



State of Arizona Office of the Auditor General

PERFORMANCE AUDIT

**ARIZONA
DEPARTMENT OF
LIQUOR LICENSES
AND CONTROL**

**Report to the Arizona Legislature
By Douglas R. Norton
Auditor General
November 1998
Report Number 98-20**



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AUDITOR GENERAL

**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

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November 12, 1998

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Mr. Howard Adams, Director
Arizona Department of Liquor Licenses and Control

Mr. Bill Snyder, Chairman
Arizona State Liquor Board

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona Department of Liquor Licenses and Control. This report is in response to a May 27, 1997, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2959.

The report addresses the Department's effectiveness in regulating the manufacturing and sale of liquor in the State. While the Department has undertaken several activities to enhance its regulatory efforts, additional improvements are needed. First, we found that the Department inconsistently issues penalties for liquor law violations and does not always take appropriate action against licensees who repeatedly break the law. By formalizing its policies and procedures governing its enforcement practices and documenting circumstances that influence penalties, the Department can appropriately and consistently discipline licensees who commit liquor law violations.

We also found that the Department can improve its processing of liquor license applications and oversight of liquor license renewals. For example, the Department did not comply with statutorily required time frames for allowing public and city comment

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on liquor license applications and did not fully document required application information for 36 percent of the applications reviewed. Additionally, while hundreds of licensees fail to renew their liquor licenses on time, the Department does not ensure that these licensees cease liquor sales until renewing their licenses. Although Arizona law prohibits the sale of liquor on an expired license, 10 out of 24 licensees were observed selling liquor after their license had expired.

Finally the Department lacks adequate policies and procedures to safeguard the over \$4 million in fine and fee receipts that it receives annually.

In addition to the findings and recommendations presented in this report, this audit presents additional information on the status of quota liquor licenses (bar, beer and wine bar, and liquor store licenses) in the State and the trend toward greater community involvement in the licensing and regulation of liquor establishments.

As outlined in its response, the Department of Liquor Licenses and Control agrees with all the findings and recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on November 13, 1998.

Sincerely,

A handwritten signature in dark ink, appearing to read "Douglas R. Norton", written in a cursive style.

Douglas R. Norton
Auditor General

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Liquor Licenses and Control pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The Arizona Department of Liquor Licenses and Control (Department) consists of the Office of Director of the Department and the Arizona State Liquor Board (Board). The Board consists of seven members appointed by the Governor to three-year terms and performs duties such as granting or denying liquor license applications that have been referred to the Board due to city or county, public citizen, or Department protest. The Department of Liquor Licenses and Control is headed by a Governor-appointed director and is charged with licensing and regulating the manufacturing and sale of liquor in the State.

Recently, the Department has undertaken several activities to improve its regulation of the manufacturing and sale of liquor in the State. For example, the Department maintains a paperless work environment and relies entirely on its automated information system to retain documents and store and retrieve information. Additionally, both the Department and Board have become more responsive to communities by meeting and working with concerned citizens. Finally, the Department quickly reviews and evaluates complaints alleging violations of state liquor law, and it conducted an employee opinion survey that revealed a high degree of employee satisfaction within the Department.

Department Inconsistently Enforces Liquor Law Violations (See pages 11 through 19)

The Department inconsistently issues penalties for liquor law violations. While the Department adopted internal penalty guidelines in response to a 1988 Auditor General report, it deviated from these guidelines in approximately two-thirds of the cases auditors reviewed. As a result, the Department creates the potential for inequitable treatment of licensees. For example, the Department fined a convenience store \$1,500 for various violations involving selling alcohol to a minor, but fined another market \$3,500 for the same violations despite both licensees having a similar history of liquor offenses. The Department also fails to record why it fines some licensees differently than others for similar violations, or why its fines deviate from its guidelines. Therefore, the Department should develop a substantive policy statement to formally establish its penalty guidelines and at the same time consistently document factors, such as previous violations and other aggravating or mitigating circumstances, that influence a licensee's penalties.

Additionally, while most of the Department's 8,800 licensees operate without violating state liquor laws, the Department does not always take appropriate action against licensees who repeatedly break the law. Currently, the Department only escalates its penalties if it charges a licensee with the same violation. It does not consider prior, closely related violations. For example, even though there are five violations relating to alcohol sales to minors, the Department will only escalate a penalty if the licensee again commits the exact same violation—even if the licensee had other, prior minor-related liquor law violations. If the Department grouped together similar violations (such as the five minor-related liquor law violations) when determining penalties, it may have increased the disciplinary actions taken against 21 of 58 licensees reviewed. In addition, the Department does not adequately record when it combines separate violations into one penalty, an action that may not disclose a licensee's true violation record, and it does not consider violation records of other licenses held by the same owner.

Finally, due to a lack of formal procedures, the Department also allows some repeat offenders to take advantage of a program designed for first-time offenses. Specifically, the Department offers first-time, minor liquor law violators the option of admitting responsibility and paying their fine through the mail in exchange for a reduced penalty amount. However, the Department issued 27 reduced-penalty tickets to licensees who previously committed the same offense or had already participated in the program, and issued 158 of these tickets for violations involving alcohol sales to minors, offenses considered serious by the Department and the Legislature. Therefore, the Department should develop a written policy defining which licensees can participate in the mail-in ticket program and consider requiring training as a condition for receiving a discounted penalty.

Department Does Not Follow Procedures When Processing Some Liquor License Applications (See pages 21 through 25)

For 36 percent of the liquor licenses reviewed, the Department failed to follow Arizona law and established internal procedures for processing liquor license applications. For example, in 1997, the Department issued and/or approved 3 of 91 liquor license applications reviewed before the expiration of a statutorily required 15-day period reserved for citizen protest. Additionally, if local governments do not submit a recommendation on a liquor license application within 60 days, statute requires that the Department forward the application to the Board for consideration. However, for 14 percent of the liquor license applications reviewed, the Department inappropriately granted licenses without forwarding the application to the Board even though the city or county recommendation on the license was not received within 60 days. Finally, the Department accepted incomplete or incorrect forms or failed to collect the required legal documents or information for several applications.

Because cities report that it can be difficult to always forward liquor license application recommendations within 60 days, the Legislature should consider two amendments to A.R.S. §4-201(E). First, the Legislature should consider giving the Department the authority to extend the 60-day local government comment period an additional 30 days upon receipt of a written request. Second, the Legislature should consider adding language to this statute that would deem a liquor license application approved by the local governing body if the Department does not receive a recommendation or a written request for a time extension within 60 days.

Finally, to address the other processing errors found, the Department should develop a policies and procedures manual and institute a supervisory review of license applications.

Numerous Licensees Fail to Renew Licenses on Time (See pages 27 through 30)

The Department should take steps to ensure licensees renew their licenses prior to expiration and do not continue to sell liquor on expired liquor licenses. Currently, hundreds of licensees do not renew their licenses before they expire. Eight percent of over 4,000 licensees who renewed their licenses between June 1997 and May 1998 did so after their license expired. Additionally, auditors observed 10 out of 24 licensees selling liquor on expired licenses in April 1998. The current \$150 late penalty does not effectively deter licensees from renewing late, and a survey of other states reveals that some employ more stringent late penalties. Therefore, the Legislature should consider increasing the current late renewal penalty fee to provide a greater incentive for timely renewal. Further, the Department should notify licensees that they are prohibited from selling liquor when their licenses expire and inspect establishments to ensure alcohol is not being served.

The Department Does Not Adequately Safeguard Licensee Fees and Fines (See pages 31 through 35)

The Department can help prevent the loss or theft of state monies by making a number of changes to its cash-handling policies. Currently, the Department processes over 13,000 liquor license fee and fine payments each year, primarily in the form of checks and money orders. To better protect these monies, the Department should immediately endorse checks and money orders, storing them in a secure place while using a receipt for processing. Further, to help track these monies the Department should regularly reconcile the monies it receives to its deposits. Additionally, the Department should cease using inter-agency mail to transport checks and money orders to Phoenix by establishing a depository account for monies received at the Tucson office. Finally, to ensure consistency, the Department should

record these policies and procedures, and periodically request a procedural review from the State's General Accounting Office.

Other Pertinent Information (See pages 37 through 42)

During the audit, other pertinent information was collected regarding the policies and practices for issuing quota liquor licenses in Arizona. Statute establishes a quota on the number of bar, beer and wine bar, and liquor store licenses that can be issued in each county. While the Department has not issued new quota liquor licenses since fiscal year 1987-88, population growth in 12 of the State's 15 counties meets statutory requirements for additional licenses. However, any issuance of new quota liquor licenses could face stiff opposition and the Department Director has indicated he would need agreement from local government and the industry before considering the issuance of new licenses in any area of the State.

Other pertinent information was also collected regarding community involvement in the liquor licensing and regulation process. Nationally, and within the State, communities are becoming more involved in the licensing and regulation of liquor establishments within their communities and neighborhoods. Currently, local governing bodies and citizens have the opportunity to protest liquor license applications, triggering a hearing before the State Liquor Board. In addition, recent legislation has expanded the role of communities and the public in this process by making it more difficult for the Board to overturn some local governing body protests and establishing a Departmental unit that responds to complaints from communities. While the Department and the Board have been criticized in the past for being unresponsive to the community, recent efforts by the Board and the Department suggest improved responsiveness to community concerns.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Liquor Licenses and Control pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

Liquor Regulation in Arizona

The regulation of liquor in Arizona precedes statehood. The 1864 Howell Code assessed liquor taxes on vendors of wines and distilled spirits and represented Arizona's first liquor regulations. However, Congressional passage of the Volstead Act in 1919 enacted a national Prohibition and eliminated the need for liquor regulation. With the repeal of the Volstead Act and the end of Prohibition in 1933, the 21st amendment to the United States Constitution gave individual states the right to choose their own system for regulating alcoholic beverages. Arizona placed the responsibility for liquor regulation within the Temperance Enforcement Commission under the State Tax Commission until 1939, at which time the Arizona Legislature established the Department of Liquor Licenses and Control. The Legislature added a three-member State Liquor Board in 1967, later increasing the number of Board members to seven.

While the regulation of liquor sales and manufacturing varies across the nation, states employ two basic regulatory approaches: licensure and/or control. States that use a control approach to regulation actually control part or all of the liquor distribution process, either through wholesale or retail sales of liquor. For example, Utah and Alabama actually own and operate retail liquor stores, while Michigan orders and buys spirits (hard liquor) from suppliers for sale to its retail licensees, but allows private wholesalers to supply retailers with beer and wine. In contrast to the control approach, Arizona licenses every manufacturer, wholesaler or supplier, and retailer of alcoholic beverages who does business in the State.

Department and Board Organization and Staffing

Although established by statute as a single state agency, the Arizona Department of Liquor Licenses and Control consists of two separate operating agencies: the Office of Director of the Department and the Arizona State Liquor Board (Board). The Board consists of seven members appointed by the Governor to three-year terms, with one mem-

ber representing the liquor industry, another member representing neighborhood associations, and five at-large members with no ties to the liquor industry. Currently, the Board meets once a month for up to two days to carry out its various responsibilities, which include granting or denying liquor license applications that have been referred to the Board due to city or county, public citizen, or Department protest; adopting rules to carry out the provisions of Title IV (the state liquor code); and holding hearings.

The Department of Liquor Licenses and Control (Department) is headed by a Governor-appointed director. The Department, which provides a staff person and some clerical assistance to the Board, has 50 staff, consisting of 44 FTEs funded through General Fund appropriations and 6 FTEs funded by annual surcharges assessed to licensees. The Department has organized these personnel into three divisions to fulfill its statutory responsibilities for regulating the manufacturing and sale of liquor:

- **Administration Division (17.5 FTEs)**—In addition to its accounting, budgeting, purchasing, and personnel responsibilities, staff in this division maintain and operate the Department's computer system as well as ensure that licensees comply with sanctions imposed for liquor law violations. Currently, the Department maintains a paperless work environment and relies entirely on its automated information system, which includes an imaging system, to retain documents and store and retrieve information. The Department also maintains three computer terminals for public access to license and compliance information and documentation.

