



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit and Sunset Review

Arizona Department of Liquor Licenses and Control

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Auditor General

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OFFICE OF THE
AUDITOR GENERAL

WILLIAM THOMSON
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August 24, 2009

Members of the Arizona Legislature

The Honorable Janice K. Brewer, Governor

Jerry A. Oliver, Sr., Director
Arizona Department of Liquor Licenses and Control

Transmitted herewith is a report of the Auditor General, A Performance Audit and Sunset Review of the Arizona Department of Liquor Licenses and Control. This report is in response to an October 5, 2006, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona Department of Liquor Licenses and Control agrees with all of the findings and plans to implement all of the 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 August 25, 2009.

Sincerely,

Debbie Davenport
Auditor General

Attachment

SUMMARY

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona Department of Liquor Licenses and Control (Department) pursuant to an October 5, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The Department regulates the manufacturing, distribution, and sale of liquor in the State. The Department reported issuing or renewing more than 15,000 liquor licenses in fiscal year 2008, primarily for restaurants, bars, beer and wine stores, and liquor stores, but also to producers, wholesalers, and sponsors of special events and festivals. Besides issuing licenses, the Department also conducts investigations to ensure licensees are complying with state liquor laws. These investigations include responding to complaints and police reports, conducting routine visits to determine compliance with state laws, and conducting covert investigations to check for such violations as selling or serving alcohol to underage patrons. Additionally, the Department imposes penalties, such as fines or license suspensions or revocations, against licensees who violate state liquor laws.

The audit focused on the Department's investigations approach, its processes and practices for taking disciplinary action against licensees who violate state liquor laws, and its process for issuing new quota liquor licenses for bars, beer and wine bars, and liquor stores.

Department has improved investigative approach, but additional steps needed (see pages 13 through 21)

Although the Department has improved its investigative approach, it should take additional steps to further improve its investigations. Auditors observed officers during their shifts and identified the following:

- During the shifts observed, officers spent a significant portion of their shift driving around looking for licensed establishments to visit, traveling back and forth

between the opposite ends of their assigned areas during the same shift, and passing numerous licensed establishments without stopping. Each officer's area has hundreds of licensees. Time spent driving decreases the amount of time available to visit licensees.

- After conducting a covert investigation, officers do not identify themselves unless they find a violation, nor does the Department notify the licensee that an investigation was conducted. Research indicates that active, visible law enforcement is a way to deter licensees from violating liquor laws.¹ Seventy-five percent of the investigative activities on the shifts auditors observed were covert investigations. If licensees remain unaware that investigations have taken place, the Department does not realize any deterrent effect from its investigations.

In response to auditors' findings and to staff reductions brought on by fiscal year 2009 budget cuts, the Department is pursuing a new investigations approach. Among other things, this approach centralizes officers but retains an investigative presence throughout the State, revises officers' schedules, and establishes a more visible presence by requiring officers to conduct additional routine inspections. This revised approach should enhance the Department's enforcement presence. However, several additional steps can further enhance this approach. Specifically, the Department should develop and implement policies and procedures that incorporate guidance for prioritizing officer workloads and effectively planning investigation shifts. Additionally, the Department should notify licensees about the results of all investigations, including covert investigations, and conduct follow-up investigations of licensees who have seriously or repeatedly violated state liquor laws.

The Department should also improve the way it collects, analyzes, and uses data to support its investigative activities. Although the Department collects a variety of information related to its investigative activities, some of this information is inaccurate and incomplete. This includes inaccurate and incomplete information recorded on officer weekly activity logs and entered into the Department's database. As a result, the Department cannot track who has been investigated or what types of investigations are being conducted and does not have the information to determine investigative priorities and activities. The Department is in the process of implementing a new information system, which it anticipates will improve investigation tracking and analysis. However, to ensure the information within this system is accurate, complete, and useful, the Department should establish and implement additional policies and procedures for collecting, entering, analyzing, and using the information.

1 Wagenaar & Tobler, 2006

Department should take stronger action against repeat and serious violators (see pages 23 through 31)

Research indicates that strong enforcement actions can help deter liquor law violations and lessen the negative effects of the inappropriate and illegal use of alcohol. The Department has established policies to help guide its enforcement actions, and for the most part, it follows these policies. However, when auditors examined a sample of enforcement cases the Department processed from 2004 through 2008, they found that the Department deviated from penalty guidelines about one-fourth of the time without providing required explanation. This is an improvement from the previous performance audit conducted in 1998, which found that disciplinary actions deviated from penalty guidelines approximately two-thirds of the time. Nonetheless, the Department still needs to follow its policy of stating the reasons for such deviations.

Several of the Department's enforcement policies and practices weaken enforcement efforts over repeat and serious violators. Specifically:

- **Incomplete penalty guidelines lead to inconsistent discipline**—The Department has established penalty guidelines that outline penalties for 75 offenses, but 59 other offenses lack such guidelines. Inconsistent penalties can result for offenses not included in the guidelines. For example, the Department imposed a \$375 fine for one licensee and a \$1,000 fine for another licensee for first-time violations of a statutory requirement that licensees purchase alcohol from an authorized supplier. This violation is not included in the Department's penalty guidelines.
- **Policies limit Department's ability to take strong action against repeat offenders**—To help identify licensees who repeatedly commit similar offenses, the Department groups some similar violations into classifications, such as underage drinking. A licensee who is cited within 2 years for a second offense in the same classification is considered a repeat offender. However, these groupings contain only 19 of the 134 potential liquor-related violations. For example, there are 12 different underage violations, but the Department includes only 5 of these offenses in its underage classification. In addition, under department policy, a licensee who commits an offense in one classification and a second offense in another classification within 2 years is not considered a repeat offender.
- **Reduced fines imposed for some serious first offenses**—Department policy states that if a case against a licensee is a minor first-time offense and the licensee has no other violations within the last 2 years, the Department may offer the licensee a 50 percent reduction of the fine designated by its penalty

guidelines. However, the Department does not define the term “minor,” and auditors found that this policy is frequently applied to serious offenses relating to underage drinking, over-service, and public health and safety. Sixteen of the 40 enforcement cases involving 13 of the 14 licensees auditors reviewed were first offenses that received a discount for serious violations, such as selling alcohol to a minor and employees consuming alcohol while on duty.

Application of these policies has allowed some licensees to commit serious and repeated violations without receiving consistently strong discipline. For example, auditors identified one licensee with a 4-year history of underage violations who, despite six different violations over this time, had received at most a \$4,500 fine.

The Department should take several steps to strengthen its enforcement policies and take consistently strong and effective disciplinary action against licensees who commit serious violations or repeatedly violate state liquor laws. Specifically, the Department should revise its penalty guidelines to include penalties for all possible state liquor law violations, revise/expand its violation groupings to encompass more liquor violations, and group violations by the severity of the offense instead of only on the nature of the violation. The Department should also weigh any violation within 2 years as an aggravating circumstance, regardless of its classification. Finally, the Department should either eliminate discounts for minor offenses altogether or revise its policies to define “minor” and limit the number of times a licensee can receive the discount.

Other Pertinent Information (see pages 33 through 38)

During the course of the audit, auditors collected and reviewed information regarding statutory requirements and department processes for issuing new quota liquor licenses for bars, beer and wine bars, and liquor stores, and for determining the licenses’ fair market value. Laws 2005, Ch. 284, §16, required the Department to issue new quota licenses annually based on each Arizona county’s population through fiscal year 2010. In response to these requirements, the Department has issued 151 new quota liquor licenses state-wide from fiscal years 2006 through 2009. The number of new licenses is only about 31 percent of the number authorized by statute. Department officials indicated that applicants’ interest has not matched the number of licenses available. In accordance with state laws, the Department has issued these licenses at their fair market value, which it reports has generated more than \$15.2 million in revenues for the State General Fund.

Beginning in fiscal year 2011, A.R.S. §4-206.01(B) will require the Department to issue new quota liquor licenses based on population growth in each county instead of total county population.

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concluded ♦

INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona Department of Liquor Licenses and Control (Department) pursuant to an October 5, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

Importance of liquor regulation

Various data and studies indicate that regulating the sale of alcohol helps to protect the public from the potentially dangerous effects of the misuse of alcohol. The misuse of alcohol manifests itself in several ways. For example:

- **Public health problems**—According to research by Aidan Moore, a program manager for the Northeast Region of the National Center for Alcohol Law Enforcement, “at least 85,000 Americans die each year from alcohol related causes, making alcohol related problems the third leading actual cause of death in the United States.”¹
- **Underage drinking**—Drinking by youths contributes to alcohol-related problems, including impaired driving and violence. According to a 2006 research report by the Pacific Institute for Research and Evaluation (PIRE), an independent, nonprofit organization focused on various problems associated with the use of alcohol and other drugs, “underage drinking cost Arizonans \$1.3 billion in 2005. These costs include medical care and work loss related to youth violence, traffic crashes, high-risk sex, property crime, and other problems associated with underage drinking.”²
- **Over-service of alcohol**—Providing alcohol to people who have already had too much to drink, regardless of their age, also contributes to alcohol-related problems. According to a 2008 research study in the journal *Addiction*, the majority of licensed liquor establishments are likely to sell alcohol to obviously

Liquor regulation helps to protect the public from the potentially dangerous effects of alcohol misuse.

