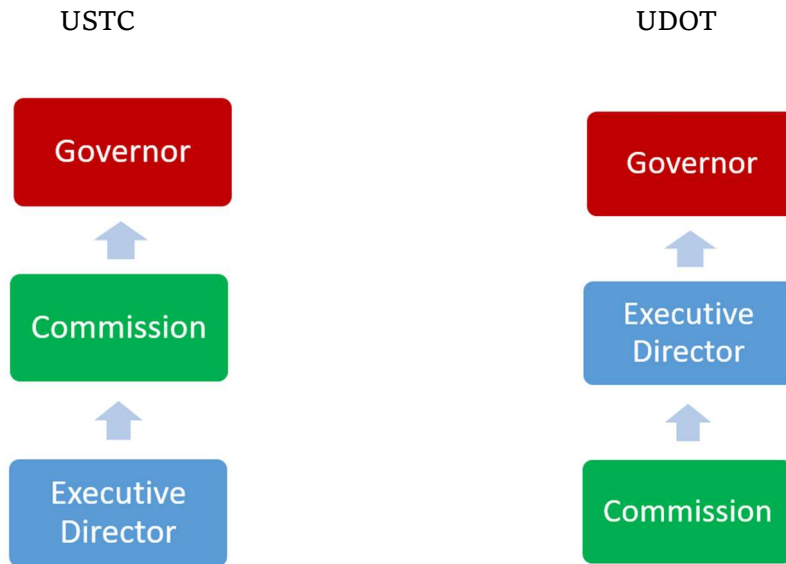
In contrast, the UDOT Executive Director oversees day-to-day operations and reports to the Governor. The Transportation Commission functions as a limited governing board, prioritizing projects. It also reviews UDOT’s rules, but does not approve those rules. Historically, UDOT’s structure was similar to USTC’s. The Executive Director reported to the Transportation Commission, which would then report to the Governor. Over time, that structure evolved into its current form. Figure 5 illustrates the reporting chain of USTC and UDOT.

²⁴ Senate Bill 314 in the 2011 General Session, line 1126

²⁵ UCA 32B-2-205(1)(b)

²⁶ Some agency Directors have different titles, but they function as an Executive Director, such as the Commissioner of the Department of Agriculture and Food and the Major General of the Utah National Guard.

Figure 5 – USTC and UDOT Reporting Structures



DABS is an outlier among State agencies. DABS appears to be on a similar evolutionary trajectory to UDOT, but has not fully realigned to have a clearly defined hierarchy and reporting chain.

In addition, according to statute,²⁷ the DABS Commission oversees both operational and regulatory matters, but because Commission members are part-time,²⁸ they have limited resources to fulfill all of their duties. It appears that the majority of Commission resources are currently devoted to regulatory aspects, rather than operational or financial matters.

If the DABS Commission's role was focused to regulatory and adjudicative matters, it should allow the Commission to better utilize its limited resources on its most critical responsibility. This realignment would also resolve potential reporting redundancies or conflicts.

Recommendations:

We recommend that the Governor consider making a recommendation to the Legislature to:

- Focus the Commission on regulatory and adjudicative matters,
- Remove the Commission's responsibility to oversee operations, and
- Establish a clearly defined hierarchy and reporting chain for DABS.

²⁷ UCA 32B-2-202

²⁸ UCA 32B-2-201(2)(a)

Finding 9. DABS Internal Inventory Analysis Does Not Fully Measure Operational Efficiency

Liquor warehoused by DABS consists of State owned inventory and bailment inventory. Bailment inventory is product stored at the DABS warehouse but is still owned by the vendor. When DABS purchases product from the bailment inventory, DABS removes the products from bailment and ships them to State liquor stores and PAs for sale. Ownership is transferred from the vendor to DABS when product is removed from bailment. Bailment constitutes approximately 65% of warehouse inventory.