The Compliance section within the division takes disciplinary action against licensees for violations of liquor law. Potential actions include warnings, consent agreements that might include fines and/or license suspension, or referral to a full administrative hearing, which may result in license revocation. In many cases, the Department will attempt to hold an informal compliance meeting with licensees to discuss the violation and determine an appropriate course of action that will be included in a consent agreement. For fiscal year 1997-98, the Department issued 119 warning letters, collected 643 fines, suspended 43 licenses, and revoked 6 others. The Department also forwarded 72 cases to administrative hearings, which could result in any of the above actions.

- **Investigations Division (23 FTEs)**—The investigative staff consist of certified peace officers and two restaurant auditors who investigate violations of liquor law committed by licensees or license applicants. The Department maintains investigative staff in Phoenix, Tucson, Flagstaff, and Lake Havasu City to investigate any matter involving liquor law. Additionally, the division performs background checks on all liquor license applicants, provides training and assistance to local law enforcement agencies regarding liquor regulations, conducts routine license inspections, conducts audits of restaurant licensees to ensure they generate at least 40 percent of revenue from food sales, and participates with other law enforcement agen-

cies on joint covert or sting operations. In fiscal year 1997-98, the Department reports that it received 668 complaints, opened and completed over 1,000 investigations, and conducted 2,707 license inspections and 28 restaurant audits.

In addition to these investigative and audit duties, statute also requires the Department to respond in writing to any law enforcement agency that submits an investigative report to the Department relating to a liquor law violation. The Department receives over 3,000 police reports each year and must inform the referring law enforcement agency what action it intends to take on the report or, if the report lacks sufficient information, what the law enforcement agency must do to remedy the report.

- **Licensing Division (9.5 FTEs)**—The licensing division processes all manufacturing, supply/wholesale, and retail license applications the Department receives. As illustrated in Table 1 (see page 4), the Department offers 16 different types of liquor licenses. With the exception of quota licenses, which consist of bar, beer and wine bar, and liquor store licenses, the Department can accept and process an unlimited number of applications for new liquor licenses. However, statute limits the number of quota liquor licenses in the State to prevent their proliferation. Also, the Division will not issue new quota liquor licenses unless it determines that they meet the public's need and convenience. The Department has not issued new quota liquor licenses since 1988. Therefore, quota liquor licenses currently must be purchased from private parties, after which the buyer must receive approval from the Department through the license application process before the purchased license can be used. During fiscal year 1997-98, the Department reports that it issued 1,608 new liquor licenses, including 508 transferred quota liquor licenses, and renewed 8,647 liquor licenses. (See Finding II, pages 21 through 25 for additional information about the Department's processing of liquor license applications; and Other Pertinent Information, pages 37 through 42 for additional information about quota liquor licenses.)

The Department has performed some self-evaluation of its activities. The Department formed a volunteer employee committee to assess employee satisfaction with and public attitudes toward the Department. This committee conducted an employee opinion survey that revealed a high degree of employee satisfaction within the Department. Additionally, the committee plans to develop a customer survey that will inquire about neighborhood, police department, and liquor industry attitudes toward the Department.

Budget

While the Department has generated over \$3.5 million annually in fee and fine revenue for the past three fiscal years, it relies on legislative appropriations to fund agency op-

erations. As shown in Table 2 (see page 5), the Department generated approximately \$3.9 million and \$4 million in revenues in fiscal years 1996-97 and 1997-98, respectively, but remitted most of these revenues to the State General Fund. The Department retains only the \$25 and \$20 annual surcharges assessed licensees to pay for additional investigators and restaurant auditors.¹ In fiscal years 1996-97 and 1997-98, these surcharges generated \$295,550 and \$304,580, respectively.

Table 1
Department of Liquor Licenses and Control
Active Liquor Licenses Issued
At July 1, 1998
(Unaudited)

License Type	Active Licenses	Annual Renewal Fee
Restaurant	1,973	\$500
Beer and wine store	1,770	50
Bar ¹	1,477	150
Liquor store ¹	1,378	50
Beer and wine bar ¹	1,061	75
Out-of-state producer	516	50
Club	301	150
Hotel/motel	152	500
Wholesaler	66	225
Government	50	100
In-state producer	26	350
Conveyance	22	250
Domestic farm winery	12	100
Domestic microbrewery	<u>11</u>	300
Total active licenses	<u>8,815</u> ²	

¹ The number of these licenses, commonly referred to as quota liquor licenses, is restricted by statute.

² The number of active licenses does not include temporary special event or wine festival licenses issued by the Department. Statute permits qualifying organizations to apply for and receive a special event license to sell liquor for no more than 10 days in a calendar year. During fiscal year 1997-98, the Department issued 1,478 special event licenses. Further, statutes allow the Department to issue up to 12 wine festival licenses a year for each of the 12 domestic farm wineries licensed in the State.

Source: Department of Liquor Licenses and Control liquor license count as of July 1, 1998, and Arizona Revised Statutes §4-209.

¹ The \$20 surcharge pays for the Department's two restaurant auditors and is only assessed on bar, beer and wine bar, and restaurant licensees. The \$25 surcharge is assessed on all licensees.

Table 2
Department of Liquor Licenses and Control
Statement of Revenues, Expenditures, and Other Changes in Fund Balance
Years Ended June 30, 1996, 1997, and 1998
(Unaudited)

	1996	1997	1998
Revenues:			
State General Fund appropriations	\$2,653,300	\$2,530,000	\$2,728,600
Licenses and fees ¹	3,114,445	3,286,776	3,434,164
Fines and forfeits	401,309	630,925	565,650
Federal grants and reimbursements	100,173		
Sales and charges for services	17,174	14,913	9,638
Other	6,076	7,145	212
Total revenues	<u>6,292,477</u>	<u>6,469,759</u>	<u>6,738,264</u>
Expenditures: ²			
Personal services	1,248,135	1,268,012	1,433,993
Employee related	378,440	346,603	375,278
Professional and outside services	350,957	78,902	45,754
Travel, in-state	115,094	118,768	118,786
Travel, out-of-state		182	1,326
Other operating ³	1,133,687	1,054,473	1,050,808
Capital outlay	94,379	62,596	6,444
Total expenditures	<u>3,320,692</u>	<u>2,929,536</u>	<u>3,032,389</u>
Excess of revenues over expenditures	<u>2,971,785</u>	<u>3,540,223</u>	<u>3,705,875</u>
Other financing uses:			
Reversions to the State General Fund	10,725	14,357	7,581
Remittances to the State General Fund	3,228,840	3,639,370 ⁴	3,705,676
Total other financing uses	<u>3,239,565</u>	<u>3,653,727</u>	<u>3,713,257</u>
Excess of revenues under expenditures and other uses	(267,780)	(113,504)	(7,382)
Fund balance, beginning of year	<u>580,162</u>	<u>312,382</u>	<u>198,878</u>
Fund balance, end of year	<u>\$ 312,382</u>	<u>\$ 198,878</u>	<u>\$ 191,496</u>

¹ Excludes amounts collected on behalf of counties and other state agencies. For fiscal years 1996, 1997, and 1998, the Department collected and distributed license fees of approximately \$408,800, \$468,900, and \$450,100, respectively, to counties, the Department of Health Services, and the Department of Economic Security, Division of Developmental Disabilities. The amount collected includes surcharges collected for the audit and enforcement functions. For fiscal years 1996, 1997, and 1998, the Department assessed surcharge fees of \$281,570, \$295,550 and \$304,580, respectively, for these audit and enforcement functions.

² Includes immaterial administrative adjustments from each of the prior years.

³ Includes in each fiscal year approximately \$543,200 that was used to make loan payments on the Department's automated file and retrieval system.

⁴ Includes approximately \$1.9 million of revenue that should have been remitted to the State General Fund in fiscal year 1997, but was inadvertently recorded in the wrong fund and not remitted until fiscal year 1998.

Source: The Uniform Statewide Accounting System *Revenues and Expenditures by Fund, Program, Organization, and Object and Trial Balance by Fund* reports, the *State of Arizona Appropriations Report*, and the Department of Liquor Licenses and Control *Annual Report* for the years ended June 30, 1996, 1997, and 1998.

1988 Report and Follow-up

As part of the current audit, concerns identified in the Auditor General's 1988 performance audit of the Department of Liquor Licenses and Control (Auditor General Report No. 88-9) were reviewed. Specifically, the 1988 report made recommendations to more clearly delineate the responsibilities of the Board and the Department, improve regulations governing special event licenses, and improve records management. Currently, the responsibilities of the Board and Department appear well-defined, both in statute and practice. The Board basically serves as an appellate body to deliberate protested license applications and hear appeals of Department decisions. Additionally, statute now clearly defines qualifying organizations eligible for special event licenses and organizations can obtain these licenses for as many as ten days in a calendar year, as opposed to a previous limitation of four days. Since the prior audit, the Department has implemented an automated system where it stores all documents and information. While the Department currently scans all licensing and compliance documentation into the system, it also ensures that all necessary documents from its previously maintained hard copy files are appropriately scanned into the system.

While the Department has responded to some of the recommendations made in the 1988 report, many problems identified in that report were again identified in this audit.

- **Greater controls needed over the compliance process**—The 1988 report found that one compliance officer handled much of the Department's disciplinary action against licensees, without benefit of penalty guidelines and review. This resulted in inconsistent disciplinary actions and increased the potential for abuse. As such, the report recommended that the Department establish penalty guidelines and document factors affecting the disciplinary action taken by the Department.

While the Department has established penalty guidelines, inconsistent disciplinary actions and lack of documentation to support disciplinary actions continue. (See Finding I, pages 11 through 19 for additional information on the Department's current compliance process.)

- **Licenses improperly issued**—The 1988 report found that some license applications received special treatment, the Department approved the transfer of liquor licenses to ineligible applicants, and the Department issued interim permits to unqualified individuals that allowed these individuals to sell liquor for as long as one year. The report recommended that the Department establish and adhere to license application policies and procedures and not process incomplete license applications. Additionally, the report recommended that the Department should not issue interim permits to unqualified applicants or cancel interim permits when it determines an applicant is unqualified to hold a license.

Currently, statute allows sufficient time for the Department to conduct a background investigation on all license applicants prior to approving a license application, to ensure only qualified applicants hold a liquor license. However, the Department does not ensure that all required application documentation is submitted and does not adhere to statutory time frames for public comment on license applications. (See Finding II, pages 21 through 25 for additional information.) Additionally, the Department continues to issue interim permits that allow individuals to sell liquor while the Department reviews and processes their applications. As a result, individuals deemed unqualified to hold a liquor license through the application process are permitted to sell liquor until their application is denied.

- **Cash and impounded evidence not safeguarded**—The 1988 report found that the Department employed poor internal controls that resulted in the improper handling of cash and seized evidence. The report recommended that the Department implement several internal control policies and procedures to better safeguard cash and evidence. Currently, the Department employs appropriate policies and procedures to safeguard evidence, but continues to place state monies at risk. (See Finding IV, pages 31 through 35 for more information on internal controls.)
- **Liquor license renewal not adequately controlled**—The 1988 report found that many licensees sold liquor illegally after their licenses had expired and the Department took little or no action to prevent this practice. The report recommended that the Department step up its enforcement of this practice by visiting establishments with expired licenses to verify that sales of liquor have ceased and by supplying a list of nonrenewed licenses to wholesalers and local law enforcement agencies to further prevent liquor sales on expired licenses. However, many licensees continue to sell liquor on expired licenses and the Department currently takes little action to prevent these sales. (See Finding III, pages 27 through 30 for more information on liquor license renewal.)