¹ Moore, 2006

² PIRE, 2006

intoxicated patrons, despite laws prohibiting it.¹ Further, a 2005 National Center for Alcohol Enforcement study on over-service asserts that preventing alcohol sales to intoxicated people has tremendous potential for preventing car crashes and fatalities, assaults, and disorderly conduct, and for improving the quality of life in local neighborhoods.²

Active and appropriate regulation of the sale of alcohol can help to minimize the harmful effects of the inappropriate and illegal use of alcohol. Specifically, research shows that “compliance with laws improves when those subject to mandates believe that violations will be detected and punished.”³

Liquor regulation in Arizona

The Department is responsible for protecting the public by regulating the production, distribution, and sale of liquor throughout the State. As part of these responsibilities, the Department licenses all liquor manufacturers, suppliers/wholesalers, and retailers; audits restaurant licensees to ensure compliance with license requirements; and investigates and enforces compliance with state liquor laws. Specifically:

- **Licensing**—The Department processes all manufacturing, supply/wholesale, and retail license applications it receives. According to A.R.S. §4-202, licenses should be granted only to U.S. citizens who have not been convicted of a felony within 5 years prior to submitting the application, and who have provided a full set of fingerprints to the Department and complete financial disclosure statements when requested by the Director. Additionally, according to A.R.S. §4-201(C), local government bodies, such as cities, towns, or counties, have 60 days to review liquor license applications and make a recommendation of approval or disapproval to the Department; while A.R.S. §4-201(B) provides citizens who live or lease/own property within a 1-mile radius of the proposed liquor establishment 20 days to file a protest with the Department regarding the proposed establishment. The filing of a timely protest by either a local governing body or citizen requires the Department to forward the license application to the Arizona State Liquor Board (Board) for further consideration. All other license applications are either approved or denied by the Department.

Consistent with statute, the Department issues 17 different types of liquor licenses. As Table 1 illustrates (see page 3), these include licenses for bars, liquor stores, and restaurants, as well as various licenses for those who

1 Toomey et al., 2008

2 Carmona, 2005

3 Wagenaar & Tobler, 2006

manufacture liquor and for wholesalers who distribute alcohol to retailers.¹ In April 2009, the Department reported having nearly 11,000 active licensees. The majority of these, or 9,209 licenses, were issued to businesses where beer or alcohol was consumed or purchased, while the remainder were issued to producers, wholesalers, or others involved in the production and supply chain.

Table 1: Active Liquor Licenses and Associated Fees by Type
As of April 8, 2009

License Type	Number of Active Licenses	Initial Fees	Annual Renewal Fees¹
Restaurant	2,874	\$1,500	\$500
Beer and wine store	2,200	1,500	50
Out-of-state producers ²	1,518	200	50
Liquor store ³	1,386	1,500	50
Bar ³	1,333	1,500	150
Beer and wine bar ³	874	1,500	75
Club	292	1,000	150
Hotel/motel	162	1,500	500
Wholesaler	93	1,500	250
Government	66	100	100
Domestic farm winery	41	100	100
Domestic microbrewery	30	300	300
Conveyance	22	1,500	225
In-state producer	1	1,500	350
Total active licenses	10,892⁴		

¹ Additional fees may apply. Specifically, the annual renewal fee does not include surcharges, which the Department uses to help pay for the costs of investigations or audits.

² The total number of active out-of-state producers consists of 1,025 out-of-state producers and 493 limited out-of-state producers. To be eligible for a limited license, limited out-of-state producers, microbreweries, and/or wineries must meet restrictions on the amount of alcohol that can be produced and then sold in the State. According to department documents, the Department charges a \$25 initial fee and a \$25 annual renewal fee for these licenses.

³ Liquor stores, bars, and beer and wine bars have quota liquor licenses. In addition to the fees listed in the table, applicants for new quota liquor licenses must pay additional fair market value fees, which ranged between \$5,133 and \$235,800 in fiscal year 2008, dependent upon the license type and county in which the business was located.

⁴ The total does not include special event, wine festival, or direct shipment licenses.

Source: Auditor General staff counts of active licenses, obtained from the Department's Licensing Control System database as of April 8, 2009, and Auditor General staff analysis of A.R.S. §4-209(B) and (D).

¹ The total in Table 1 does not include special event, wine festival, or direct shipment licenses, which are authorized by A.R.S. §§4-203.02 through 4-203.04. Consistent with statute, qualifying organizations may apply for and receive a special event license to sell liquor on a temporary basis. According to Arizona Administrative Code R19-1-309(B), these licenses may be issued for no more than 10 days in a calendar year. During fiscal year 2008, the Department reported issuing 1,828 special event licenses. Further, the Department may issue up to 25 temporary wine festival licenses each year for up to a total of 75 days per licensed winery. In fiscal year 2008, the Department reported issuing 158 wine festival licenses. Finally, direct shipment licenses allow persons engaged in the business of brewery, distillery, or the like and who are licensed by another state to directly ship alcohol for personal use to individuals who are over 21 years of age. As of April 2009, the Department reported having 7 active direct shipment licenses.

Quota liquor licenses comprise three types of licenses—those for bars, beer and wine bars, and liquor stores. For all other licenses, the Department can accept and process an unlimited number of license applications. However, statute limits the number of quota liquor licenses in the State to prevent their proliferation, which significantly increases the value of these licenses. Quota licenses can be acquired in one of two ways:

- **Transfer**—Existing quota liquor licenses may be transferred by their purchase 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.
- **Obtain from Department based on fair market value**—The Department also issues new quota liquor licenses based on their fair market value. Prior to 2006, the Department had the ability to issue new quota licenses, but it was not required to do so and had not issued any new quota licenses since fiscal year 1988. However, Laws 2005, Ch. 284, §16, required the Department to issue new quota liquor licenses each year between fiscal years 2006 and 2010, with the maximum number of new licenses to be based on a county's population. In response to this requirement, the Department has issued 151 new quota liquor licenses between fiscal years 2006 and 2009. Beginning in fiscal year 2011, A.R.S. §4-206.01 will slightly change the requirements for issuing these licenses and will require the Department to issue quota liquor licenses based on county population growth (See Other Pertinent Information, pages 33 through 38, for more information).

The Department reported that it issued 2,083 new liquor licenses (including transferred quota liquor licenses), 1,828 special event licenses, and 158 wine festival/fair licenses in fiscal year 2008. The Department also reported renewing 10,963 liquor licenses, for a total of 15,032 licenses issued in fiscal year 2008. In contrast, in fiscal year 1998, the Department reported issuing and/or renewing 10,293 licenses.

- **Auditing**—The Department conducts audits of restaurant licensees to ensure they generate at least 40 percent of their revenue from food sales. In fiscal year 2008, the Department reported completing 61 audits, identifying a total of 133 violations, and collecting \$55,500 in fines (See Sunset Factors, pages 40 to 41, for more information).

A statutory change made in 2006 allows the Department to continue licensing some restaurants that do not meet the 40 percent standard. Specifically, A.R.S. §4-213(E) allows restaurant licensees that fall below the 40 percent of food sales but that maintain at least 30 percent in food sales to continue operating as a restaurant licensee upon the Department's approval. Statute further specifies that the Department can only approve up to 15 restaurant licensees annually

In fiscal year 2008, the Department reported issuing more than 2,000 new liquor licenses and renewing nearly 11,000 existing liquor licenses.

through fiscal year 2013 under this provision. Additionally, A.R.S. §4-209(D)(12) authorizes the Director to establish an additional fee for these licensees to continue operating, and according to department staff, the Department has established a one-time fee of \$30,000. Prior to 2006, the Department revoked restaurant licenses if these establishments did not maintain 40 percent of their revenues from food sales. If the licensee desired to continue selling alcohol, he/she had to apply to become licensed as a bar, which is a limited quota liquor license, and in fiscal year 2008, cost as much as \$111,667 depending on the county in which the bar was located. The Department reported approving two restaurant licensees to continue operating under this statutory provision in fiscal year 2008 and three in fiscal year 2009.

Although the Department has established a one-time fee of \$30,000 for these licenses, this amount has not yet been adopted in its administrative rules. The Department had included this one-time fee in a proposed rule change package, but in January 2009, the Governor halted ongoing rulemaking efforts to ensure that her appointees have the opportunity to review any new or pending rules. As a result, the Department has not taken any further action on these proposed rule changes (See Sunset Factors, page 45, for more information).

- **Investigations**—Statute requires the Department’s Director to establish a separate investigations unit to investigate noncompliance with state liquor laws. The Department employs certified peace officers to perform several investigative activities. In addition to performing background checks on license applicants and site inspections for restaurant license applicants, and providing training on state liquor laws to law enforcement agencies state-wide, investigative activities include:
 - **Complaints**—Members of the public can submit complaints to the Department regarding potential violations of state liquor laws. Department staff reported that complaints are received by word of mouth, department hotline, e-mail, U.S. mail, and voice mail. The Department’s goal is to investigate and resolve 85 percent of complaints within 90 days. In fiscal year 2008, the Department reported receiving 701 complaints.¹
 - **Covert investigations**—Wearing street clothes, department officers enter licensed establishments and observe practices and compliance with state liquor laws. Officers do not typically identify themselves during these investigations unless violations are observed. The Department reported conducting 4,326 covert investigations in fiscal year 2008.