DABS routinely analyzes inventory activity by calculating inventory turns. This common metric shows how often inventory turns over during a period of time and is used to measure efficiency. Higher inventory turns indicate greater efficiency. Inventory turns are calculated as follows:

$$\text{Inventory Turns} = \text{Cost of Goods Sold} / \text{Average Inventory for the Period}$$

DABS excludes bailment inventory from average inventory in its analysis since it does not own the product. As a result, the analysis only considers the time between when DABS purchases bailment inventory, and when DABS sells that inventory. DABS could store bailment in the warehouse for an extended period of time without ever impacting inventory turns. As long as DABS sells bailment inventory quickly after it purchases it, DABS appears hyperefficient, regardless of how long that product has actually been stored. If DABS sells bailment inventory to a PA, the purchase and sale occur essentially simultaneously. The product immediately becomes Cost of Goods Sold without ever being considered inventory and is essentially “infinitely” efficient.

DABS’s analysis focuses on financial efficiency because it considers the duration between when DABS expends funds to purchase a product and when that product generates revenue. However, because bailment constitutes such a significant portion of product stored by DABS, the analysis does not provide an accurate measure of operational efficiency. The result is that DABS operations appear more efficient than they are. To illustrate this point, DABS’s internal analysis shows DABS significantly outperforming its peers, including large publicly traded companies with massive economies of scale. However, if bailment is included in the analysis, DABS’s perceived efficiency drops significantly. The following is a comparison of DABS inventory turns with and without bailment inventory for fiscal year 2022.

Fiscal Year 2022 Inventory Turns Without Bailment: 10.0

Fiscal Year 2022 Inventory Turns Including Bailment: 4.8

DABS’s current analysis method does not fully capture inventory activity. DABS recently received approval and funding to expand its warehouse. Although accurate data may not have impacted the decision to expand the warehouse, it is crucial for decision makers to have complete data to ensure the best use of public funds.

Recommendation:

We recommend that DABS monitor operational efficiency and include bailment inventory as part of its inventory analysis metrics.

Finding 10. Limited Aspects of the Rare and High Demand Product Distribution Process Could Be Susceptible to Potential Favoritism

Various liquor control states, including Utah, have programs to distribute rare and high demand products (RHDP). These RHDP are highly sought after due to their limited availability. The RHDP distribution process in another state has recently come under scrutiny for favoritism because certain government officials were given preferential access to RHDP. Although we did not find any instances of actual favoritism in our review of Utah's DABS RHDP distribution process, limited aspects of DABS's process could be subject to favoritism.

DABS conducts drawings to distribute RHDP. For each drawing, DABS sets aside a safety stock to accommodate for breakage. If no breakage occurs, the safety stock items have historically been distributed to State liquor stores for sale to the public. Although the main drawing and distribution process did not appear to be susceptible to favoritism, DABS personnel were allowed to use their discretion to determine which stores received remaining safety stock items. DABS's policy is to limit the sale of these products to one per customer. However, DABS did not have a process to ensure that store managers followed these restrictions.

Although we did not note any instances of improper RHDP distribution, the ability of DABS personnel, including store managers, to use discretion in distributing the remaining safety stock items increases the risk of inequitable distribution. DABS indicates that it is currently working to change the process to allow for unused safety stock to be distributed in future drawings. However, we were unable to verify this prior to the completion of the audit.

Recommendation:

We recommend that DABS remove personnel discretion in the RHDP distribution process.

DABS's Response



State of Utah

SPENCER J. COX
Governor

DEIDRE M. HENDERSON
Lieutenant Governor



Department of
Alcoholic Beverage Services

TIFFANY CLASON
Executive Director

July 11, 2023

John Dougall
Utah State Auditor

Auditor Dougall:

I want to extend my gratitude to you and your staff for the care and diligence taken in auditing the Department of Alcoholic Beverage Services.

Enclosed is the DABS response to each finding and recommendation. We are working diligently to execute our mission with fidelity and provide the best service possible to every Utahn, whether they drink alcoholic beverages or not. Your findings and recommendations have given us much to reflect and act on and will help us continue to improve as an agency. For that, I thank you.

Finding 1: DABS Operations Are Not Accurately Recorded in the State's Accounting System

DABS Response:

The Department of Alcoholic Beverage Services agrees with this recommendation. The fiscal health and accuracy of financial reporting for the department is our continued administrative priority.

The Department of Alcohol Beverage Services (DABS) has coordinated with the Department of Government Operations (DGO) Division of Finance (State Finance) and Division of Technology Services (DTS) and identified the steps needed to accurately upload DABS financial data into FINET by fiscal year end close-out deadlines, which we anticipate to be on or before August 30, 2023. These steps include engaging a CPA firm to add additional resources as part of our finance team. DABS is also in the process of summarizing D365 data by month and manually entering the data into FINET. DABS, State Finance and DTS are working diligently together to ensure DABS financial data is accurately reflected in FINET, the state's general ledger.