Audit Scope and Methodology

This audit focuses on efforts by the Department, including the State Liquor Board, to fulfill its responsibilities regarding the regulation of liquor sales and manufacturing in the State. Several methods were used to study the issues addressed in this audit, including:

- Reviewing the Department's computer database of disciplinary actions taken between July 1995 through March 1998, including a review of all 434 mail-in tickets the Department issued since November 1996 and an analysis of a random sample of 130

out of a total of 988 disciplinary actions taken by the Department against licensees with multiple liquor violations to assess the appropriateness and consistency of the Department's enforcement activities;

- Reviewing a random sample of 90 out of a total of 1,306 liquor license applications processed by the Department during 1997 to determine whether the Department adheres to statutory time frames for processing applications. An additional sub-sample of 61 of the 90 randomly sampled license applications was reviewed to determine whether the Department obtains complete and accurate application information;
- Conducting a structured observation of 24 licensed liquor establishments in April through June 1998 to determine whether these establishments were selling liquor on expired licenses;
- Documenting and reviewing Department policies and procedures for handling cash and seized evidence;
- Surveying 14 other states' Liquor Department, Commission, or Board; the National Conference of State Liquor Administrators; and reviewing information on all 50 states regarding the regulation of liquor;¹ and
- Interviewing various individuals involved in the liquor industry and the regulation of the industry including neighborhood activists; various city and state officials; law enforcement officials; industry representatives; industry and Department attorneys; Department management and staff; and all seven Board members.

The report presents findings and recommendations in four areas:

- The Department needs to take stronger and more consistent enforcement actions against licensees who violate liquor regulations;
- The Department needs to adhere to statutory and internal requirements for processing liquor license applications;
- The Legislature should consider creating stronger incentives for timely renewal of liquor licenses and the Department should enforce compliance with laws prohibiting the sale of liquor on expired licenses; and

¹ Fourteen states having similar characteristics to Arizona's regulation of liquor or employing notable enforcement programs were identified and contacted, including Alaska, Arkansas, California, Colorado, Florida, Idaho, New Jersey, New Mexico, North Dakota, Pennsylvania, Tennessee, Texas, Utah, and West Virginia.

- The Department needs to implement stronger cash receipt policies and procedures to adequately safeguard state monies.

In addition, the report contains Other Pertinent Information regarding the current status of quota liquor licenses in the State and the movement toward greater community involvement in liquor regulation. Also, the report includes responses to the 12 Sunset review factors for the Department.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Director and staff of the Department of Liquor Licenses and Control and the members of the Arizona State Liquor Board for their cooperation and assistance throughout the audit.

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FINDING I

DEPARTMENT INCONSISTENTLY ENFORCES LIQUOR LAW VIOLATIONS

The Department of Liquor Licenses and Control inconsistently enforces liquor law violations. Although the Department has established internal penalty guidelines, it deviated from these guidelines for 65 percent of the cases reviewed. The Department has also taken inconsistent enforcement action against licensees who repeatedly violate state liquor laws, and has allowed other repeat offenders to take advantage of a program designed for first-time offenders. Therefore, the Department should promote consistent enforcement by formally establishing and following enforcement guidelines, and consistently taking strong enforcement action against licensees with multiple liquor law violations.

Department Charged with Enforcing Liquor Laws

Through its enforcement activities and disciplinary actions, the Department works to ensure that liquor licensees adhere to state liquor laws. These activities or actions include issuing administrative penalties for over 70 different liquor-related violations. Potential administrative penalties include warnings, fines ranging from \$200 to \$3,000, and license suspensions or revocations. The Department has adopted informal guidelines that suggest penalties for the first, second, and third violations of liquor law within a two-year period. For example, the first time an employee consumes alcohol while on duty, the guidelines call for the licensee to pay a \$250 fine. For a second and third offense of this same violation, the penalty guidelines call for fines of \$750 and \$1,500, respectively. If a licensee commits the same violation more than three times within two years, the Department can refer the licensee to an administrative hearing, where a hearing officer will weigh evidence concerning the violation and forward a recommendation for discipline to the Department.

The Department adopted these penalty guidelines in response to a 1988 Auditor General report, which noted that penalties issued by the Department appeared inconsistent. The Auditor General recommended that the Department develop penalty guidelines to promote consistency and equity. Further, the 1988 report suggested that the Department document the factors that affect the disciplinary action it imposes on licensees who violate state liquor laws.

Enforcement Efforts Remain Inconsistent

While the Department has established penalty guidelines to assist with its enforcement actions, it often departs from these guidelines, resulting in inconsistent enforcement action. These departures arise because the Department has not fully developed and formalized its penalty guidelines.

Department penalties continue to be inconsistent—Although the Department adopted internal penalty guidelines, it continues to issue inconsistent penalties. Specifically, a review of 59 compliance cases from licensees with multiple liquor violations found that the Department's disciplinary action deviated from its internal guidelines approximately two-thirds of the time.¹ For approximately 80 percent of the cases reviewed, the Department's fines were within \$500 of its guidelines. However, in approximately 20 percent of the incidents reviewed, the Department deviated from its guidelines by \$500 or more. For example, the Department fined a bar \$1,000 less than its guidelines suggested. In late 1997, this licensee admitted to one count of allowing a minor to possess alcohol on their premises and an additional count of an employee consuming alcohol while on duty. Since this was the third time that an employee of the licensed establishment consumed alcohol on duty in two years, the Department's penalty guidelines called for a \$2,000 fine for these two violations, but the Department instead levied a \$1,000 fine.

By deviating from penalty guidelines, the Department creates the potential for inconsistent enforcement and inequitable treatment of licensees. For example, the Department fined a convenience store \$1,500 for various violations involving sales to a minor in November 1996. This was at least the third time within a two-year period the licensee had committed these violations. In contrast, in February 1998, the Department issued a \$3,500 fine to another retailer for the same violations and with a similar history of violations. Additionally, the Department cited two licensees with no prior history for allowing an employee to consume alcohol on duty. While the Department issued one a \$375 fine, it gave the other a warning letter.

Failure to adopt sufficient policies causes inconsistencies—Discrepancies in penalties result from the Department's continued failure to formally adopt and follow written policies and procedures, and to adequately document why some licensees are disciplined more or less harshly than others. In its 1988 report, the Auditor General recommended that the Department adopt a schedule of expected penalties, which would promote consistency and equity in the Department's disciplinary actions. While the Department adopted informal penalty guidelines, it has not formally published or incorporated these guidelines into rule, or a substantive policy statement, nor does it require its investigations staff or compliance officer to

¹ These cases were randomly sampled from licenses and owners who violated liquor laws in at least three separate incidents over two years beginning July 1, 1995.

follow them. Moreover, when the Department deviates from the guidelines, it does not document reasons for the deviation.

Action Not Always Taken Against Repeat Offenders

In addition to the Department's inconsistent penalties against licensees, the Department does not always take appropriate action against some repeat liquor law violators. While the Department has successfully pursued some licensees who repeatedly violate the State's liquor laws, it has not consistently disciplined all multiple offenders. The Department's narrow definition of repeat liquor law violations and a failure to consider a licensee's full violation history contributes to this problem.

Limited action against some repeat offenders—While most licensees operate without violating state liquor laws, the Department inconsistently takes action against those licensees who do commit several violations. Of the approximately 8,800 licensees in the State, Department records show that in March 1998, 322 active licensees have committed more than one offense since July 1995. Moreover, 32 of these licensees have committed 4 or more offenses. While the Department has recently revoked the licenses of 2 clubs and 2 liquor stores that repeatedly violated the state liquor code, other licensees with multiple offenses have not received significant fines or punishment. In one exceptional case:

- A licensed establishment with a history of violent altercations continues to operate. A Phoenix-area nightclub witnessed nearly 80 violent events since 1995. While A.R.S. §4-210(A)(1) allows the Department to suspend, revoke, or refuse to renew a liquor license if the business is the scene of repeated acts of violence, the Department has neither suspended nor revoked this license. Moreover, the Department cited the club three times since August 1997 for violence-related infractions, but when the licensee failed to report an act of violence occurring in December 1997, the Department only issued a warning letter.

Several factors contribute to inconsistent punishment against repeat offenders—The Department does not consistently take appropriate action against multiple liquor law violators because it does not consider violations for like or similar offenses, combines separate violation incidents into one enforcement action, and does not review a licensee's full violation history.

According to its guidelines, the Department increases a penalty only if it charges the licensee with repeating the same violation. As a result, the Department does not escalate penalties for similar offenses that are technically different.

Specifically, while the Department regulates the behavior of exotic dancers at licensed establishments, prohibits employees from consuming liquor while on duty, and serving alcohol to minors, there are several different violations that a licensee can be charged with for each of these types of offenses. For example, as *Item 1* illustrates, the Department has five different violations relating to serving alcohol to minors. However, the Department will only escalate its disciplinary action if the licensee repeats the same serving to minors violation but will not escalate its disciplinary action if the licensee commits any of the other four violations. In one typical case, the Department fined a licensee for violating A.R.S. §4-244.9, selling alcohol to a minor, in November 1995. Less than two years later, the Department fined the licensee \$500 for violating A.R.S. §4-244-16, allowing a minor to possess alcohol on their property. While the two violations involved selling to minors, the second violation was not a repeat of the first, and as a result the Department did not increase the penalty amount to \$1,000, as its guidelines suggest.

Item 1: Potential Minor-Related Liquor Law Violations

- Failure to Request I.D., A.R.S. §4-241(A).
- Sale to a Minor and Not Recording Their Age, A.R.S. §4-241(B).
- Sale to a Minor, A.R.S. §4-244-9.
- Minor in Possession on Premises, A.R.S. §4-244-16.
- Underage on Premises, A.R.S. §4-244-23.

Source: Department of Liquor Licenses and Control Compliance Fine Structure.

In addition, the Department undermines its efforts against repeat offenders by not accurately documenting separate incidents that are combined into one disciplinary action. The Department sometimes combines incidents for administrative convenience, or when the police document several violations without notifying the licensee after the first incident that he or she was breaking the law. In other cases the Department may dismiss some violations if a licensee will admit to committing other violations. However, with the exception of violations that the Department dismisses, the Department blurs a licensee's true violation history when it does not accurately document separate violation incidents. In one example, from January 1996 to March 1996, a licensee violated the same liquor law governing adult entertainers on three separate instances. However, the Department combined these incidents into one case. Therefore, when the licensee repeated the same offense in 1997, Department records showed it was the licensee's second offense, rather than the fourth violation. As a result, the licensee received a \$1,500 fine, rather than a 30-day suspension or license revocation.

Finally, the Department weakens its enforcement actions because it does not consider the violation records of other locations owned by the licensee. Department officials do not believe the Department has the authority to escalate a penalty if it previously warned or penalized the licensee for the same or similar offenses at another location. However, statute does not appear to support the Department's position. A.R.S. §4-210.01, which grants the Department authority to impose penalties, implies that penalties are levied against owners, not licenses. Therefore, the Department can consider an owner's complete violation history, without regard to where the violations occurred. This may be especially appropriate in cases

in which the owner has, or should have, direct influence on the management of the locations. In fact, on at least one occasion, the Board has considered such history. In February 1998, the State Liquor Board denied a liquor license transfer because, in part, other Arizona liquor licenses currently held by the two applicants had a long history of liquor violations, resulting in over \$5,000 in fines between 1994 and 1998. However, as a result of this case, the Department may be revising its policies. Specifically, Department officials plan to use the Board's ruling and the licensees' enforcement history to pursue action against other licenses held by these owners.