If during a covert investigation officers observe a violation, they disclose their identity, and the Department classifies the investigation as an on-view or overt investigation. The Department reported performing 649 on-view or overt investigations in fiscal year 2008.

¹ Auditors’ review of investigations statistics from various sources revealed that insufficient controls were in place to establish the reliability of the complaint, covert, Routine License Inspections, Covert Underage Buyer Program, and Target Responsibility for Alcohol Connected Emergencies, and police report statistics for any use other than general background information.

- **Routine License Inspections (RLIs)**—An RLI is an inspection that follows a set checklist and is designed to assess whether a licensee is following state liquor laws, including appropriate sign displays, availability of employee records, proper liquor storage, and authorized floor plans. According to a department official, as of March 2009, each department officer should complete 60 RLIs each month. In fiscal year 2008, the Department reported conducting 4,738 RLIs.
- **Covert Underage Buyer Program (CUB) investigations**—Department officers accompany undercover teens who attempt to buy liquor from various licensed establishments. Other law enforcement agencies throughout the State also perform these undercover operations. The Department reported completing 572 CUB investigations in fiscal year 2008.
- **Target Responsibility for Alcohol Connected Emergencies (TRACE) inspections**—For very few accidents or fatalities that occur in connection with Driving while Under the Influence of alcohol, department officers attempt to trace the over-the-limit driver back to the licensee who served the driver. According to a department official, TRACE investigations begin by referral to the Department that a serious accident involving alcohol has occurred. Without this notification, the Department is unaware that accidents have occurred and cannot initiate an investigation. Additionally, many law enforcement agencies are not familiar with the Department's ability to perform these investigations, so they do not refer these accidents to the Department. As a result, according to department records, the Department performed three TRACE investigations in fiscal year 2008.
- **Police reports**—Department officers review and in some cases conduct further investigation of reports submitted by any law enforcement agency relating to liquor law violations. If these reports substantiate liquor law violations, the Department reports that it will consider disciplinary action. The Department reported reviewing about 5,100 police reports during fiscal year 2008. According to statute, the Department is required to 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 improve the report.
- **Enforcement**—The Department imposes disciplinary action against licensees for violations of state liquor laws. A.R.S. §§4-210.01(A) and 4-210(A) and (G) grant the Department the authority to issue warnings, and civil penalties of not less than \$200 but not more than \$3,000 for each violation; suspend or revoke licenses; and refuse to renew a license. Additionally, the Department may require the licensee to attend a training program approved by the Department. In some cases, the Department will attempt to hold a compliance meeting with

licensees to discuss the violation and determine an appropriate course of disciplinary action that will be included in a consent agreement. In fiscal year 2008, the Department reported that it issued 77 warning letters, collected 255 fines totaling \$391,125, suspended 12 licenses, and revoked 5 others. The Department also forwarded 32 cases to administrative hearings, which could result in the Department's taking any of the above actions.

Organization and staffing

In 1939, the Arizona Legislature established the Department of Liquor Licenses and Control and in 1967, created a three-member board, which was later increased to seven members. The Governor appoints the Board's seven members for 3-year terms, with one member being a licensed retailer or employee of a licensed retailer, another member representing a neighborhood association recognized by a county, city, or town, and five members with no financial ties to the liquor industry. The Board meets once a month to carry out its responsibilities, which include holding hearings. Specifically, the Board holds hearings (1) to review liquor license applications that have been protested by a city, county, public citizen, or the Department, and (2) to address licensees' appeals of department disciplinary decisions concerning violations of liquor laws. Additionally, the Board is responsible for adopting rules to carry out the provisions of Title IV (state liquor laws).

The Department is headed by a Governor-appointed Director and is authorized 54.2 staff. As of April 2009, the Department reported that it had 30 positions funded through State General Fund appropriations and 7 positions funded by annual surcharges assessed to licensees, and that 17.2 of its 54.2 FTE positions were vacant.¹ In January 2009, the Department had to significantly reduce staffing as part of state-wide budget reductions brought on by the worsening economy. As a result of these reductions, the Department has fewer staff than it had in 1998. In 1998, the Department employed 50 staff, consisting of 44 FTEs funded through State General Fund appropriations and 6 FTEs funded by annual surcharge fees.

Budget

The Department generates much more in revenues than it is appropriated for its operations. As shown in Table 2 (see page 8), the Department generated more than \$12.5 million and \$8.4 million in revenues solely from license and permit fees in fiscal years 2008 and 2009, respectively. During these same fiscal years, the Department was appropriated approximately \$3.6 million and \$3.85 million, respectively. A.R.S. §4-115(B) requires the Department to remit two-thirds of the licensing fee revenues that it generates to the State General Fund, and the Department remitted more than

The Department generates much more money than it is appropriated for its operations.

¹ A.R.S. §4-209(J), (K), and (L) authorize the Department to charge three surcharge fees to licensees to help pay for the Department's investigation and audit costs. These surcharge fee totals range from \$55 to \$100, depending upon the type of license.

Table 2: Schedule of Revenues, Expenditures, and Changes in Fund Balances
Fiscal Years 2007 through 2009
(Unaudited)

	2007	2008	2009
Revenues:			
Licenses and permit fees ¹	\$10,779,504	\$12,551,868	\$ 8,409,707
State General Fund appropriations	3,465,953	3,596,505	3,852,575
Fines, forfeits, and penalties	720,667	745,034	1,027,065
Intergovernmental	469,355	265,067	176,270
Other	5,051	984	637
Total revenues	<u>15,440,530</u>	<u>17,159,458</u>	<u>13,466,254</u>
Expenditures:²			
Personal services and employee-related	3,400,448	3,558,464	3,162,904
Professional and outside services	194,298	196,328	246,091
Travel	269,023	266,120	210,786
Other operating	532,075	521,041	482,823
Equipment	283,074	276,261	613,906 ³
Total expenditures	<u>4,678,918</u>	<u>4,818,214</u>	<u>4,716,510</u>
Excess of revenues over expenditures	<u>10,761,612</u>	<u>12,341,244</u>	<u>8,749,744</u>
Other uses:			
Operating transfers out ⁴		511,500	681,500
Distributions to Arizona counties and other state agencies ⁵	545,587	583,513	525,902
Remittances to the State General Fund ⁶	<u>10,620,401</u>	<u>11,517,514</u>	<u>8,039,445</u>
Total uses	<u>11,165,988</u>	<u>12,612,527</u>	<u>9,246,847</u>
Deficiency of revenues over expenditures and other uses	(404,376)	(271,283)	(497,103)
Fund balance, beginning of year	1,469,261	1,064,885	793,602
Fund balance, end of year	<u>\$1,064,885</u>	<u>\$ 793,602</u>	<u>\$ 296,499</u>

1 In addition to issuing licenses, the Department may issue an interim permit to an applicant for either a transferrable quota liquor license or a nontransferable spirituous liquor license that allows an applicant to continue operating the liquor business during the license transfer period. The fee for this permit is \$100. In addition to permit fees, the licenses and permit fees also contain license surcharge fees collected by the Department that were \$838,335, \$883,185, and \$883,155 in fiscal years 2007, 2008, and 2009, respectively.

2 Administrative adjustments are included in the fiscal year paid.

3 Consists primarily of payments for the continuing department improvements to its data processing systems as authorized by Laws 2005, Ch. 284, §17.

4 Operating transfers out for 2008 and 2009 include \$500,000 and \$670,000, respectively, transferred to the State General Fund as required by Laws 2008, Ch. 53, §2, and Laws 2009, Ch. 1, §1.

5 Consists of license fee amounts distributed to counties based on their population in accordance with A.R.S. §4-115, and to the Arizona Departments of Health Services and Economic Security in accordance with A.R.S. §§4-116 and 4-203.02.

6 Consists of amounts remitted to the State General Fund in accordance with A.R.S. §4-115. Specifically, the Department remits two-thirds of license, registration, and other fees to the State General Fund. Additionally, any amounts collected in excess of the amount required to be distributed to counties based on their population is also remitted to the State General Fund.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for fiscal years 2007 through 2009; and for fund balances, the AFIS Management Information *System Status of General Ledger—Trial Balance* screen for fiscal years 2007 through 2009.

\$11.5 million and \$8 million in fiscal years 2008 and 2009, respectively, to the State General Fund. Consistent with statutory requirements, licensing fee revenues that were not remitted to the General Fund were distributed to the counties based on their populations. The annual surcharges that the Department collects from its licensees, which totaled \$883,185 and \$883,155 in fiscal years 2008 and 2009, respectively, represent the only revenues that the Department retains.