Additionally, DABS and DTS have developed an interface system that will upload individual transactions from D365 to FINET and transactions initiated in FINET to D365.

This interface is currently being tested and should be deployed during fiscal year 2024. Until its deployment, DABS will continue to enter monthly summarized data into FINET using manual entries.

DABS requested the ABS Commission approve the 2024 internal audit plan which includes an audit of DABS financial systems and operations post-implementation. On June 29, 2023, the ABS Commission approved this plan.

DABS, like most state government departments, experienced significant turnover and loss of staff within key accounting and information technology positions during the implementation of D365- a four year project. DABS is implementing strategies to reduce turnover, while also developing contingency plans such as cross training and redundancies, to mitigate the impact of future turnover and limited resources.

Finding 2: Challenges in Implementation impaired DABS's ERP System Deployment

DABS Response:

The Department of Alcoholic Beverage Services agrees with this finding and we accept the audit team's recommendations.

Complicated IT system implementation is complex and challenging. The department continues to learn from past issues to improve coordination and communication, understanding the important impacts that these systems have on department operations and reporting systems.

Many aspects of the implementation were successful, such as: DABS processes for managing product receiving, distribution of product, order picking, warehouse receiving, shipping orders, and order fulfillment. These and other crucial processes all allowed the department to keep working with minimal interruption to our many stakeholders. The department is working diligently to overcome outstanding issues quickly and effectively.

The Department of Alcohol Beverage Services (DABS) is working with the Department of Government Operations (DGO) Division of Finance (State Finance) and Division of Technology Services (DTS) to ensure systems are successfully tested prior to deployment going forward. DTS has worked with DABS and recently rolled out the Scaled Agile Framework (SAFe) methodology which includes formal planning meetings with DABS and other agencies on a quarterly basis. As part of this methodology, the quarterly planning meetings include an explicit discussion of risks and dependencies, including dependencies on other organizations or systems. These formal planning meetings are designed to improve communication among the members of the development team, communication between business leaders and the development team, and communication across agencies where dependencies cross agency lines.

DABS, like most state government departments, experienced significant turnover and loss of staff within key accounting and information technology positions during the implementation of D365. DABS will implement strategies to reduce turnover, while also developing contingency plans such as cross training and redundancies, to mitigate the impact of future turnover and limited resources.

Finding 3: DABS Does Not Collect the Entire Statutorily Required Markups from Type 5 Package Agencies

DABS Response:

The Department of Alcoholic Beverage Services accepts this finding. This is a long-standing practice, in place for decades, as an effort to support entrepreneurs and business owners who locally manufacture and sell alcoholic beverage products. It results in the DABS not collecting statutory markups from Type 5 PAs. Given the financial impact this will have on Utah entrepreneurs and business owners, the DABS will immediately collaborate with the appropriate state budget offices [Governor's Office of Planning and Budget (GOPB) and Legislative Financial Analyst (LFA)] as well as legislative leads in the alcohol policy space, and stakeholders who are impacted by this issue to consider next steps.

Finding 4: DABS Charged Type 5 Package Agencies An Administrative Fee Not Established According to Statute

DABS Response:

The Department of Alcoholic Beverage Services accepts this finding. This is a long-standing practice that predates the current administration. Given the financial impact this will have on the state's budgeting projections, the DABS will immediately collaborate with the appropriate state budget offices [Governor's Office of Planning and Budget (GOPB) and Legislative Financial Analyst (LFA)] as well as legislative leads in the alcohol policy space, and stakeholders who are impacted by this issue to consider next steps.

Finding 5: DABS Does Not Consistently Collect All Statutorily Required Earmarks from Type 5 Package Agencies

DABS Response:

The Department of Alcoholic Beverage Services accepts this recommendation and will explore legislative options with policy makers which could include a possible permit process for certain PAs.