Because of the above practices, the Department rarely subjects a licensee to severe disciplinary action based on his or her violation history. For example, when a licensee repeats the same violation for the fourth time within two years, the Department should consider suspending or revoking the license. However, a review of 58 licensee enforcement histories found only 1 licensee who, under the Department's current practices, was shown to have repeated the same violation 4 times. If the Department had grouped similar violations together, the Department could have taken more severe disciplinary action against 21 of these 58 licensees.

Some Licensees Inappropriately Receive Penalty Discounts

In addition to not always taking appropriate action against licensees with multiple liquor law violations, the Department has also inappropriately allowed some offenders to participate in a mail-in ticket program that offers reduced penalties.

Mail-in ticket program created to promote efficiencies—In November 1996, the Department created a mail-in ticket program to address first-time and minor liquor law violations and promote certain efficiencies within the Department. To save on the cost and time of meeting with licensees to discuss violations, the Department allows licensees to remedy a violation by paying a reduced fine through the mail. By signing the mailed ticket, licensees admit responsibility for the violation in exchange for reducing their fine by 50 percent. According to the Department's Director, tickets are intended for the first-time offenders. However, the Department has not developed written policies and procedures for this program, leading to various interpretations and policy changes regarding licensee participation.

Additionally, when the Department instituted the mail-in ticket program, it eliminated a requirement that a licensee participate in a training program as a condition for reducing the penalty for a first-time offense. By requiring training, the Department sought to reduce future violations by educating licensees and their employees about Arizona's liquor laws, and how to detect invalid identification and recognize excessively intoxicated patrons.

Inappropriate mail-in tickets issued—Without written policies and procedures for its mail-in ticket program, the Department sometimes inappropriately issues mail-in tickets. As *Item 2* shows, a review of all 434 mail-in tickets issued from November 1996 to March 1998 revealed that the Department issued 27 tickets to licensees who had either previously committed the same offense or had already participated in the program. Moreover, the Department sometimes uses this program to issue tickets for more serious offenses. For example, A.R.S. §4-117 stresses the importance of deterring underage drinking by requiring the Department to annually report its efforts to curb underage consumption. However, 158 of the 308 mail-in tickets issued for violations occurring in 1997 involved violations associated with selling alcohol to minors. For example:

Item 2: Previous Violators Received Mail-in Tickets

- **16** licensees received a mail-in ticket after committing the same offense during the previous year (5 of these received two mail-in tickets for the same offense).
- **11** licensees received a mail-in ticket after committing a different offense within one year.

Source: Department of Liquor Licenses and Control compliance data, November 1996 to March 1998.

- A licensee with a history of serving minors inappropriately participated in the mail-in ticket program. In January 1997, the Department issued a \$500 ticket to a licensee for allowing a minor to possess alcohol on the premises and selling alcohol to a minor. In May 1997, the licensee committed a second, related offense by allowing a minor on its premises. This time, the Department fined the owner \$750 through its normal process. The licensee repeated this same violation six months later, warranting a \$1,000 penalty for a second offense. However, the Department set the fine at \$500 and allowed the licensee to use the mail-in ticket program, which reduced the fine even further, to \$250.

Department Should Improve Enforcement Policies

The Department should strengthen its enforcement effectiveness by improving policies guiding its liquor law enforcement. Specifically, the Department should formally adopt its penalty guidelines by developing a substantive policy statement and develop better controls over the fine amounts it sets. Additionally, to more effectively pursue repeat offenders, the Department should make a number of policy changes to improve its enforcement of state liquor laws. Finally, to prevent the Department from inappropriately issuing mail-in tickets, it should formally define who is eligible for the mail-in ticket program.

Department should strengthen guidelines over enforcement—The Department should take a number of steps to formalize its penalty guidelines and policies. Specifically,

- **The Department should formally establish penalty guidelines**—The Department should adopt its penalty guidelines into a substantive policy statement. A.R.S. §41-

1001(21) defines a substantive policy statement as “a written expression which informs the general public of an agency’s current approach to, or opinion of, the requirements of the federal or state constitution, federal or state statute. . . .” Since this statement is advisory only, the Department will maintain its ability to base its penalties on the merits of each case, and allow for less or more severe sanctions depending on the violation. Other states, such as Texas, have formally adopted fine guidelines. Texas’ Alcoholic Beverage Control Commission publishes its penalty guidelines in its agency rules. The rules list penalties for first, second, and third violations of each offense, and offer the Commission flexibility by defining a range of fines for each offense. For example, when a Texas licensee sells alcohol to a minor, guidelines call for a 7- to 20-day suspension for the first offense and a 10- to 90-day suspension for the second offense. If the licensee commits this violation a third time within 3 years, the license is suspended for a minimum of 60 days or canceled.

- **The Department should document reasons for setting penalties**—In addition to formalizing its penalty guidelines, the Department should document the factors that influence each enforcement action to improve controls over the penalties it sets. Therefore, when the Department imposes penalties, and especially when it plans to deviate from its guidelines, the Department should require staff to document the factors that influence the penalties. These factors should include previous violations and any other aggravating or mitigating circumstances that may influence the penalty. Texas employs a similar process in which its Alcoholic Beverage Control Commission can deviate from its published guidelines if mitigating circumstances are involved. However, support for deviations must be documented and recorded with the licensee’s case report.

Department should tighten policies over repeat offenders—The Department should also adopt a number of policies to strengthen its enforcement actions against licensees who repeatedly violate the State’s liquor laws. Specifically,

- **The Department should revise its definition of a repeat offense**—Similar to enforcement practices in other states, the Department should group similar offenses together when determining the appropriate disciplinary action for repeat offenses. For example, the Department could consider any previous violation of a health, safety, or welfare nature in escalating the penalty for a repeat violation, or escalate the penalty for an underage drinking violation if the licensee previously committed any other offense involving minors. Other states also group together similar offenses when determining a licensee’s punishment. The Colorado Department of Revenue’s Liquor Enforcement Division increases penalties by using categories of similar violations. One category consists of infractions involving administrative violations such as failing to post a required sign, while another category includes violations threatening the public health, safety, or welfare. Texas’ Alcoholic Beverage Commission uses a similar classification scheme, and considers previous health, safety, and welfare violations when it sets penalties.

- **The Department should document cases in which separate incidents have been combined into one penalty**—The Department should revise its current policy that combines separate investigations into one penalty. Specifically, the Department should document when separate incidents have been combined into one enforcement action so it can appropriately consider the separate incidents for future penalties.
- **The Department should look at a licensee's other businesses**—The Department should use the violation history of other licenses held by the same owner as a factor in setting penalties. As mentioned previously, Department management does not believe it has the authority to review what actions have been taken against licenses under the same owner. However taking an owner's complete record into account is consistent with the Department's statutory authority.

Define mail-in ticket program participation—Finally, the Department should formalize its policies governing the mail-in ticket program. First, the Department should develop a written policy defining which licensees can participate in the mail-in ticket program, including how often a licensee can participate in the program, when a licensee's previous violation history disqualifies his or her participation, and the types of violations that qualify for a mail-in ticket. In addition, the Department should consider reintroducing the requirement that licensees complete training to receive a discounted penalty.

Recommendations

1. The Department should adopt a substantive policy statement formally establishing its penalty guidelines.
2. The Department should consistently record and document factors, such as previous violations and other aggravating or mitigating circumstances that influence a licensee's penalties.
3. The Department should strengthen its policies and procedures for identifying and penalizing repeat liquor law violators by:
 - a. Grouping similar offenses in different categories, such as employee alcohol consumption or minor-related penalties, to more adequately consider previous liquor law violations in determining penalties for repeat violations;
 - b. Documenting cases in which separate violation incidents have been combined into one disciplinary action so the separate violations can be appropriately considered in future enforcement actions; and
 - c. Taking into account, where appropriate, the violation histories of other licenses held by the same owner when setting penalties.
4. The Department should adopt a written policy defining the types of violations and licensees eligible for the mail-in ticket program and consider requiring licensee training as a condition for receiving the mail-in ticket discount.

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FINDING II

DEPARTMENT DOES NOT FOLLOW PROCEDURES WHEN PROCESSING SOME LIQUOR LICENSE APPLICATIONS

The Department has not followed statutory requirements and its own internal procedures for processing liquor license applications in 36 percent of the cases reviewed. Specifically, the Department did not comply with statutorily required time frames for allowing public and city comment and did not fully document required application information. While some of the problems related to receiving timely comments from cities appear to be beyond the Department's control, insufficiently trained, inexperienced staff; limited supervisory oversight; and lack of written policy and procedures contribute to the other processing errors. Therefore, not only should the Department ensure that licensing staff are adequately trained and supervised, but the Legislature should consider amending statute to ensure timely city action on liquor license applications.

Background

One of the Department's primary responsibilities is to "[p]rotect the health, safety and welfare of Arizona citizens by licensing the liquor industry. . . ." As such, the Department has established a variety of procedures to ensure only qualified individuals receive liquor licenses. In doing so, the Department not only requires that applicants submit a complete application, but also supporting documentation concerning the ownership structure of the business seeking licensure. Moreover, the Department conducts a background investigation on individuals associated with the proposed license. Consequently, owners, shareholders, and partners must submit fingerprint cards and personal history questionnaires. Additionally, on April 1, 1998, the Department adopted a new policy that expanded the scope of the background investigation to include a search of Department records for liquor law citations the applicant has received at other licensed businesses. If the Department uncovers violations, it may protest the application based on the applicant's lack of personal "capability, qualifications or reliability."

Department Improperly Processes and Approves Some Licenses

Auditors' review of the Department's process for handling initial licensing applications identified a variety of procedural errors, including cases in which the Department did not

comply with the statutory requirement to allow 15 days for public comment or 60 days for city comment. Additionally, in 39 percent of the applications reviewed, the Department did not obtain all required application information to verify the applicant's capability, qualifications, and reliability. Finally, the Department inappropriately issued an interim permit that allowed a license applicant to begin selling liquor before the applicant's license was approved.

Department does not always follow statutory time frames—For 13 of 90 (14 percent) liquor license applications reviewed, the Department did not follow Arizona law regarding the review of applications where the local government failed to approve license applications within the statutory time period. According to statute, local government bodies have 60 days to review liquor license applications and forward a recommendation to the Department; otherwise, statute requires that the Department forward the license application to the Board for consideration. For 13 of the applications reviewed, instead of submitting the applications to the Board, the Department improperly approved the applications and issued licenses when the local government body recommended the license be approved after the allotted 60 days. Cities have explained that occasionally they fail to submit their recommendations within the 60-day period either because applicants fail to satisfy city licensing requirements or because city councils meet infrequently in the summer.

In at least three instances in 1997, the Department also issued or approved liquor licenses before the expiration of the period reserved for citizen protest. Upon a local governing body's recommendation of approval, the Department must wait a minimum of 15 days before approving a license application. Statute provides citizens who live within a 1-mile radius of the proposed liquor establishment 15 days to file a protest with the Department regarding the proposed establishment. The filing of a timely protest requires the Department to forward the license application to the Board for further consideration. However, for three applications made in 1997, the Department did not provide sufficient time for citizen protest.¹ For example:

- The Department approved a liquor store license only 8 days after the local governing body recommended approval. The City of Mesa approved this application on February 18, 1997, and the Department approved and issued the license on February 26, 1997.