The \$13.47 million in total revenues that the Department received in fiscal year 2009 represent a significant increase from the nearly \$7.2 million in total revenues it received in fiscal year 1998. This increase can be attributed to three main factors. First, the Department resumed issuing quota liquor licenses, and the fair market value of these licenses can range from \$5,133 to \$235,800, depending upon the license type and county in which the business is located. Second, the number of licenses issued has increased. Third, the Department is generating more revenue from fines—more than \$1 million in fiscal year 2009, compared to \$565,650 in fiscal year 1998. However, the license and permit fee revenues that the Department generated in fiscal year 2009 were more than \$4.1 million less than in fiscal year 2008. Most of this decrease can be attributed to the lower number of new quota liquor licenses issued in fiscal year 2009. For example, in fiscal year 2008, the Department issued 54 quota liquor licenses for a reported total of more than \$6.95 million in revenues. However, in fiscal year 2009, the Department issued 43 quota licenses and generated a reported total of nearly \$3 million in revenues, almost \$4 million less than in fiscal year 2008.

For fiscal years 2008 and 2009, department expenditures totaled more than \$4.8 million and \$4.7 million, respectively. The majority of the expenditures were for salaries and employee-related expenditures.

1998 report and followup

The Office of the Auditor General's most recent performance audit and sunset review of the Department of Liquor Licenses and Control was issued in 1998 (see Auditor General Report No. 98-20) and included four findings. Specifically:

- **Inconsistent enforcement of liquor law violations occurred**—The 1998 audit report found that although the Department adopted internal penalty guidelines, it deviated from these guidelines in approximately two-thirds of the cases auditors reviewed, and did not always take appropriate action against licensees who repeatedly violated state liquor laws. The report recommended several improvements to the Department's enforcement policies and practices, including documenting aggravating or mitigating circumstances that influence a licensee's penalties and strengthening policies and procedures for identifying and penalizing repeat liquor law violations.

During the current audit, auditors found that although the Department more consistently follows its penalty guidelines, when it does deviate from the guidelines, it does not always document the reasons for doing so, as required by its policies (See Finding 2, pages 23 through 31, for more information).

- **Licensing procedures not always followed**—The 1998 audit report found that the Department did not comply with statutorily required time frames for allowing public and city comment on the liquor license application and did not fully document required application information for liquor licenses. Although some problems related to receiving timely comments from cities appeared to be beyond the Department's control, insufficiently trained and inexperienced staff, limited supervisory oversight, and lack of written policy and procedures contributed to the other processing errors. The report recommended a statutory change to allow the Department to extend its licensing time frames, and that the Department improve staff training and supervisory review of license applications prior to approval.

During the current audit, auditors found that the Department has improved its licensing processes. First, A.R.S. §4-201.01(B) allows the Department to extend the licensing time frame established in Arizona Administrative Code R19-1-317(5) from 105 days up to 210 days, if the Director determines that doing so is in the public interest. Additionally, while still in draft form, the Department's policies and procedures have been changed to ensure that licenses are not approved until a supervisory review has been performed and applications are deemed complete. Further, auditors reviewed a stratified sample of 18 of the 1,267 license applications issued by the Department in fiscal year 2008 and found that it issued the majority of the 18 licenses within the required time frame. For those applications that were not processed within the time frames, the Department had to wait for either the applicant or local government to submit required information. Additionally, auditors' review of 15 of these licenses found that all 15 applicants met licensure requirements (See Sunset Factors, pages 39 through 49, for more information).

- **Licensees failed to renew on time, and some sold alcohol on expired licenses**—The 1998 audit report also found that several licensees did not renew their licenses on time and that some of these licensees continued to sell alcohol on expired licenses. The report recommended that the Department coordinate the investigation of licensees selling liquor on expired licenses with other officer duties and notify licensees that they are prohibited from selling liquor on an expired license.

In response, the Department has implemented procedures for providing department officers with a list of expired licenses monthly for investigation. Further, after license expiration, the Department notifies licensees through a cease-and-desist letter that selling liquor on an expired license is prohibited.

- **Department not sufficiently safeguarding state monies**—The 1998 audit report found that the Department lacked an adequate system of policies and procedures to properly safeguard monies that it collected, and recommended that the Department take several steps to improve its cash handling.

In response, the Department has significantly revised its cash-handling procedures, including immediately endorsing checks, limiting employee access to monies, better safeguarding monies by storing some monies received and processed in a locked drawer during the day and all monies received in a locked safe at night, and implementing appropriate policies for reconciling monies. However, the Department should take additional steps to further safeguard the monies it collects (See Sunset Factors, pages 39 through 49, for more information).

Scope and objectives

This audit focused on the Department's investigations approach and the additional steps it can take to improve its investigative activities, its processes and practices for taking disciplinary action against licensees who violate state liquor laws, and its processes for issuing new quota liquor licenses and determining the fair market values for these licenses.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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.

FINDING 1

Department has improved investigative approach, but additional steps needed

The Arizona Department of Liquor Licenses and Control (Department) has improved its investigative approach, but should take some additional steps to further improve its investigations. Auditors' initial review of investigations showed opportunities for improving efficiency and impact, such as increasing the amount of time spent inspecting rather than traveling between locations. In response to this review, as well as in response to staff reductions brought on by budget cuts, the Department is pursuing a new investigations approach that should improve the effectiveness of its investigations and enforcement presence. However, the Department should take some additional steps to further enhance its investigations approach and also improve the way it collects, analyzes, and uses data to support its investigative activities.

Review of investigations showed opportunity for greater efficiency and impact

Department officers perform a variety of investigative activities (see textbox), but auditors' observations of six officers on four different investigation shifts conducted between October 2008 and January 2009 showed opportunities to improve the efficiency of

Investigative Activities

Complaints—The Department investigates complaints received from the public and other law enforcement agencies alleging violations of state liquor laws.

Covert Investigations—Undercover investigations conducted by department officers.

Covert Underage Buyer (CUB)—Department officers accompany undercover teens who attempt to buy liquor at licensed establishments.

Police Reports—Officers review police reports involving licensees and investigate as needed.

Routine License Inspections (RLIs)—An inspection that follows a set checklist and assesses whether a licensee is following various statutes.

Target Responsibility for Alcohol Connected Emergencies—For some DUI vehicle accidents or fatalities, the Department attempts to trace the intoxicated driver back to the licensee who served him or her.

Source: Auditor General staff summary of the Department's August 2008 Investigation Statistics Report, auditors' investigator shift observations conducted in October 2008 and January 2009; Arizona Revised Statutes §4-112; the Department's June 2008 Governor's Monthly Report; and interviews with department management. For additional information, see Introduction and Background, pages 5 and 6.

For two of the four investigations shifts that auditors observed, 22 to 38 percent of officer time was spent driving.

these activities. For example, auditors observed that officers spent significant portions of the shift driving around looking for licensed establishments to visit, traveling back and forth between the opposite ends of their assigned geographic areas during the same shift, and passing numerous licensed establishments without stopping. For two of the four shifts observed, 22 to 38 percent of officer time was spent driving between licensed establishments. According to a department official, this amount of driving is acceptable during an officer's investigations shift. However, any reduction in the amount of time officers spend driving offers the potential to visit and/or investigate more licensees. This is important because, according to the Department, each officer's assigned geographic area has hundreds of licensees, and over 2,000 licensees are located in unassigned areas in the State.

These observations also showed opportunities to increase the law enforcement impact of investigation activities. For example,

- **Licensees not made aware of active law enforcement**—Literature suggests that active, visible law enforcement is a way to deter licensees from violating liquor laws.¹ Auditors observed, however, that when officers conducted covert investigations, they did not identify themselves, nor did the Department notify the licensee by letter, for example, that an officer had conducted a covert investigation. Therefore, most licensees were unaware that an investigation had occurred. During the shifts that auditors observed, 33 of the 44 investigative activities performed (75 percent) were covert investigations. Although announcing covert investigations beforehand would defeat their purpose, not informing licensees afterwards lessens the deterrent effect of reminding licensees that officers are conducting these investigations.
- **Investigative activities not well planned**—Auditors observed that officers did not have well-defined plans for the activities they will conduct and the licensees they will visit during a shift. Although this allows for officers to exercise their discretion in determining the licensees to visit, including licensees with prior violation histories, some licensees may be visited multiple times, even during the same shift, while others are not visited. In fact, department officials confirmed that some licensees have not received a visit for several years, and because of a lack of investigative resources and the existence of thousands of licensees, may not be visited at all. As a result, some licensees may be operating outside the law without the Department's knowledge.

¹ Wagenaar & Tobler, 2006

Department has improved investigative approach, but needs additional improvements

To address the issues auditors identified, as well as to make operations more efficient because of budget reductions, the Department revised its investigative approach, but it should take additional actions to further improve this revised approach. Actions already taken will help to maintain the Department's enforcement presence and increase visibility despite staffing reductions. In addition, the Department should notify licensees of covert investigation results, conduct focused investigative follow-ups, and further revise its policies and procedures to reflect these changes.