Finding 6: DABS Does Not Issue Notices of Agency Action for Violations in a Timely Manner

DABS Response:

The Department of Alcoholic Beverage Services accepts this finding and the recommendations. The DABS understands the importance of processing and tracking violations as a fundamental part of preserving public safety. After creating and staffing a violations program last year, it became apparent that the program required additional staffing. Recently, DABS Licensing & Compliance Division leadership has reallocated resources to support tracking and NOAA issuance and will continue to monitor the need for additional FTEs for productivity support. Several factors have contributed to NOAA issuance over the course of the last year, including changes in attorney general staffing, changes to the agency ERP system, and re-timing the implementation of the new software system partially intended to streamline violations processes. The DABS intends to improve on the average timeline for NOAA issuances by evaluating compliance processes, managing partnership with the attorney general's office, and monitoring the recent implementation of the new software system and its impact on violations tracking and NOAA issuances.

It is important to note that Utah Code Section 32B-3-203 allows the DABS to, under certain circumstances, initiate a disciplinary proceeding after a final adjudication of criminal liability or a final adjudication of civil liability under Utah Code 32B, Chapter 15, Alcoholic Product Liability Act, both of which can take a substantial period of time to play out. The DABS intends to work with national partners to better define an appropriate metric for measuring timelines for NOAA issuances, with a focus on balancing nuanced cases that may take more time with the need to preserve public safety and licensee due process.

Finding 7: DABS Allows Certain Package Agency Contracts to Exist in Perpetuity

DABS Response:

The Department of Alcoholic Beverage Services accepts this finding. Over the past five years, an organized effort has been in place to improve operations with all package agencies. We recognize that all package agency types are different and should be considered for their unique qualities and purposes. One solution that is an alternative to the recommendations above could be for legislators to consider converting Type 1, 4, and 5 PAs to a permit system. The DABS will explore various options with policy makers and stakeholders to determine the most appropriate path forward.

Finding 8: DABS's Governance Structure Could Be Simplified

DABS Response:

The Department of Alcoholic Beverage Services agrees with this finding. Given that these recommendations require extensive legislative changes to the Alcoholic Beverage Control Act, we will work collaboratively with the Governor's office and legislators to consider whether making these adjustments is the desired path forward.

Finding 9: DABS Internal Inventory Analysis Does Not Fully Measure Operational Efficiency

DABS Response:

The Department of Alcoholic Beverage Services agrees to continue to monitor operational efficiency; the DABS will include bailment inventory as an additional inventory analysis metric but it will not replace the current inventory analysis metric.

Bailment is a standard retail and warehouse arrangement used in the private sector. Utah DABS is regularly complimented by its peers in this space for its effective use of bailment and warehouse efficiency. The DABS leverages its bailment arrangement to the fiscal benefit of the state of Utah and its taxpayers. By efficiently leveraging bailment, the department creates a purchase order for the product on the day that it leaves the warehouse to be shipped to a store and then pays the purchase order a few weeks later, usually after the department has already sold the product. The current warehouse inventory turn metric reflects that fiscal efficiency, not at the detriment of a capacity efficiency statistic.

The DABS provided comprehensive data to policy makers over the multiple years this project was studied and discussed in numerous public meetings and committees. The DABS goes to great lengths to collect and analyze data, then present the data with integrity to all partners and stakeholders. The warehouse is the backbone of our operation and delivery of service to the citizens and hospitality businesses that depend on it and the warehouse analysis was completed and presented thoroughly and thoughtfully.

Additional information and planned benefits that were provided to decision makers and in numerous focus groups and stakeholders meetings included: the ability for the department to carry additional, increased number of skus, setting the foundation for licensee delivery (a long sought after service by the licensee community and which also provides an in-store replenishment efficiency for our retail store operations), the ability to provide split casing to the public and licensees (another long sought after service).

What is Bailment?

A bailment agreement is created for the sole benefit of the bailee when both parties agree the property temporarily in the bailee's custody is to be used to his or her own advantage