Staff does not consistently implement Department application procedures—In 24 of the 61 (39 percent) license applications reviewed, licensing staff did not follow established applica-

¹ While 2 of the 3 cases where the Department did not allow sufficient time for citizen protest were identified during a review of 90 randomly selected license applications, auditors were referred to the third case.

tion processing procedures.¹ As previously described, these procedures require the Department to collect and process complete and accurate information on the individual applicants, ownership structure, and type of business seeking licensure to ensure only qualified and capable individuals and organizations hold liquor licenses in the State. However, a review of license applications submitted in 1997 identified 24 applications where the Department accepted incomplete or incorrect forms, or failed to collect the required legal documents or information. Typical procedural errors include:

- Statute requires that corporations or Limited Liability Companies (LLC) seeking liquor licenses be qualified to do business in the State. As such, Department procedures require licensing staff to check that the corporation or LLC applicant is in “good standing” with the Arizona Corporation Commission both before accepting and prior to approving the application.² In 46 of the 61 applications reviewed, either a corporation or LLC applied for the liquor license. However, for 16 of the applications, licensing staff failed to confirm the business’ “good standing” prior to approving the application.
- Licensing staff also neglected to collect required application documentation. For instance, Department procedures require LLC applicants to submit Articles of Organization and an Operation Agreement. In 2 files where an LLC applied for a license, staff did not collect this documentation and thus could not confirm the organization’s status. Furthermore, for 10 of the reviewed applications, licensing staff collected improper or incomplete application forms or support documentation. As such, without complete and accurate information, the Department could not fully assess the qualifications of these applicants to hold a liquor license.

Department inappropriately issued two interim permits—In addition to processing errors involving license applications, the Department erroneously issued an applicant two interim permits. In June 1996, an applicant applied for both a conveyance license (allowing alcohol to be sold on airplanes, trains, and boats) and a private club license. In these applications, the applicant also requested that the Department issue two 105-day interim permits that would allow the applicant to sell liquor while the Department processed the applications. According to statute, the Department can issue an interim permit only to an initial license applicant if the location of the proposed liquor establishment had an existing license of the same type. However, the Department inappropriately issued the interim permits, because the proposed location had neither an existing conveyance nor a private club liquor license.

¹ Due to time constraints, the audit team reviewed only 61 license application files for procedural errors, which represented a subset of the 90 randomly sampled license application files reviewed.

² To be in “good standing,” a corporation must maintain a statutory agent and file an annual report along with a \$45 fee to the Corporation Commission, while an LLC is required to submit Articles of Organization and proof of publication at the time of formation.

The Department contends it made this exception because the applicant had a “large ceremony ... with many dignitaries” scheduled, and had neglected to apply in a timely manner for the required liquor licenses.

Steps Needed to Ensure Accurate License Processing

The Legislature and the Department should take steps to ensure that Arizona law and internal procedural requirements are followed when processing, approving, and issuing liquor licenses. First, the Legislature should consider amending A.R.S. §4-201(E) to allow the Department the discretion to extend the 60-day local government comment period. Additionally, to ensure compliance with the 15-day citizen protest period and application processing procedures, the Department should develop a policies and procedures manual and provide licensing staff supervisory oversight.

Legislature should consider amending statute—The Legislature should consider two separate amendments to A.R.S. §4-201(E) to ensure that cities and/or counties forward recommendations on liquor license applications in a timely manner. First, the Legislature should consider amending A.R.S. §4-201(E) to give the Department the authority to extend the time local governing bodies have to review liquor applications by an additional 30 days upon written request. In fact, for the 13 applications reviewed in which the city did not forward a recommendation in 60 days, 11 of the 13 cities eventually forwarded their approval recommendations within 30 days following the 60-day deadline. Only 2 cities forwarded their recommendations after 90 days. Therefore, with the authority to grant local governing bodies an additional 30 days to consider liquor license applications upon the receipt of a timely, justified request, the Department could proceed administratively once cities forwarded an approval recommendation.

Second, the Legislature should consider adding language to A.R.S. §4-201(E) that would deem a liquor application approved by the local governing body if the Department does not receive a recommendation or written request for a time extension within 60 days. Such statutory language would allow the Department to proceed with the license application without referring it to the Board. While current law requires the Department to forward liquor license applications for which it did not receive a recommendation from the local governing body in a timely manner to the Board, the Board has indicated it would prefer not to have to consider these applications. First, the Board does not want to clutter its agenda with license applications for which an approval recommendation was eventually received from the local governing body. Second, placing these license applications on the Board’s agenda would unnecessarily delay the application’s approval since it could take at least two months for the Board to consider the application.

Increased training and supervision would help prevent licensing errors—To address the inappropriate processing of liquor license applications, the Department should correct a lack

of staff expertise by improving staff training and supervision. Many of the errors in application processing have resulted from a lack of experience among the Licensing Division's staff. Despite having only four licensing staff positions, the Department has experienced a turnover of seven licensing staff since February 1996. As a result, only one licensing staff member has more than one year of experience. While the Department is attempting to prevent future turnover by seeking higher salaries for these positions, it has not taken sufficient steps to train its current staff. Specifically, the Department has not created written policies and procedures to guide its staff, instead relying on "on-the-job" training.

Additionally, the Department should require supervisory review of license application files. Except with very new employees, neither the licensing manager nor supervisor reviews the file to ensure its accuracy or completeness before application approval. Therefore, the Department should resume conducting supervisory reviews of license application files for compliance with statutory time frames and application processing policies and procedures.

Recommendations

1. The Legislature should consider amending A.R.S. §4-201(E) to permit the Department the discretion to extend the time frame for city and county comment by an additional 30 days upon a local government entity's written request justifying the need for additional time. Additionally, the Legislature should consider amending this statute to include language that an application is deemed approved if a local government body does not make a timely recommendation or file a written request for an extension within the 60-day comment period.
2. The Department should increase licensing staff training by developing written license application policies and procedures to help ensure compliance with statutory and procedural requirements.
3. The Department should institute a supervisory review of license applications prior to their approval to ensure compliance with statutory time frames and internal policies and procedures.

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FINDING III

NUMEROUS LICENSEES FAIL TO RENEW LICENSES ON TIME

Greater efforts are needed to ensure licensees renew their licenses prior to expiration, and do not continue to sell liquor on expired liquor licenses. Based on the license renewal applications reviewed between June 1997 and May 1998, 8 percent of licensees fail to renew on time. Insufficient late renewal penalties and a lack of active Department enforcement or licensee notification have resulted in the untimely renewals and the illegal sale of liquor. To facilitate timely renewal and ensure that licensees cease liquor sales when their licenses expire, the Legislature should consider increasing the late renewal penalty fee and the Department should increase its enforcement and notification.

Renewal Process

Statute provides that all liquor licenses in Arizona expire annually.¹ A renewal is considered timely if the licensee submits the appropriate renewal fee and application form to the Department before the date his or her license expires. If licensees fail to renew their licenses before the expiration date, they have a 60-day grace period after license expiration, during which they can renew their license by paying a \$150 late penalty fee in addition to the license renewal fee. The Department terminates all licenses not renewed within the 60-day grace period. However, the Director can renew a terminated license if the licensee shows “good cause.” Furthermore, while licensees have a 60-day grace period after license expiration to renew their license, statute prohibits the licensee from selling liquor until the date the licensee renews the license. As illustrated in Table 1 (see page 4), annual renewal fees range from \$50 for liquor store and beer and wine store licenses to \$500 for restaurant and hotel/motel licenses.

Liquor Inappropriately Sold on Expired Licenses

Currently, hundreds of licensees do not renew their liquor licenses before they expire, potentially resulting in the sale of liquor on expired licenses. For instance, 8 percent of the reviewed licensees who renewed their liquor license between June 1997 and May 1998 did so

¹ The Department staggers the license renewal date by license type and county throughout the calendar year. For example, restaurant and hotel/motel licenses in Maricopa County expire each year on March 31.

after it had expired. Furthermore, even though Arizona law prohibits the sale of liquor by licensees who fail to renew on time, an inspection of 24 Maricopa County restaurants or hotel/motels in April through June 1998 revealed that 42 percent of the businesses visited were selling liquor on expired licenses.

Eight percent of licensees failed to timely renew—For the 4,153 reviewed licenses that submitted a renewal application between June 1, 1997, and May 31, 1998, 334 (8 percent) of the licensees renewed their license after it had expired.¹ However, this number could be significantly higher. Due to data limitations, auditors excluded four license types from their review, which represented 4,458 of the total 8,611 renewal applications submitted to the Department during this period.² Nevertheless, of the 334 identified late renewals, 265 renewed between 1 and 29 days late; 48 renewed between 30 and 59 days late; and 21 renewed 60 days or more after license expiration.

Licensees illegally selling alcohol on expired licenses—Not only do a number of licensees renew their licenses after the expiration date, it appears many of these licensees continue to sell liquor on expired licenses. In April 1998, auditors performed structured observations of 23 restaurants and 1 hotel/motel whose licenses had expired on March 31, 1998, and 10 of the 24 licensees were observed selling liquor at least one week after their license had expired.³ Additionally, 4 of the 10 licensees were observed selling alcohol at least 3 weeks after license expiration and 2 of these 4 licensees failed to renew their license by the end of their 60-day grace period. While the Department terminated the licenses of these 2 licensees on June 1, 1998, one of the licensees was observed selling liquor after that date. The Department renewed the second terminated license on June 9, 1998. Consequently, this restaurant licensee potentially sold liquor illegally for 69 days.

Steps Needed to Encourage Timely Renewals

Both the Legislature and the Department should take steps to facilitate timely license renewal. First, the Legislature should consider amending A.R.S. §4-209(A) to provide a disin-

¹ This number is based on whether a late renewal fee of \$150 was submitted with the renewal application.

² Auditors could not determine the accuracy of the license renewal dates associated with the renewal application data recorded on the Department's computer system for the following license types: Out-of-State Producers; Bars; Beer and Wine Bars; and Liquor Stores. Consequently, these license types were omitted from this analysis.

³ Auditors selected a convenience sample of 23 restaurants and 1 hotel/motel from a Department-generated list of 202 licenses that expired on March 31, 1998. While 10 of the 24 businesses auditors visited were operating and selling liquor after their licenses had expired, the remaining 14 businesses had either gone out of business, were operating on a different liquor license, or had renewed the license on the same day as the auditor's visit.

centive for late renewals by increasing late renewal penalties. Second, the Department should implement policies to encourage timely renewal by ensuring that licensees do not sell liquor on expired licenses and notifying licensees of the consequences of untimely renewal.

Legislature should consider amending statute to encourage timely renewal—The Legislature should consider amending A.R.S. §4-209(A) to increase the current \$150 late renewal penalty fee as well as to consider incorporating a graduated schedule that would increase the penalty the later the licensee renews. The current \$150 penalty fee has not effectively deterred untimely renewal. A survey of other states showed that several Western states impose a significantly higher late penalty fee than Arizona. For instance, both Colorado and Alaska impose a \$500 late renewal fee penalty. Furthermore, New Mexico and California increase late renewal penalty fees depending on how many days after license expiration a licensee renews. Specifically, New Mexico penalizes late renewals \$350 plus \$10 for each additional day the licensee fails to renew. Alternatively, California charges a penalty fee of 50 percent of the renewal fee if the licensee is 1 to 60 days late, but this penalty doubles for a licensee who renews between 60 and 90 days late.

Department should improve enforcement and notification of renewal laws—In addition to providing greater incentive to renew in a timely manner through statutory amendment, the Department should improve the enforcement of the statute regarding the illegal sale of liquor on expired licenses. Currently, the Department takes no steps to actively enforce this statute during the first 30 days after license expiration. After a license has been expired for more than 30 days, department investigators occasionally secure a list of expired licenses and investigate at their discretion. However, in 1996 and 1997 the Department issued only one citation to a licensee for selling on an expired license.

To improve enforcement over late license renewals, the Department should implement procedures that integrate the investigation of licensees selling liquor on expired licenses into the everyday duties of Department investigators. For instance, as part of their planned investigative and inspection responsibilities, investigators could visit licensees with expired licenses to ensure they have ceased liquor sales. Auditors found that during their visits to restaurants with expired licenses, this type of inspection took approximately five minutes.