Recent changes to investigative approach—In March 2009, in response to auditors' initial findings and to fiscal year 2009 mid-year budget reductions, the Department implemented several changes to its investigative processes. These changes were designed to better direct investigations and increase enforcement presence with available resources. Specifically:

- **Investigative activities reassigned to help maintain enforcement presence**—As of March 2009, and in response to having to reduce its investigations staff, the Department reassigned its officers in a way that was designed to help maintain its enforcement presence. Specifically, the Department reduced the number of officers from 17 to 10, which includes reducing the number of supervisors from 3 to 1. Additionally, according to a department official, the Department began implementing its plan to station all its officers in its Phoenix office, and as of June 2009, all but one part-time officer who was stationed in Yuma had been reassigned to the Phoenix office. However, in March 2009, the Department also implemented a plan to regularly send officers to cover other parts of the State. Teams of department officers are being sent weekly to locations throughout the State to actively enforce state liquor laws. Additionally, although the Department previously allowed officers some flexibility in setting their shifts on a weekly basis, as of March 2009, the Department has implemented specific shifts for all officers that require them to work every Friday and every other Saturday. According to department officials, the goal of the new schedule is to ensure that officers are out in the community enforcing liquor laws at times when licensees are traditionally more active.
- **Greater consistency in supervision**—By reducing the number of supervisors, the Department has addressed some officer-reported inconsistencies in the supervision they were provided. Specifically, the Department had three supervisors, who provided varying levels of supervision, according to those supervisors. For example, although all three supervisors reported that they had regular meetings with officers, the frequency of these meetings varied from weekly to monthly. Additionally, two supervisors reported that they worked with their officers to prioritize some complaint investigations.

Officer shifts have been reassigned to include weekly visits to licensed establishments throughout the State.

- **Increased visibility and efficiency in routine inspections**—Effective March 2009, the Department increased the number of routine license inspections (RLIs) that each officer should complete monthly from 30 to 60 and has reiterated that these types of inspections should be conducted overtly, meaning officers should identify themselves to licensees. Further, during the RLIs, officers should use a department checklist to guide their activities and perform them in a limited geographic area to reduce drive time. Moreover, these revised policies include conducting an RLI, when appropriate, as a means to resolve complaints. According to a department official, an enhanced focus on RLIs will allow the Department to increase its law enforcement presence, despite staff reductions, because more licensees will receive these routine inspections. Additionally, officers are now required to document who has received an RLI, as well as the date it was conducted, which will provide critical tracking information to the Department.

Additional actions can further enhance Department's enforcement efforts—Auditors identified several ways in which the Department should augment its efforts and enhance its law enforcement presence. Specifically, the Department should:

- **Provide additional guidance for, and review of, investigative activities**—The Department should build on the enhanced direction it has provided for RLIs by further developing and implementing policies and procedures that provide improved guidance and direction for its officers on how to prioritize their workloads, conduct various investigative activities, effectively plan investigation shifts, and define performance expectations. Auditors interviewed 9 of the Department's 17 officers, and these 9 officers reported that they were responsible for determining how to prioritize their workloads, including whom to investigate within their assigned geographic areas, which types of activities to perform, and when and how to conduct complaint investigations, RLIs, and covert investigations. Again, although officer discretion is important when performing these activities, implementing additional guidance on planning shifts, prioritizing work, and performing specific investigative activities should improve the efficiency and impact of the Department's investigations.

Additionally, such guidance will provide the Department's investigations supervisors with more tools to monitor the efficiency and impact of officers' investigative efforts. Therefore, the Department should establish specific monitoring requirements for its investigations supervisors, including monitoring officer activities against the guidance that it implements.

- **Establish greater presence by informing licensees of covert investigation results**—The Department does not inform licensees that officers have conducted a covert investigation, unless the covert investigation identified

violations. In fiscal year 2008, the Department reported performing 4,326 covert investigations that did not result in violations.¹ As a result, licensees involved in these covert investigations were not notified of the outcome of the inspection and do not know that an investigation occurred. However, according to a 2006 National Center for Alcohol Law Enforcement report, compliance with liquor laws can be achieved by escalating the perceived chances of being caught through increased surveillance, followed by notifying licensees of the surveillance.² To increase the deterrent impact of these investigations, the Department should establish and follow policies for notifying all licensees who have been the target of an investigation, covert or otherwise, and inform them of the outcome. This will help ensure that licensees are aware that the Department is actively enforcing compliance with liquor laws and that they risk detection if they choose to violate state liquor laws.

- **Conduct targeted follow-up investigations**—The Department should establish and implement policies and procedures for conducting follow-up investigations of licensees who have been found to sell alcohol to minors and/or to seriously or repeatedly violate state liquor laws. Auditors' review of the Department's policy manual found that there are no such policies. According to a department official, although the Department will conduct some follow-up investigations, these efforts are informal and unplanned. However, literature discusses the benefits of regular enforcement activities at licensed establishments to promote compliance with liquor laws. Specifically, according to a 2005 National Center for Alcohol Enforcement study on over-service, following outreach to problem establishments, enforcement agencies should engage in monitoring establishments for future compliance. This monitoring includes routine bar checks with visible officers, covert undercover observation of establishments, and continued collection of data related to disturbances and problems.³ Therefore, the Department should implement a formal program for conducting targeted follow-up investigations at problem establishments.

The Department should enhance its enforcement presence through follow-up investigations.

Improved information needed to support new approach

To enhance the effectiveness of its investigative activities, including its revised investigations approach, the Department needs accurate and complete data that can be analyzed and used to help guide investigation efforts. Although the Department collects a variety of information related to its investigative activities, some of this information is incomplete and inaccurate. The Department is aware of these deficiencies and is in the process of developing a new database that should help

¹ Auditors' review of investigations statistics from various sources revealed that insufficient controls were in place to establish the reliability of the investigations information, including covert investigation statistics, for any use other than background information.

² Cannon & Carmona, 2006

³ Carmona, 2005

address many of them. However, auditors identified several additional areas in which the Department needs to establish and implement policies and procedures so that it can help ensure the accurate and complete collection, analysis, and use of the data it collects.

Data inaccurate and incomplete—Although the Department collects investigative information, some of this information is inaccurate and incomplete. Specifically:

- **Weekly logs contain inaccurate and inconsistent information**—Officers complete weekly logs that document how they spend their time. This information is then entered into a department database and later used to create statistical reports. Although the Department has a coding system for the weekly logs, little guidance was provided to officers regarding how to use it to properly and consistently code their activities and time. Auditors reviewed the weekly logs that corresponded with investigations shift observations and found that the information recorded on the logs inaccurately and inconsistently reflected auditors' observations. For example, auditors observed several investigations that were documented as RLIs on the weekly logs, even though the investigations observed did not meet management's definition of an RLI. Additionally, auditors' review of 60 weekly logs from November 2008 also found inconsistencies in how officers were classifying their investigative activities. For example, auditors found that when two officers visited several different licensees together, each officer would record his or her activities as different types of investigations. One officer documented his activities as complaint followups while the other documented the activities as RLIs. Further, although the licensee names are listed on the logs, unique identifying information for each licensee, such as addresses or license number, is not. This makes it difficult to determine which licensee was investigated, especially for multiple licensees with the same name, such as convenience stores and other retail outlets.

Because the weekly log is the only document that is to be a complete record of which licensees were visited and the type of investigative activity performed, the Department does not have consistent and accurate information about its investigations. Thus, the Department cannot track which licensees have or have not been investigated and which investigative activities were used, and cannot use this information to effectively guide future investigations.

As of May 2009, the Department reported providing training to its officers on how to accurately complete weekly logs and has adopted policies directing its officers to complete an accurate, specific log of their activities each day. However, this policy does not provide guidance to department officers on how to accurately complete weekly logs. Therefore, the Department should develop procedures specifying how to code investigative activities on weekly logs and requiring the use of unique identifiers for each licensee investigated.

Department officers inconsistently recorded investigation information on the weekly log.

- **Database that stores records is incomplete**—The Department’s database is incomplete because it does not contain all complaints or all types of investigations. The Department has a central phone line where, according to department staff, complaints are received and entered into the database. However, some officers said they receive complaints directly, but at least one officer states that he does not enter the information into the database. For example, one officer said he receives complaints by phone, voice mail, or e-mail and keeps track of these complaints in his head.

In addition, department officers enter into the database information from investigations that result in violations. Covert investigations that are not complaint driven, do not involve covert funds, and do not result in violations are not entered into the database. As a result, the Department does not have complete information in its database for all of the investigations it performs.

Finally, because of the incomplete and inaccurate information in the database, the Department cannot easily determine which licensees have been investigated and the results of previous investigations. Additionally, the Department’s database cannot generate any reports showing the geographic areas where the majority of complaints and/or violations are found, thus depriving the Department of critical information to guide future investigative efforts.

As a result of these combined information deficiencies, the Department is unable to track who has been investigated and what types of investigations are being conducted, and therefore does not have the information to determine investigative priorities and activities, including hot spots and repeat violators, which may require an increased enforcement presence.

Success of new database will depend on accurate data—The Department’s need to address its inaccurate/incomplete information is particularly critical at this time because the Department is in the process of implementing a new Electronic Licensing Information System (ELIS) and has been appropriated \$1.25 million for this project. ELIS will replace the existing database and assist with the collection and use of investigations information. The Department anticipates that ELIS should be able to generate helpful reports and statistics, and should allow for better oversight by providing improved access to data. For example, the Department indicated that ELIS should generate reports on repeat violators, status of complaint investigations, and officers’ caseloads. Investigative supervisors will also be able to quickly view the progress of officers’ caseloads at a glance, instead of having to manually search for each investigation. Additionally, the investigative supervisors will be able to leave comments regarding complaints for officers in the system, instead of relying on e-mails and phone calls. These capabilities should increase the efficiency of the investigative process and allow for improved oversight and monitoring of investigations. The Department reported that the

The Department is implementing a new electronic licensing system that should assist with the collection and use of investigations information.

system will be implemented in October 2009. However, unless the Department addresses the deficiencies previously noted, the information in the new system will not be any more complete or accurate than its current database.