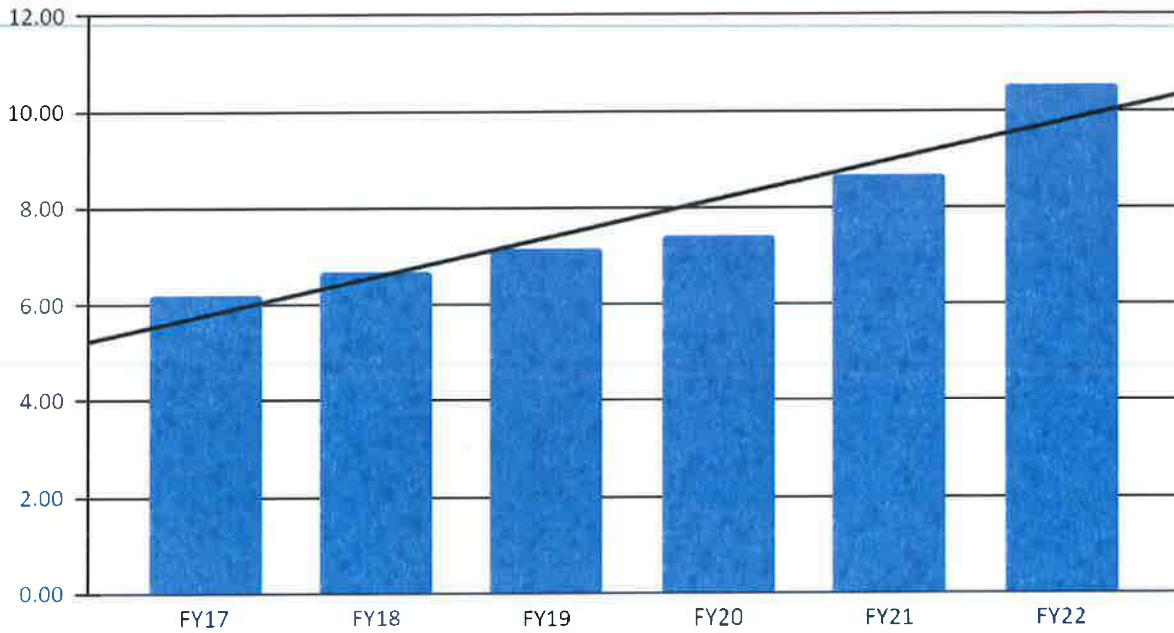
without giving anything to the bailor in return. As an example; the loan of a book from a library is a bailment agreement for the sole benefit of the bailee.

What benefits come from a bailment system?

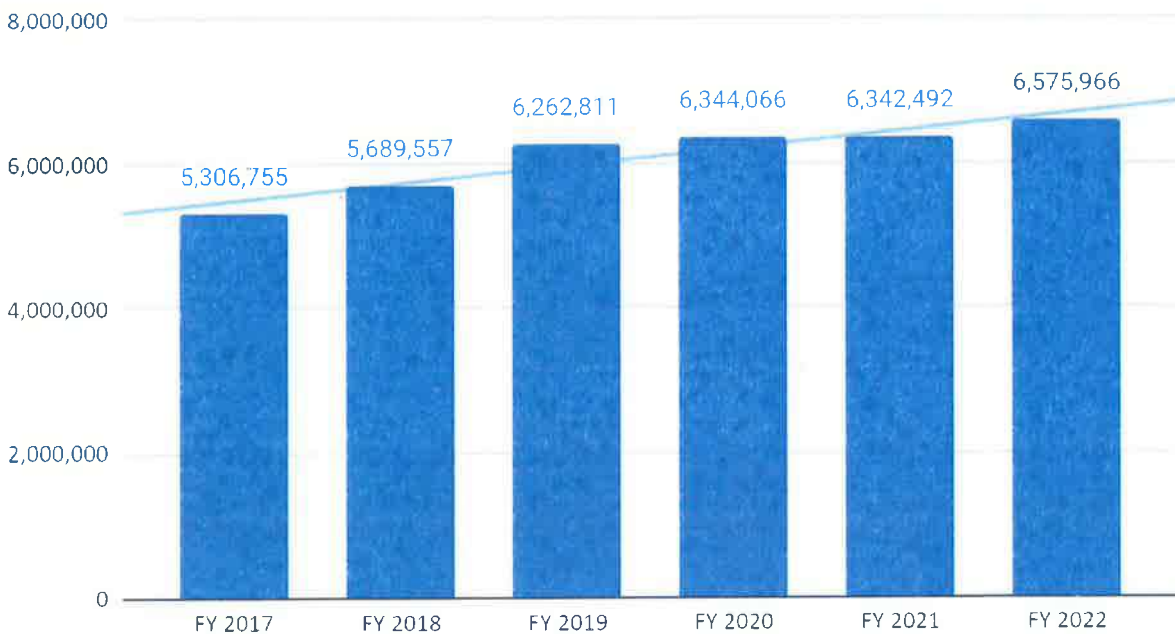
1. **Convenient distribution:** DABS operating as the bailee is responsible for distributing the goods, a bailment system can provide a seamless process. Once the bailor sells the goods (this happens on the day the goods leave the warehouse), the bailee (DABS) ship them directly to our retail outlets, eliminating the need to wait for ordering, handling and receiving costs.
2. **Low investment:** DABS operating as the bailee only pays for the bailment goods when a need occurs and the PO is generated on the day of distribution. Shipment occurs the following day and the goods are on the shelf the next day. Potentially, DABS sells the original bailment product (Cost + Profit) before payment of bailment P.O. is required. Resulting in little to no upfront investment by the State.
3. **Top selling items qualify for bailment:** All high-demand and fast-moving products are critical and must never run out of stock, the bailment program allows for the DABS and its partners to ensure low out of stocks. : Inventory items that have consistently high demand and rapid turnover are less likely to go out of stock when they are involved in the bailment program. These may include popular everyday items, fast-selling popular items, or trending products that experience frequent replenishment.
4. **Longer shelf life:** Products that have a longer shelf life and can be stored for extended periods without deterioration or obsolescence are good for bailment agreements. Non-perishable food items, durable goods, and items with a long expiration date fall into this category. Most of the DABS products have long shelf lives.
5. **Strong relationships:** Building strong relationships with reliable suppliers and establishing agreements for consistent inventory replenishment can help mitigate the risk of out-of-stock situations. Having preferential treatment, priority access, or dedicated production capacity from suppliers can ensure a steady supply of inventory items.
6. **Expertise in alcohol storage and compliance:** The bailee in an alcohol bailment system is typically experienced and knowledgeable about storing alcohol products. They understand the specific requirements for handling and storing alcohol, such as temperature control, proper ventilation, and compliance with regulatory standards.
7. **Financial benefit** - Investment buy programs allow the state to buy bailment products at reduced markup at select times throughout the year.