In addition to a lack of enforcement, the Department also does not adequately communicate to licensees that Arizona law prohibits the sale of liquor on expired liquor licenses. While the Department sends licensees a renewal notice approximately six weeks prior to license expiration, this notice does not inform licensees that statute prohibits liquor sales on expired licenses. Furthermore, when the Department receives a late renewal without the late penalty fee, it returns the renewal application form and fee to the licensee along with an explanatory letter. However, while this letter notifies the licensee that they must remit a \$150 late fee with the renewal payment, it does not warn licensees that they are prohibited from selling liquor on the expired license.

Recommendations

1. The Legislature should consider amending A.R.S. §4-209(A) to increase the current \$150 late renewal penalty fee and incorporate a graduated schedule that would increase the penalty amount the later the licensee renews after license expiration.
2. The Department should implement procedures that coordinate the investigation of licensees selling liquor on expired licenses with other investigator duties to ensure licensees cease liquor sales when their licenses expire.
3. The Department should notify licensees both in the license renewal packet and through a letter after license expiration that licensees are prohibited from selling liquor on an expired license.

FINDING IV

THE DEPARTMENT DOES NOT ADEQUATELY SAFEGUARD LICENSEE FEES AND FINES

Despite receiving millions of dollars each year in fee and fine receipts, the Department lacks an adequate system of policies and procedures to protect this money. The Department places these monies at risk because it fails to immediately endorse checks and money orders upon receipt, does not restrict employee access to these monies, does not regularly reconcile receipts to deposits, and uses a system that incurs more risk than necessary to transport checks and money orders collected at its Tucson office. By taking steps to correct these problems, the Department can help prevent the loss or theft of the monies it receives.

Background

The Department processes over 13,000 liquor licensee fee and fine payments each year, collecting over \$4.3 million in receipts in fiscal year 1996-97 and \$4.4 million in receipts in fiscal year 1997-98. Consequently, the Department needs adequate policies and procedures to protect monies it receives from loss or theft. By establishing policies and procedures, organizations can better safeguard cash and cash-like receipts, and encourage adherence to prescribed managerial policies. Without adequate policies and procedures, the potential for loss or theft greatly increases.

In a 1988 report, the Auditor General found that the Department's policies and procedures were weak, and resulted in the theft of over \$2,400 in state monies. The report recommended the Department develop written procedures to immediately process receipts and restrictively endorse checks, and develop procedures to adequately safeguard cash to reduce the temptation for theft.

Department Fails to Sufficiently Protect Licensee Payments

Currently, the Department lacks adequate policies and procedures to protect state monies. Specifically, the Department employs several inappropriate procedures in its cash-handling procedures, including not immediately endorsing checks and money orders upon receipt, allowing unnecessary access to these receipts, and not reconciling deposits to receipts. Additionally, the Department's current practice of transporting receipts from Tucson to

Phoenix via interagency mail further places these receipts at risk. Finally, once the Department takes action to correct these problems, it should document and regularly review its policies and procedures.

Insufficient procedures over check processing—The Department’s current procedures for processing cash receipts fail to sufficiently protect monies during processing. Currently, the Department’s Information Services Section opens the mail and forwards checks, money orders, and associated documentation to the Licensing or Compliance units. Once these units verify that the dollar amount remitted and associated paperwork are correct, they return the money to the Information Services Section for endorsement and later deposit. If anything is incorrect, the Department returns the money to the owner and asks for the correct payment or documentation. However, during the time that the Department retains the money, it is not adequately safeguarded, due to the following weaknesses:

- **Checks not endorsed immediately**—The Department does not safeguard its checks and money orders through restrictive endorsement until the very end of its process. Restrictively endorsing a check helps prevent someone other than the Department from depositing the money. However, the Department waits as much as a week before endorsing and depositing this money while it verifies the accuracy and completeness of the payment and accompanying documentation. During this time, at least four to five employees handle these checks as part of their normal license application or fine processing duties, making it difficult to trace lost or stolen payments.

To protect these payments, the Department should immediately endorse checks and money orders and securely store them during processing. Ideally, the Department should immediately endorse and deposit the payments, and if the application or payment is incomplete, issue a refund for the payment. However, since the Department does not maintain a checking account and does not want to request state warrants to issue refunds, the Department should immediately upon receipt restrictively endorse checks and money orders and store them in a safe in the Information Services Section. Rather than forwarding payments with the documents, the Department should prepare a receipt noting the payment amount to accompany the documentation. Once Department staff verify that the payment amount and associated documentation are complete and accurate, it can then deposit these monies. These procedures would better safeguard receipts and minimize employee access to these receipts during processing.

- **Access to receipts not restricted**—In addition to the employees who handle receipts as part of their job duties, staff uninvolved with processing also have easy access to checks and money orders. Specifically, the Compliance unit, Information Services Section, and Licensing Section each keep a safe to store money overnight. Seven employees have access to the Information Services safe and six employees can access the Licensing safe. Moreover, several Licensing Section staff have keys to a set of locking cabinets used to store license fees during the workday. Additionally, monies are left inside a wire bas-

ket within the Information Services Section in an area easily accessible by any Department employee or the public. Finally, the Compliance section sometimes leaves checks unattended on an employee's desk. While this desk is behind locked doors, all other Department employees have the door's combination. By failing to limit employee access to checks and money orders, the Department increases the potential for loss or theft. In fact, in March 1997 over \$500 in cash disappeared from the Department's Licensing safe and the Department was unable to trace the loss because so many employees had access to the safe.

The Department can reduce unnecessary access to state monies by strengthening its control over monies stored in the Information Services safe. As such, the Department should limit access to this safe to only necessary staff. Additionally, by retaining all cash, checks, and money orders in the Information Services safe, the Department will negate the need for safes and locking cabinets in the Licensing and Compliance sections, since monies will no longer be routed to these areas.

- **Money received not matched to deposits**—The Department also fails to reconcile receipts to deposits. Specifically, Information Services staff scan receipts and associated documentation received by the Department in its imaging system. After processing is complete, other staff record the amount deposited with the State Treasurer. However, the Department does not compare receipts to deposits to ensure that all monies received are deposited. Therefore, once the Department has finished processing payments, the Department should regularly reconcile receipts to deposit records to ensure that all cash, checks, and money orders received by the Department were deposited.

Procedural problems exist at the Department's Tucson office—While the above-mentioned weaknesses were identified at the Department's main office in Phoenix, cash-processing procedures at the Department's Tucson office further place cash-like receipts at risk. Tucson staff receive license application and renewal fees, but do not process these fees. Instead, Tucson forwards all monies received to Phoenix for final processing. However, the method of transporting these monies presents significant cash-handling problems. Specifically, the Department's Tucson office sends the checks and money orders it receives to Phoenix using the State's interagency mail system, a system designed to transport mail, not safeguard state monies. As a result, the Department creates an unnecessary risk of losing or misplacing these monies by transporting them via courier to Phoenix.

To limit the risk posed to state monies at the Department's Tucson office, the Department should cease using interagency mail to transport checks and money orders to Phoenix, instead establishing a depository bank account in Tucson for the monies it receives. The Department could then verify the monies deposited by reconciling the deposit to the monies received at the Tucson office. Establishing a depository bank account in Tucson would conform to the practice employed by several state agencies that maintain offices in Tucson. For example, the Departments of Building and Fire Safety, Real Estate, and the Registrar of

Contractors maintain depository bank accounts in Tucson to deposit any monies received in their Tucson offices. These monies are then automatically transferred to the State Treasurer.

Document cash-handling procedures—Once the Department institutes these changes, it should document policies and procedures for handling cash and cash-like receipts. These policies and procedures should incorporate the recommended changes to the Department's cash-handling process, and define employee responsibilities for each step in the process. Additionally, to refine and update its cash-handling process, the Department should periodically request a procedural review from the State's General Accounting Office. Such a review analyzes an organization's cash-handling process and looks for internal control weaknesses. By regularly reviewing its internal controls, the Department can ensure its procedures effectively safeguard state monies.

Recommendations

1. The Department should establish and maintain the following processes and procedures to better safeguard state monies.
 - a. Immediately endorse all checks and money orders upon receipt;
 - b. Store monies only in the Information Services safe, limit access to this safe to only necessary Department staff, and discontinue using the safes and locking storage areas in the Licensing and Compliance areas;
 - c. Generate a record of money received, such as a receipt, to accompany license application, license renewal, or compliance documentation during processing;
 - d. Regularly reconcile monies received to deposits;
 - e. Establish a depository account in Tucson for monies received at the Tucson office rather than transporting those monies to Phoenix via inter-agency mail;
 - f. Develop policies and procedures for handling cash and cash-like receipts that incorporate the recommended changes made in this report and define employee responsibilities for each step in the cash-handling process; and
 - g. Periodically request a procedural review from the State's General Accounting Office to ensure it adheres to established policies and procedures.

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OTHER PERTINENT INFORMATION

During the audit, other pertinent information was gathered regarding policies and practices for issuing quota liquor licenses. In addition, the audit team collected information concerning community involvement in the liquor licensing and regulatory process.

Quota Licenses

Although the Department issues and regulates 16 separate types of liquor licenses, statute restricts the number of bar, beer and wine bar, and liquor store licenses that the Department can issue. The Department has not issued new quota liquor licenses in several years. Population growth throughout the State meets statutory requirements for the issuance of additional licenses; however, public sentiment for or against the issuance of new quota liquor licenses will likely determine whether new licenses are issued.

Statute restricts certain liquor licenses—Currently, statute establishes a quota on the number of bar, beer and wine bar, and liquor store licenses that the Department can issue within each county. According to A.R.S. §4-206.01(B)(C), the director can only issue such licenses if the population in a county increases by statutorily defined amounts. In Maricopa and Pima Counties, the population must increase by 5,000 persons, while in all other counties, the population must increase by 4,000 persons before the director can issue a new license of each of these types. The population in each county as of July 1, 1992, serves as the base population for determining population growth. Should the Director decide to issue new quota licenses in a particular county that has experienced sufficient population growth, the Director would employ a lottery system to issue these licenses.

The Department has not issued new bar, beer and wine bar, and liquor store licenses since fiscal year 1987-88. As such, the number of these licenses has remained relatively constant for the past several years. Currently, there are over 4,100 quota liquor licenses across the State. As illustrated in Table 3 (see page 38), the majority of these licenses are in Maricopa and Pima Counties.

Population increases meet requirements for new licenses—While the Department has not issued any new quota licenses for 10 years, population growth in 12 of the 15 counties meets statutory requirements for additional licenses. As illustrated in Table 4 (see page 39), based on population increases in these counties from July 1, 1992 to July 1, 1997, the Department could potentially issue 149 new licenses for each type of quota liquor license for a total of 447 new quota liquor licenses.

Should the Department ever decide to issue new quota liquor licenses, it could generate significant revenue for the State. Statute requires that the Department obtain fair market value

Table 3

**Department of Liquor Licenses and Control
Total Quota Licenses per County
At July 1, 1998
(Unaudited)**

County	Bar	Beer and Wine Bar	Liquor Store	Total
Apache	26	10	18	54
Cochise	73	37	46	156
Coconino	55	65	57	177
Gila	49	20	27	96
Graham	19	8	15	42
Greenlee	7	3	9	19
La Paz	17	19	16	52
Maricopa	712	517	762	1,991
Mohave	46	55	45	146
Navajo	47	24	45	116
Pima	252	203	254	709
Pinal	85	44	62	191
Santa Cruz	16	9	17	42
Yavapai	79	47	53	179
Yuma	<u>53</u>	<u>36</u>	<u>50</u>	<u>139</u>
Total licenses	<u>1,536</u>	<u>1,097</u>	<u>1,476</u>	<u>4,109</u>

Source: Department of Liquor Licenses and Control reports dated July 1, 1998, on current liquor license and pending application counts.

for quota licenses that it issues. As such, the Department would need to set license fees according to the market value of quota licenses sold on the open market. According to a survey conducted by a private liquor license broker, liquor licenses sold for as much as \$60,000 in July 1997. For example, liquor store licenses sold for \$60,000, \$53,000, and \$30,000 in Mohave, Maricopa, and La Paz or Navajo Counties, respectively. Additionally, bar licenses sold for \$55,000 and \$50,000 in Maricopa and Mohave or Coconino Counties, respectively. While prices for liquor licenses differ in each county and for each type of license, the broker also explained that liquor license prices will be affected by the economy and number of licenses for sale. In a good economy, license prices will be high, as they are now in Coconino, Maricopa, Mohave, Pima, and Yavapai Counties.