Department should develop and implement policies and procedures for collecting and analyzing investigations information—Although the Department is in the process of implementing a new system, it should improve its overall data collection and analysis process by developing and implementing policies and procedures for collecting, analyzing, and using accurate information to guide its investigative efforts. Specifically, the Department should:

- **Enter all investigations information into its database**—The Department should develop and implement policies and procedures for ensuring that all investigations information is accurately entered into its database. Policies should require department staff to enter information from investigator weekly logs, all complaints, and all covert investigations. Additionally, the Department should monitor the information entered to ensure its accuracy and completeness.
- **Develop policies for analyzing and using information collected**—Conducting analysis of investigations information should help the Department track the licensees who have and have not been investigated, the types of investigative activities performed, and the results of those activities. It would also help the Department and its investigations supervisors to more effectively direct and prioritize its investigative activities. For example, if the Department generated a list of all licensees who had not been investigated for more than 2 years, officers could use this list when determining whom to investigate to complete their required monthly RLLs. Additionally, if the Department knew which investigative activities yielded the most violations, the Department could direct its officers to increase their use of these activities.
- **Identify and generate any additionally desired reports**—Also, the Department should identify any reports it would need to generate in order to help its supervisors direct investigative activities. For example, if the Department had a report detailing which licensees either sold alcohol to minors during a CUB investigation or committed repeat or serious violations of liquor laws, the Department could direct focused follow-up investigations for these licensees.

Analyzing investigations information would help the Department more effectively prioritize its investigative activities.

Recommendations:

- 1.1. In order to enhance its law enforcement presence and the effectiveness of investigations, the Department should:
 - a. Develop and implement policies and procedures that incorporate guidance and direction to its officers regarding how to prioritize their workloads, conduct various investigative activities, effectively plan investigation shifts, and define performance expectations;
 - b. Establish and implement specific monitoring requirements for its investigations supervisors, including monitoring officer activities against the guidance that it implements;
 - c. Inform all licensees who have been the target of an investigation, covert or otherwise, of the outcome of the investigation; and
 - d. Develop and implement a formal program for conducting targeted follow-up investigations at problem establishments.

- 1.2. The Department should establish and implement policies and procedures that ensure its investigations data is complete and accurate, and supports its revised approach by:
 - a. Developing procedures specifying how to code investigative activities on weekly logs, and requiring the use of unique identifiers for each licensee investigated;
 - b. Entering all investigation information into the Department's database, including information for all complaints and all investigations, regardless of whether violations are found or not;
 - c. Monitoring the information collected and entered into the database and ensuring that staff follow the new policies and procedures;
 - d. Analyzing the information collected to help track and identify the licensees who have and have not been investigated, the types of investigative activities performed, and the results of those activities to more effectively direct and prioritize its investigative activities; and
 - e. Identifying and generating any additional reports it would need to direct its investigative activities.

FINDING 2

Department should take stronger action against repeat and serious violators

The Arizona Department of Liquor Licenses and Control (Department) should strengthen the actions it takes against repeat and serious violators. Strong enforcement actions can help deter liquor law violators and lessen the negative effects of the inappropriate and illegal use of alcohol. However, although the Department has established policies to help guide its enforcement actions and for the most part follows these policies, auditors identified some instances in which the Department deviated from these policies without providing required explanation. Additionally, despite adequate statutory authority, some department enforcement policies and practices weaken its ability to take strong and consistent action against repeat and serious offenders. These weaknesses include a lack of penalty guidelines for 44 percent of potential violations, inadequate policies to guide disciplinary action for repeat offenses, and reductions of penalties for serious—and sometimes repeated—violations involving such offenses as selling alcohol to minors or allowing minors on the premises without being accompanied by a parent or guardian. Therefore, the Department should strengthen its enforcement policies and consistently follow them.

Strong enforcement needed to deter liquor law violations

Literature indicates that implementing severe, deterrence-based penalties can reduce the negative effects associated with underage drinking, over-service, and other threats to public health and safety. For example, a 2006 National Center for Alcohol Law Enforcement report cites various efforts to enforce compliance with laws involving alcohol sales to underage and intoxicated individuals.¹ Specifically, preventing alcohol sales to minors and limiting alcohol sales to intoxicated individuals can have a positive impact on the community. Further, the study asserts that changing the environment in which alcohol is sold and consumed and reducing access to alcohol can result in a reduction of crime and violence, but liquor laws must

Literature indicates that implementing severe, deterrence-based penalties can reduce the negative effects of alcohol misuse.

¹ Cannon & Carmona, 2006

The Department has established various policies to guide its disciplinary actions.

be enforced. Additionally, a 2005 National Highway Traffic Safety Administration report on the role of alcohol beverage control agencies in the enforcement and adjudication of alcohol laws asserts that the certainty and swiftness of a penalty, as well as the severity, are key factors in deterring liquor violations. Further, licensees should believe that the costs of violating the law significantly outweigh the benefits.¹

Arizona state laws provide the potential for strong action. Specifically, Arizona Revised Statutes (A.R.S.) §4-210(A) authorizes the Department to suspend and revoke establishment licenses in response to state liquor law violations. Additionally, A.R.S. §4-210.01(A) states that “in lieu of or in addition to the suspension or revocation of or refusal to renew a license, the director may impose a civil penalty of not less than \$200 nor more than \$3,000 for each violation.”

Based on this authority, the Department has established various policies to help guide the actions it takes in response to state liquor law violations. These include:

- Guidelines for levying penalties, including stiffer penalties for repeat offenses—**
 The Department has established penalty guidelines for 75 common types of violations of state liquor laws. For example, as illustrated in Table 3, a first offense for violating A.R.S. §4-244(22), allowing underage patrons on the premise without a parent or guardian, carries a \$1,000 fine, followed by fines of \$1,500 and \$3,000 for second and third offenses, respectively.

Table 3: Selected Penalties from the Department's Penalty Guidelines As of April 30, 2009

Statute	Description of Offense	1 st Offense	2 nd Offense	3 rd Offense
§4-244(9)	Sale of alcohol to an underage person	\$1,000 to \$2,000 and/or up to 30 days' suspension of license	\$2,000 to \$3,000 and/or up to 30 days' suspension of license	\$3,000 and/or up to 30 days' suspension of license
§4-244(22)	Underage person on premises	\$1,000	\$1,500	\$3,000
§4-244(23)	Serving more alcohol than the law allows	\$750	\$1,500	\$3,000

Source: Auditor General staff analysis, as of April 30, 2009, of the Department's *Compliance Penalty Guidelines for the Most Common Violations*.

¹ NHTSA, 2005

- **System for grouping some similar types of violations to determine repeat offenses**—The Department has established violation classifications for some related underage, over-service, and public health and safety offenses. The Department considers a violation to be repeated if it occurs within the same classification and was committed within 2 years of the prior violation. For example, the offenses of A.R.S. §4-241(A), failure to request identification; A.R.S. §4-244(9), selling alcohol to a minor; and A.R.S. §4-244(22), allowing an underage person on the premises without a parent or guardian, are included together under one classification, so that if a bar is cited for A.R.S. §4-241(A) in one investigation and A.R.S. §4-244(9), in a subsequent investigation conducted within 2 years, the second instance, while not the exact same offense, can be considered a repeat violation. The Office of the Auditor General's 1998 performance audit and sunset review of the Department (see Report No. 98-20) had recommended that the Department develop such classifications.
- **Reductions in penalties for minor, first-time offenses**—Department policy states that if a case against a licensee is a minor first-time offense and the licensee has no other violations within the last 2 years, the Department may offer the licensee a 50 percent reduction of the fine designated by its penalty guidelines.

Department generally followed enforcement policies, but needs to better document reasons when it deviates

For the enforcement cases reviewed by auditors, the Department generally followed its enforcement policies when it disciplined licensees for liquor law violations, but auditors identified some undocumented deviations from these policies. Department policy allows staff to deviate from policy guidelines but requires them to document the reasons for doing so. Auditors reviewed a sample of 40 enforcement cases, involving 14 licensees, processed by the Department between 2004 and 2008. Thirty of these cases involved violations included in the penalty guidelines, and the Department followed its penalty guidelines for 23 of these (77 percent). This represents a significant improvement from the 1998 performance audit and sunset review, which found that the Department's disciplinary actions deviated from its penalty guidelines approximately two-thirds of the time.

For the remaining seven cases where the Department did not follow the guidelines, department staff used their discretion to assign penalties, but did not document the reasons for deviating from policy. For example, the Department issued a warning to one licensee for a first offense of an underage violation. According to the penalty guidelines, this violation should have resulted in a \$1,000 fine. Although the Department has the authority to issue a lesser penalty, it did not document the reason or mitigating circumstances that led to this reduced penalty, as policy requires.

Auditors' review of enforcement cases identified some undocumented deviations from penalty guidelines.