The below 2 graphs capture a compelling story of increased demand placed on the single point of failure warehouse of the DABS.

DABS FY Warehouse Turns



DABS Total Cases Received and Shipped



The fact that the current warehouse was completed 17 years ago and the growing demand placed on it indicates that the current warehouse may no longer be sufficient, regardless of how you choose to calculate warehouse turns. In six years time the

department has almost doubled its warehouse turns (FY 2017 to FY 2023 as shown in the graph above). If this trend increases, then whether you measure capacity with bailment or without bailment, the state still needs to take precautions for meeting customer demand given it is the state's only purveyor of these products.

At the time of this audit the Department will not have a completed warehouse for another three years. The strain this places on current capacity and operations creates a single point of failure, meaning that if nothing is done then the warehouse reaches its maximum capacity and the DABS might be unable to fulfill its core mission effectively. To address this issue, it has become necessary for the DABS to consider expanding its warehouse capacity or exploring alternative solutions to mitigate the risk of operational disruptions. By investing in a larger and more efficient warehouse, the DABS can ensure that it can handle the increasing demand and maintain its ability to fulfill its core mission.

It was important for the DABS and its support partners to carefully assess the current and projected demand, conduct a cost-benefit analysis, create a strong feasibility study and consider potential funding sources before making decisions about expanding or improving its warehouse infrastructure. This helps the State of Utah ensure that any investment aligns with the state's goals and provides long-term operational resilience.

Finding 10: Limited Aspects of the Rare and High Demand Product Distribution Process Could Be Susceptible to Potential Favoritism


DABS Response:

The Department of Alcoholic Beverage Services accepts this finding.

The DABS agrees that it wants to eliminate any aspect of the RHDP program that could compromise, either in reality or by perception, the integrity of the process. The DABS will work to further refine its processes and drawing policies with this in mind.

Please let me know if you have any questions or concerns about the department's proposed course of action in response to the audit.

Sincerely,


[Tiffany Clason \(Jul 12, 2023 10:24 EDT\)](#)

Tiffany Clason
Executive Director
Utah Department of Alcoholic Beverage Services

cc: Cade Meier, Deputy Director
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