Table 4

Department of Liquor Licenses and Control
Potential New Quota Liquor Licenses
Based on Population Growth
(Unaudited)

County	Population Growth ¹	Bar	Beer and Wine Bar	Liquor Store	Total
Apache	2,600	0	0	0	0
Cochise	18,475	4	4	4	12
Coconino	16,125	4	4	4	12
Gila	5,750	1	1	1	3
Graham	4,875	1	1	1	3
Greenlee	525	0	0	0	0
La Paz	2,800	0	0	0	0
Maricopa	486,875	97	97	97	291
Mohave	27,825	6	6	6	18
Navajo	8,745	2	2	2	6
Pima	89,385	17	17	17	51
Pinal	27,775	6	6	6	18
Santa Cruz	5,300	1	1	1	3
Yavapai	27,965	6	6	6	18
Yuma	16,450	<u>4</u>	<u>4</u>	<u>4</u>	<u>12</u>
Total licenses		<u>149</u>	<u>149</u>	<u>149</u>	<u>447</u>

¹ The population growth totals were derived from population estimates for Arizona counties on July 1, 1992, and July 1, 1997.

Source: Department of Economic Security, Research Administration, Population Statistics Unit, *July 1, 1992 Corrected Population Estimates for Arizona's Counties and Incorporated Places* and *July 1, 1997 Population Estimates for Arizona's Counties and Incorporated Places*; and Auditor General staff analysis.

Public sentiment affects number of liquor licenses—While the Department could issue new quota liquor licenses at this time, any issuance of these licenses could face stiff opposition from the public and the industry. The Department Director has indicated that most city officials would not support the issuance of new quota liquor licenses and that he would need agreement from local government and industry before considering the issuance of new licenses in any area of the State. Additionally, an industry representative stated that the Department should not issue new quota liquor licenses, except in

rare cases where the number of existing licenses is insufficient. For example, according to this industry representative and some Board members, Mohave County could benefit from new licenses due to its population growth and the short supply of liquor licenses, which has caused existing licenses to recently sell for as much as \$60,000 to \$90,000.

Community Involvement in Liquor Regulation

Nationally, and within the State, communities are becoming more involved in the licensing and regulation of liquor establishments within their communities and neighborhoods. While communities currently have a voice in the liquor regulation process, recently passed legislation will further expand community involvement. Additionally, both the Department and Board have become more responsive to community concerns.

In recent years, communities across the country have become increasingly involved in liquor regulation. In 1993, the *San Francisco Chronicle* reported that “*Neighborhood groups across the country are successfully lobbying for local ordinances to regulate or chase out taverns and liquor stores in what is proving to be the most aggressive alcohol-control movement since Prohibition.*”¹ Additionally, as reported in a 1995 journal article titled “What Role Will Law Enforcement Have in Alcohol Policy Planning by the Year 2005?” a panel of California law enforcement officials, community leaders, and alcohol experts indicated that “*citizens are increasingly: (1) working to abate alcohol related nuisances in their neighborhoods, (2) pushing for stricter standards in conditional use permits and tighter zoning control, and (3) lobbying the state legislature to expand local control of alcohol beverage outlets.*”² Arizona is also witnessing increased community involvement through new legislation and active neighborhood groups that have become very involved in liquor licensing and regulatory decisions.

Statute provides for community involvement in liquor regulation—To allow for community involvement in liquor licensing decisions, Arizona statute requires that both communities and citizens have an opportunity to approve or protest a liquor license application. According to A.R.S. §4-201(B)(C), the local governing body of a city, town, or county of the proposed liquor establishment has 60 days to consider the license application and forward a recommendation to the Department. During this 60 days, citizens living within a one-mile radius of the establishment can voice their approval or protest of the application to the local governing body. Moreover, A.R.S. §4-201(E) provides for additional citizen protest to the Department within 15 days following city ac-

¹ Ronningen, Judy. “Neighborhoods Go After Drinking,” *The San Francisco Chronicle*, June 3, 1993, p.1.

² Wills, Frank J. *What Role Will Law Enforcement Have In Alcohol Policy Planning By the Year 2005?*, California Commission on Peace Officer Standards and Training, 1995.

tion on the application. Protests received from a city or qualifying persons will cause the application to be heard and considered by the State Liquor Board.

In addition to current statutory requirements, recently enacted legislation will expand community involvement in liquor regulation. During the 1998 legislative session, the Legislature passed and the Governor approved Laws 1998, Chapter 259, which contains two provisions that enhance community involvement in liquor regulation. The first provision will require a two-thirds vote of Board members to overturn a disapproval recommendation on a liquor license application resulting from a two-thirds vote of the local governing body. This provision, which pertains to license applications at locations that have never had a license or are seeking a license of a different type, takes effect on September 1, 1998. The second provision requires the Department to establish a Neighborhood Association Interaction and Liquor Enforcement Management Unit that will respond to complaints from neighborhood associations, civic groups, and local governing authorities.

Although statute provides for community involvement in initial licensing decisions, cities and/or citizens currently do not have a voice in the license renewal process. A legislative proposal that would have allowed cities to challenge the renewal of a certain number of liquor licenses each year was introduced during the 1998 legislative session, but did not pass. In contrast, other states allow communities and citizens to play a larger role in the renewal of liquor licenses. Specifically, local communities and/or citizens can approve, disapprove, or protest a liquor license renewal. For example, Colorado cities can approve or disapprove a license renewal based on the licensee's conduct during the previous year. In New Jersey, Alaska, and Texas, cities and/or citizens can protest the renewal of a liquor license.

Department and Board more responsive to communities—While the Department has been criticized in the past for its nonresponsiveness to the community, recent actions taken by the Department and Board suggest attempts to become more responsive to community concerns. For example, the Department director or his representatives have met with numerous community activists in May and June 1998, and in June 1998, held the first of two seminars with neighborhood associations or groups. In these seminars, the director plans to educate these groups regarding the Department's role in liquor licensing and regulation and gather information on how the Department can work more effectively with communities. Additionally, the director plans to work with neighborhood groups to develop and propose legislation that will broaden the Department's authority to investigate liquor establishments that cause problems for neighborhoods because they bring increased noise, litter, traffic, and crime.

In addition to the activities the Department has undertaken, recent actions the Board has taken suggest improved responsiveness to communities. While local communities have perceived the Board as favorable toward license applicants and anti-community, Board members have characterized this perception as unfair since cities have often not

appeared before the Board to support their position, have been unprepared, or have not understood the legal requirements that bind the Board. These reasons partially explain why the Board overruled 20 local governing body objections to liquor license applications in 1997. However, in recent license application decisions before the Board, Board members have sided more frequently with cities and/or citizens that have filed timely, valid protests against a license application. For example, in Board meetings held in January 1998 through June 1998, the Board denied 16 of 29 license applications in which a city and/or citizen had protested the application. Two of the applications were withdrawn, while the Board granted 11 of the applications. For the 11 applications that the Board granted, either the city did not attend the hearing to present its case, the protest was withdrawn, or the protest was based on insufficient evidence.

Finally, while the Board's recent actions indicate a greater responsiveness to community concerns, the recent appointment of a neighborhood representative to the Board, in accordance with A.R.S. §4-111(B), should further assist the Board in its efforts to properly consider community concerns in liquor licensing or regulatory decisions.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether to continue or terminate the Department of Liquor Licenses and Control and the State Liquor Board.

1. The objective and purpose in establishing the Department of Liquor Licenses and Control.

The courts and the Legislature have stated that the objective and purpose for establishing the Department center on protecting the public health, safety, and welfare. The Legislature, in Laws 1984, Chapter 32, Sections 1 and 24 defined the purpose of the Department as: “. . .to regulate the liquor industry through the license control process, collect fees and taxes for the maintenance of government and enforce statutes in order to maintain the health and welfare of the community.” As such, the Department licenses all liquor manufacturers, suppliers/wholesalers, and retailers in the State; investigates suspected noncompliance with state liquor laws; trains local law enforcement agencies in the proper investigation and reporting of liquor law violations, conducts compliance hearings and imposes sanctions for liquor law violations, and maintains for public inspection a public record of liquor licenses and any persons having a legal or equitable interest in such licenses.

Arizona law does not currently define the legislative intent for the Arizona State Liquor Board (Board). Although technically part of the Department, the Board operates independently of the Department, yet does not provide oversight. When created in 1967, the Board had authority to grant, deny, and revoke licenses, and hold hearings and consider appeals of Department decisions. While current statutes retain the appellate authority, the Board no longer has sole authority to revoke licenses, and it now considers and makes final decisions only on protested liquor license applications.

2. The effectiveness with which the Department has met its objectives and purposes and the efficiency with which it has operated.

The Department has generally met its objectives and purposes by licensing and conducting background checks on all Arizona manufacturers, suppliers, and retailers of alcoholic beverages. In addition, the Department conducts timely investigations of state liquor violations to enforce state liquor statutes and rules, and works closely with local law enforcement agencies to regulate the liquor industry.

However, the audit found the Department can more effectively meet its objectives by:

- Formally adopting penalty guidelines, recording deviations from these guidelines, and improving enforcement over licensees who repeatedly violate liquor law. Currently, the Department inconsistently applies penalties and fails to appropriately penalize or consider the entire violation record of some repeat offenders (see Finding I, pages 11 through 19).
- Seeking legislative changes to the liquor license application process, and improving the Department's training and supervision of employees processing these applications. Currently, the Department improperly processes and approves some applications, and as a result inappropriately issues some licenses (see Finding II, pages 21 through 25).
- Raising its penalties and increasing enforcement over licensees who fail to renew liquor licenses before expiration. By increasing penalties and actively ensuring that licensees do not sell liquor on expired licenses, the Department could provide greater incentive for timely license renewal and disincentive for illegal liquor sales (see Finding III, pages 27 through 30).

3. The extent to which the Department has operated within the public interest.

The Department generally operates in the public interest by licensing the liquor industry and assuring compliance with state liquor laws through enforcement, training, and adjudication. In addition, the Department has tried to improve the public's access to Departmental information by electronically storing most agency records, including licensing and enforcement information. Currently, the public can access information on liquor license applications and licensee enforcement records through the Department's Internet Website and three public computer terminals at the agency's office. However, members of the public and auditors have noted slow computers and frequent system "crashes" that limit the public's ability to effectively access this data. The Department recognizes this problem and is currently seeking approval from the Government Information Technology Agency for new software and updated equipment before it approaches the Legislature for funding to address its computer system problems.

In addition to enhancing public access to liquor-related information, the Department has become more responsive to communities and their concerns regarding liquor establishments in their neighborhoods. Nationally and locally, communities and citizens seek a greater role in the liquor licensing and enforcement process. While previously perceived as nonresponsive to community concerns, recent actions taken by

the Department and the Board demonstrate their efforts to become more responsive to community concerns. For example, the Department Director has met with numerous community activists over the past few months and held the first of two seminars with neighborhood groups and industry representatives in June 1998. Additionally, the Board has become more responsive to community concerns regarding licensing and enforcement decisions it makes (see Other Pertinent Information, pages 37 through 42).