Some department policies and practices weaken enforcement efforts for repeat and serious violators

Serious violations refer to those violations of state liquor laws that limit the Department's protection of the public and entail violations relating to underage drinking and service, serving already intoxicated patrons, and threats to the public health and safety. These do not include violations that are more administrative in nature, such as failing to post required signs or license.

Source: Auditor General staff summary of Arizona Revised Statutes, Title IV (liquor laws), and the Department's administrative rules.

The Department's penalty guidelines are incomplete and do not include 59 of the 134 potential liquor-related violations.

Although the Department typically disciplines the liquor law violators it identifies, some of its policies and practices weaken enforcement efforts against repeat and serious violators. Auditors' review of department data found that the majority of enforcement cases the Department handles involve serious and/or repeat violations. Specifically, 87 percent of the 2,495 enforcement cases that the Department processed between 2004 and 2008 involved serious violations related to underage drinking, over-service, and other threats to public health and safety. Additionally, 53 percent of licensees involved in these cases had two or more serious enforcement cases. For the 40 cases involving 14 licensees that auditors reviewed in detail, however, systemic weaknesses in department policies resulted in consistently reducing disciplinary actions for serious violations, including violations for underage drinking and over-service. As a result, some licensed establishments that repeatedly sell alcohol to minors, serve already intoxicated patrons, or otherwise threaten public health and welfare, do not face strong and possibly more appropriate disciplinary action. The weaknesses include penalty guidelines that do not include all potential liquor law violations, inadequate policies for determining repeat offenses, and an inadequately defined and misapplied policy for discounting penalties for minor first-time offenses. Specifically:

- **Incomplete penalty guidelines lead to inconsistent and potentially inadequate discipline**—The Department has established penalty guidelines that outline penalties for 75 offenses, but these guidelines are incomplete because they do not include another 59 liquor-related violations for which licensees can be charged. For those violations that are not included in the guidelines, the omission can lead to inconsistent penalties. For example, auditors found that the Department imposed a \$375 fine for one licensee, but a \$1,000 fine for another licensee for first-time violations of the same statutory requirement—A.R.S. §4-243.01, which requires licensees to purchase alcohol from an authorized supplier. This statutory violation is not included in the Department's penalty guidelines. Because the penalty guidelines are incomplete, staff lack guidance on the appropriate penalty to charge for this violation and are not able to readily ensure they are consistent in their enforcement of violations of this law.
- **Incomplete violation groupings limit Department's ability to take strong action against repeat offenders**—Consistent with the recommendations from the 1998 performance audit and sunset review of the Department, the Department groups some similar violations to help determine repeat violations. However, these groupings and associated policies are incomplete, which affects the Department's ability to take appropriately strong action against repeat offenders. Specifically, only 19 of the 134 state liquor law violations

(approximately 14 percent) are represented in the classifications. For example, auditors determined that there are 12 different underage violations, but the Department includes only 5 of these offenses in its underage classification. A licensee who committed 1 of the 5 underage violations in the classification and then subsequently committed 1 of the 7 violations not included in the classification, such as failing to follow proper identification procedures to detect/prevent underage drinking (A.R.S. §4-241(A)), would not be considered a repeat violator. Similarly, auditors identified 72 public health and safety violations, but the Department has classified only 12 of these offenses in the associated class.

- **Department's policy for determining repeat violations further limits its ability to take strong action**—To be considered a repeat violator under the Department's policy, a licensee must have had two violations in the same classification within a 2-year period. Under this policy, if a licensee has serious violations in two different classifications within 2 years, that licensee is not considered to be a repeat violator, and therefore is not subject to penalties of increasing severity. For the 40 cases that auditors reviewed, 4 involved licensees that committed two serious violations within a 2-year period, yet did not receive escalated penalties because the violations were not from the same department classifications as the violations from the prior enforcement cases. Again, this makes it difficult for the Department to impose appropriate fines and escalate discipline against repeat violators.
- **Discounted fines imposed for some serious first offenses**—Although department policy allows fines to be reduced in the case of minor first-time offenses, the Department does not define the term "minor." In the sample reviewed, auditors found that this policy was frequently applied to serious offenses relating to underage drinking, over-service, and public health and safety. Sixteen of the 40 cases involving 13 of the 14 licensees auditors reviewed involved first-time offenses that received a discount even though they involved such offenses as selling alcohol to a minor, allowing minors on the premises without a parent or guardian, and employees consuming alcohol while on duty. In one case, a licensee received a penalty discounted by 50 percent for allowing 12 minors on site without a parent, selling alcohol to minors, failing to request identification, and allowing an intoxicated patron to remain on the premises. Although this was the licensee's first enforcement case, the violations did not appear to be minor. In addition, for 4 additional enforcement cases involving 3 licensees, the Department issued discounted fines for serious offenses that were not first-time offenses.

Because these policies were established prior to the Department's existing administration, department officials could not necessarily explain the rationale for these policies, but agreed that they should be reviewed and revised.

Contrary to department policy, the Department issued discounts in 16 cases involving serious violations, and 4 cases that were not first-time offenses.

Example shows collective effect of policy weaknesses—Collectively, the weaknesses in these policies mean that some licensees can continue operating without receiving consistently strong discipline even if they have a history of serious violations. The following is one example involving a licensee cited for multiple serious violations over a 4-year period. Although the Department has taken disciplinary action against this licensee that is in line with its policies, these policies have lead to inadequate discipline.

- **First Case**—In October 2003, the Department conducted an undercover investigation of the licensee, found two underage patrons drinking, and charged the licensee with failing to check identification and selling alcohol to minors. The Department assessed a \$2,375 fine.¹
- **Second Case**—In May 2004, the Department conducted another undercover investigation and cited the licensee for failing to request identification, serving alcohol to a minor, and allowing a minor to remain on-site without a parent or guardian. The Department escalated the fine for a second offense and charged the licensee \$4,000.
- **Third Case**—In January 2005, an underage patron was found on the licensee's premises.² This was the licensee's third underage violation in 2 years and, consistent with its policies, the Department imposed a \$3,000 fine.
- **Fourth Case**—In September 2005, department officers found that the licensee had served a customer too much alcohol. Although this was the licensee's fourth serious offense in less than 2 years, this violation is from a different classification than the underage violations. Therefore, the Department classified it as a first offense rather than a fourth offense. As a first offense, the licensee received a \$750 fine instead of a much higher penalty of at least \$3,000 that the Department could have imposed for a fourth offense. Further, the Department then gave the licensee a 50 percent discount, and the licensee paid only a \$375 fine.
- **Fifth Case**—In January 2007, officers found two underage patrons on-site. Because this enforcement case occurred 2 years and 1 week after the preceding enforcement case that included a similar underage offense, which is the third case listed above, the Department did not consider the underage violations as repeated violations and classified these violations as a first offense. In line with department policies, the licensee received the first offense underage penalty of a \$2,000 fine (\$1,000 for each underage patron on the premises).

¹ The Department's penalty guidelines became effective in November 2004, after the first two cases occurred. The Department could not locate prior versions of the penalty guidelines, so the fines for these cases could not be compared to department policies that were in effect at that time.

² According to the Department, it can be difficult for officers to cite a licensee for selling to or serving minors. For example, if an officer does not observe the minor drinking or if the minor is unable to identify the employee who served him/her, the officer may instead issue a citation for A.R.S. §4-244(22), allowing an underage person on the premises without a parent or guardian.

- **Sixth Case**—In August 2007, a local Arizona city police department complained to the Department about the frequent problems at this establishment. The Department conducted an undercover investigation and found two underage patrons on-site. Although this was the sixth serious offense at this location and the fifth violation involving underage drinking, under department policy, the Department counted it as the second underage offense and fined the licensee the second offense fine from its penalty guidelines—\$1,500 for each count. In addition, the Department cited the licensee for an employee drinking while on duty and an administrative offense. In total, the Department fined the licensee \$4,500.

Department should strengthen enforcement policies

The Department should take several steps to strengthen its enforcement policies and take consistently strong disciplinary action against licensees who commit serious violations or repeatedly violate state liquor laws. Consistent with this audit's recommendations to enhance the Department's investigative effectiveness and law enforcement presence, a strong disciplinary stance should also increase the impact of the Department's enforcement efforts. According to the 2005 National Highway Traffic Safety Administration report, deterrence includes three key factors: the probability of being detected, the swiftness of penalty, and the extent of the penalty imposed.¹ Implementing effective enforcement policies and practices becomes even more important given the budget constraints under which the Department must operate. Specifically, as previously discussed in Finding 1, (see page 15), in response to a reduction in its fiscal year 2009 budget, the Department has reduced the number of officers from 17 to 10. Therefore, the Department should revise and implement stronger disciplinary policies to enhance its enforcement efforts and maintain an effective enforcement presence. Specifically, the Department should:

- **Complete penalty guidelines**—The Department should include specific penalties for all possible state liquor law violations within its penalty guidelines. As previously mentioned, the Department's penalty guidelines identify potential penalties for only 75 of a possible 134 liquor violations.
- **Expand and revise violation groupings**—The Department should not only expand its violation groupings to encompass all liquor violations, but it should also revise its groupings. Auditors contacted nine states and found that although three of these states require licensees to commit the same violation within a set time period in order to escalate the penalty, six states group violations by the severity of the offense or by the nature of the violation, similar to the Department.² In particular, Utah has an approach that focuses on severity of the offense rather than just on the type of offense. Specifically, the Utah Department of Alcoholic Beverage Control groups liquor violations into

The Department should implement stronger disciplinary processes to enhance its enforcement efforts.