4. The extent to which rules and regulations promulgated by the Department are consistent with legislative mandate.

Pursuant to A.R.S. §§4-112(A)(2) and 4-112(B)(1), the Board and the Department may adopt rules to carry out provisions of the state liquor code. The rules encoded in R19-1-101 to R19-1-305 are consistent with the Department's purpose as outlined in Arizona statute.

5. The extent to which the Department has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.

Generally, the Department gains input from the public when it promulgates rules. While the Board has not promulgated rules recently, the Department has developed rules as needed. For example, in accordance with statutory mandate, the Department is working on rules to define the length of the liquor license application process. As the Department develops these rules, it plans to hold public hearings if there is enough public interest. In addition, in the 1997 legislative session, the Department gained an emergency exemption from the rulemaking process to adopt rules governing licensed establishments that serve alcohol at events attended by minors. The Department informed the public of its actions and sought and received public input prior to adopting these rules.

With one exception, the Department complies with the State's open meeting laws. Specifically, the Department publishes Liquor Board meeting notices before each meeting, makes an agenda available to the public, and provides recordings of the meetings. However, the open meeting laws also require the Department to file a statement with the Secretary of State indicating where all meeting notices will be posted, but when contacted by auditors, the Secretary of State's Office did not have this statement on file.

6. The extent to which the Department has been able to investigate and resolve complaints that are within its jurisdiction.

The Department is able to quickly investigate and resolve complaints. Because the Department maintains responsibility for regulating the liquor industry, the Department has an established process for resolving complaints of state liquor law violations. Specifically, the Department accepts complaints regarding liquor law violations from the public, or local law enforcement, or complaints developed from internal Departmental investigations. The Department investigates these complaints, and if they are substantiated, sets penalties for the violations. The Department also makes records of confirmed violations available to the public. In fiscal year 1997-98, Department records indicate it opened and completed over 1,000 investigations involving state liquor law violations. As a result of those investigations, the Department collected over \$500,000 in fines, issued 119 warning letters, suspended 43 licenses, and revoked 6 others. This review found that the Department quickly reviewed and evaluated these complaints. Specifically, Department investigators are able to recommend action on these complaints within an average of three days from the date they received the complaint.

While the Department quickly reviews complaints, it fails to consistently communicate the results of these reviews. Specifically, A.R.S. §4-112(B)(5) charges the Department with “. . .responding in writing to any law enforcement agency that submits an investigative report to the department relating to a violation of this title, setting forth what action, if any, the department has taken or intends to take. . .”. Auditors contacted law enforcement officials in Phoenix, Tucson, Flagstaff, Scottsdale, and the State’s Department of Public Safety to evaluate the Liquor Department’s compliance with this statute. While most city officials felt the Department performed adequately, some indicated the Liquor Department did not always update them on the progress of investigations. In fact, one city official noted that the Liquor Department has not reported on the status of most complaints forwarded to the Department during 1996 and 1997.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.

A.R.S. §4-112(C) requires that the Department investigate compliance with the State’s liquor laws. If licensees violate these laws, A.R.S. §4-210.01 establishes the Department’s authority to set civil penalties from \$200 to \$3,000. Additionally A.R.S. §4-210 provides the circumstances under which the Department can suspend or revoke a liquor license. Currently, a representative from the Attorney General’s Office represents the Department in all legal matters, including formal hearings before the Board, administrative hearings, or any appeals before the State’s Superior or Supreme Courts. Additionally, a representative from the Attorney General’s Office advises the Board on all legal matters. However, when the Department appears before the State

Liquor Board, a member of the State's Solicitor General section, a section within the Attorney General's Office, offers independent legal advice to Board members. The Department's Director indicates that the assignment of a permanent Attorney General's representative to the Department is crucial to its ability to enforce liquor laws.

8. The extent to which the Department has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate.

While the Department has not recently recommended any changes to its statutes, it has been involved in several bills designed to improve the liquor license process. For example, the Department supported Laws 1996, Chapter 307, which included provisions defining food and wine clubs and establishing restaurant audit time frames. Moreover, the Department supported Laws 1997, Chapter 146, which adjusted the Liquor Board's composition to include a member of a neighborhood association. This law also increased the number of wine festival permits available to each winery to 12 per year, and defined "gross revenues."

Additionally, Laws 1998, Chapter 259 made further procedural and organizational changes to the Department. For example, to broaden the role of the community in liquor licensing, the bill stipulates that if a city or town disapproves certain liquor license applications by a two-thirds majority, the Board needs a two-thirds majority to overturn the vote. Also, the bill established a Neighborhood Association Interaction and Liquor Enforcement Management Unit, which responds to complaints from neighborhood associations.

Finally, for the 1999 legislative session, the Department is considering proposing changes to A.R.S. §4-210, which would allow the Department to issue administrative penalties to licensees based on the criminal actions of their patrons.

9. The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in the Sunset Law.

Based on our audit work, we recommend that the Legislature consider making a number of statutory changes to improve the licensing process. First, the Legislature should consider amending A.R.S. §4-201(E), to ensure cities and/or counties respond in a timely manner with liquor license application recommendations (see Finding II, pages 21 through 25). Second, the Legislature should consider modifying A.R.S. §4-209(A) to increase the late renewal penalty for licensees who renew late (see Finding III, pages 27 through 30).

Finally, A.R.S. §4-210(E) requires that the Department notify the Board of locations receiving three or more law enforcement complaints of alleged liquor law violations in a year. Based on this information, the Board can order the Department to investigate these locations. However, while the Department recently reintroduced this document in June 1998, the Department deviates from the statutory requirements of the report. Specifically, rather than reporting complaints, the Department reports confirmed violations because it feels that sending accusations would be unfair to licensees. To resolve this issue, the Legislature should consider amending A.R.S. §4-210(E) to authorize the Director to report only confirmed violations.

10. The extent to which the termination of the Department would significantly harm the public health, safety or welfare.

Terminating the Department and the Board would significantly harm the public's health, safety, and welfare, as both the Department and Board play a major role in encouraging the proper use of alcohol in the State. If the Department were terminated, cities and counties would be required to take up the burden of liquor licensing and civil enforcement of the state liquor code. Moreover, the Department promotes public safety by providing supplemental manpower and liquor law training to local law enforcement agencies.

11. The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent levels of regulation would be appropriate.

The Department's current level of regulation appears adequate.

12. The extent to which the Department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

Because the Department functions primarily as a licensing and law enforcement agency, there appears to be little opportunity to effectively use private contractors in performing its duties. The Department does, however, certify private companies to conduct liquor law training for licensees. Moreover, both the Board and the Department use a court reporting service to transcribe the minutes of its public meetings and proceedings.

Agency Response

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November 5, 1998

**Douglas R. Norton, CPA
Auditor General
State of Arizona
2910 North 44th St.
Phoenix, AZ 85018**

Mr. Norton:

I have received and reviewed the revised preliminary report draft of your performance audit of the Department of Liquor License and Control pursuant to the May 27, 1997 resolution of the Joint Legislative Audit Committee.

The Department is very pleased with the outcome of the audit.

Furthermore, we are satisfied that your team performed a thorough, in-depth analysis of our operations and our procedures since completion of the business process reengineering of the Department.

The Department accepted all of your findings and recommendations. Fourteen of the 19 recommendations have been implemented. The remainder are currently being developed.

Sincerely,

A handwritten signature in black ink, appearing to read 'Howard Adams', with a stylized flourish at the end.

Howard Adams, Director

RESPONSE TO FINDING I

INCONSISTENT SANCTIONS OF LIQUOR LAW VIOLATIONS

Recommendation (1) *The Department should adopt a substantive policy formally establishing its penalty guidelines.*

Response: **The finding of the Auditor General is agreed to and the recommendations will be implemented.**

Recommendation (2) *The Department should consistently record and document factors, such as previous violations and other aggravating or mitigating circumstances that influence a licensee's penalties.*

Response: **The finding of the Auditor General is agreed to and the audit recommendation will be implemented.**

Recommendation (3) *The Department should strengthen its policies and procedures for identifying and penalizing repeat liquor law violators by:*

(a) Grouping similar offenses in different categories, such as employee alcohol consumption or minor-related penalties, to more adequately consider previous liquor law violations in determining penalties for repeat violations;

(b) Documenting cases in which separate violation incidents have been combined into one disciplinary action so the separate violations can be appropriately considered in future enforcement actions; and

(c) Taking into account, where appropriate, the violation histories of other licenses held by the same owner when setting penalties.

Response: **(a) The finding of the Auditor General is agreed to and the audit recommendation will be implemented.**

(b) The finding of the Auditor General is agreed to and will be implemented.

(c) The finding of the Auditor General is agreed to and the finding will be implemented.

Recommendation (4) The Department should adopt a written policy defining the types of violations and licensees eligible for the mail-in ticket program and consider requiring licensee training as a condition for receiving the mail-in ticket discount.

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

RESPONSE TO FINDING II

LICENSE APPLICATION PROCESSING

***Recommendation (1)** The legislature should consider amending A.R.S. §4-201(E) to permit the Department the discretion to extend the time frame for city and county.*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Language has been drafted and will be submitted to a state legislator.

***Recommendation (2)** The Department should increase licensing staff training by developing written license application policies and procedures to help ensure compliance with statutory and procedural requirements.*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

***Recommendation (3)** The Department should institute a supervisory review of license applications prior to their approval to ensure compliance with statutory time frames and internal policies and procedures.*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented. An immediate interim solution has been established until programming can be obtained.

RESPONSE TO FINDING III

LICENSEES FAILURE TO RENEW LICENSES ON TIME

Recommendation (1) *The legislature should consider amending A.R.S. §4-20(A) to increase the current \$150 late renewal penalty fee and incorporate a graduated schedule that would increase the penalty amount the later the licensee renews after license expiration.*

Response: **The finding of the Auditor General is agreed to and the audit recommendation will be implemented.** Language has been drafted and will be submitted to a state legislator.

Recommendation (2) *The Department should implement procedures that coordinate the investigation of licensees selling liquor on expired licenses with other investigator duties to ensure licensees cease liquor sales when their licenses expire.*

Response: **The finding of the Auditor General is agreed to and the audit recommendation will be implemented.**

Recommendation (3) *The Department should notify licensees both in the license renewal packet and through a letter after license expiration that licensees are prohibited from selling liquor on an expired license.*

Response: **The finding of the Auditor General is agreed to and the audit recommendation will be implemented.**

RESPONSE TO FINDING IV

THE DEPARTMENT DOES NOT ADEQUATELY SAFEGUARD LICENSEE FEES AND FINES

Recommendation (1) *The Department should establish and maintain the following processes and procedures to better safeguard state moneys.*

- (a) Immediately endorse all checks and money orders upon receipt;*
- (b) Store moneys only in the Information Services safe, limit access to this safe to only necessary Department staff, and discontinue using the safes and locking storage areas in the Licensing and Compliance areas;*
- (c) Generate a record of money received, such as a receipt, to accompany license application, license renewal, or compliance documentation during processing;*
- (d) Regularly reconcile moneys received to deposits;*
- (e) Establish a depository account in Tucson for moneys received at the Tucson office rather than transporting those moneys to phoenix via inter-agency mail;*
- (f) Develop policies and procedures for handling cash and cash-like receipts that incorporate the recommended changes made in this report and define employee responsibilities for each step in the cash-handling process; and*
- (g) Periodically request a procedural review from the State's General Accounting Office to ensure it adheres to established policies and procedures.*

Response: **The findings of the Auditor General is agreed to and the audit recommendations will be implemented.**