¹ NHTSA, 2005

² Auditors interviewed officials from nine western states and/or states that issue licenses similar to Arizona's. These were Alaska, California, Colorado, Florida, Idaho, Oregon, Texas, Utah, and Washington.

The Department should revise its policies to consider prior violations as aggravating circumstances against the new violation.

categories of grave, serious, moderate, and minor. Any additional violation from the same category within a 3-year period, regardless of the nature of the violation, escalates the penalty as a repeat offense. Utah's tiered approach is something the Department could replicate, and doing so would provide a more consistent framework for identifying repeat violators and creating a deterrent against continued violations. Therefore, in addition to expanding the groupings to include more violations, the Department should revise its classification policy to include tiers of violations, which would ensure that serious violations, regardless of the class, can be used to escalate fines and other penalties against serious and repeat offenders of state liquor laws.

In addition, the Department should revise its policies to consider any prior violations committed within the previous 2 years as aggravating circumstances against the new violation, regardless of the nature of the prior violations. Based on auditors' interviews with representatives from nine states' liquor agencies, seven of these agencies expunge a licensee's history after 2 or 3 years. However, all nine of these states weigh violations as aggravating factors against any new violations, regardless of how violations are grouped.

- **Eliminate or revise discounted penalties for first-time offenses**—The Department should eliminate or revise its policy of discounting fines for first offenses. Eliminating this policy would be consistent with the policies and practices of six of the other nine states auditors contacted. Only three of the nine states allow discounts for first offenses, and only when mitigating factors are present, such as the licensee's having a clean violation history or choosing to enroll in a training program. However, should the Department opt to keep but revise the policy, those revisions should include a definition for "minor" and a requirement to apply reduced fines only to minor violations. Additionally, the Department should revise its policies to help ensure that it offers a discounted fine only for a first-time minor offense to a licensee, and only once.
- **Document any deviations from its penalty guidelines**—Finally, consistent with its policies, the Department should consistently document any deviations from its penalty guidelines.

Recommendations:

- 2.1. The Department should either establish or make the following revisions to its enforcement policies and procedures and ensure that it implements and consistently follows the revised policies and procedures:
 - a. Expand its penalty guidelines to ensure that these guidelines incorporate penalties for all possible violations;

- b. Expand its violation groupings to encompass all liquor law violations;
- c. Revise its grouping policy to ensure that serious violations, regardless of the group, can be used to escalate fines against serious and repeat state liquor law offenders;
- d. Revise its policies to consider any prior violations committed within the previous 2 years as aggravating factors against the new violation, regardless of the nature of the prior violations;
- e. Eliminate or revise the 50 percent discount for minor first offenses. If the Department opts to keep but revise the policy, those revisions should include a definition for minor and a requirement to apply reduced fines for only minor violations; and
- f. If the Department retains its policy to offer a discounted fine for a minor first-time offense, it should revise its policies to ensure that a discounted fine for a minor first-time offense is offered to a licensee only once.

2.2. The Department should ensure that it documents any deviations from its penalty guidelines.

OTHER PERTINENT INFORMATION

During the course of the audit, auditors collected and reviewed information regarding statutory requirements and department processes for issuing quota liquor licenses for bars, beer and wine bars, and liquor stores, and determining the fair market values of these licenses.

Quota liquor licenses

In fiscal year 2006 and in response to revised state laws, the Department resumed issuing three types of restricted licenses, known as quota licenses: bar, beer and wine bar, and liquor store. Unlike other types of liquor licenses, the number of quota licenses is limited by statute to prevent their proliferation, which significantly increases quota licenses' value. The Department issued 151 new quota liquor licenses from fiscal years 2006 through 2009 based on the fair market value of these licenses, which has generated more than \$15.2 million in revenues for the State General Fund. State laws partially prescribe the process for issuing these licenses and the Department implemented a revised process for issuing these licenses, in fiscal year 2008 to expand the number of applicants. To determine the fair market value of quota liquor licenses, the Department uses private vendors. Changes in statute require the Department to issue new quota liquor licenses based on county population growth instead of total population, starting in fiscal year 2011.

Statute requires Department to issue new quota liquor licenses—In response to state laws, the Department resumed issuing new quota liquor licenses for bars, beer and wine bars, and liquor stores in fiscal year 2006. Specifically, Laws 2005, Ch. 284, §16, requires the Department to issue new quota liquor licenses annually through fiscal year 2010 based on each Arizona county's population. According to department officials, the Department used the most recent U.S. Census for population data, as previously required by statute. Although statute granted the Department the option to issue new quota liquor licenses if county population growth increased by statutorily defined amounts, the Department had not done so since fiscal year 1988. When the Office of the Auditor General analyzed this issue in its 1998 performance audit and sunset review of the

Since fiscal year 2006, the Department has issued 151 new quota licenses, which has generated more than \$15.2 million in revenues for the State.

Department (see Report No. 98-20), it found that any issuance of these licenses could have faced stiff opposition from the public and the industry. Specifically, the Department's director at the time 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.

With the change in state laws, the Department must issue up to 120 quota liquor licenses annually state-wide based on each county's population. For example, as illustrated in Table 4, the Department can award up to 10 bar licenses, 10 beer and

wine bar licenses, and 10 liquor store licenses in Maricopa County annually, while it can award up to 3 liquor licenses in each of these categories in Yuma County annually.

Issuance of new quota licenses has generated significant revenues—The Department has issued a total of 151 new quota liquor licenses from fiscal years 2006 through 2009. As illustrated in Table 5 (see page 35), the Department issued 7 quota liquor licenses in fiscal year 2006, 47 in fiscal year 2007, 54 in fiscal year 2008, and 43 in fiscal year 2009. The number of licenses issued ranged from 48 in Maricopa County to none in Apache or Greenlee Counties.

Applicant interest in these licenses has not matched the number available for issuance. Department officials said, for example, that no licenses were issued in Apache or Greenlee

Counties because of lack of interest. In fact, from fiscal years 2006 through 2009 and in accordance with state law, the Department could have issued a total of 480 quota liquor licenses. Department officials speculated that there has not been more interest in these licenses because (1) the market may be saturated with all the major chains already having obtained their licenses, (2) the cost can be prohibitive for new businesses, (3) the downturn in the economy, and (4) prior to fiscal year 2008, department administrators determined that the application process may have been too difficult for some prospective licensees.

Table 4: Number of New Quota Liquor Licenses Available Annually by County Fiscal Years 2006 through 2010

County Population	County	Number of New Quota Liquor Licenses Available Annually
Less than 100,000	Apache	1 per type (3 total)
	Greenlee	
	Gila	
	La Paz	
100,000-499,999	Graham	3 per type (9 total)
	Navajo	
	Santa Cruz	
	Cochise	
500,000-999,999	Pinal	5 per type (15 total)
	Yavapai	
	Yuma	
More than 1,000,000	Maricopa	10 per type (30 total)

Source: Auditor General staff analysis of Laws 2005, Ch. 284, §16 and *Census 2000 Data for the State of Arizona, United States Census Bureau.*

Table 5: Number of New Quota Liquor Licenses Issued by County
Fiscal Years 2006 through 2009

County	Bar			Beer and Wine Bar			Liquor Store			Total			
	2006	2007	2008	2009	2006	2007	2008	2009	2006		2007	2008 ¹	2009
Apache	0	0	0	0	0	0	0	0	0	0	0	0	
Cochise	0	0	0	0	0	0	0	0	1	1	0	1	
Coconino	0	1	1	0	2	0	1	0	0	3	1	1	
Gila	0	0	0	0	0	0	0	1	0	0	0	0	
Graham	0	0	0	1	0	0	0	0	0	0	0	0	
Greenlee	0	0	0	0	0	0	0	0	0	0	0	0	
La Paz	0	0	0	0	0	0	0	1	0	1	0	1	
Maricopa	0	4	2	2	1	3	3	4	0	7	12	10	
Mohave	0	3	1	1	1	0	2	0	0	1	4	2	
Navajo	0	0	0	0	0	0	2 ²	0	1	0	0	0	
Pima	1	0	1	0	0	0	1	2	0	5	5	4	
Pinal	0	3	0	1	0	2	0	0	0	2	4	3	
Santa Cruz	0	0	1	0	0	1	0	1	0	1	1	0	
Yavapai	0	0	0	0	0	2	1	3	0	3	3	0	
Yuma	0	1	3	3	0	1	1	0	0	2	4	1	
Total	1	12	9	8	4	9	11	12	2	26	34	23	151

¹ Lottery drawings are held in April or May of each year. As a result, some licenses issued in fiscal year 2008 were awarded in the April 2007 lottery and some were awarded in the April 2008 lottery. This resulted in the Department's issuing more than the allotted number of liquor store licenses in Maricopa, Mohave, Pinal, and Yuma Counties in fiscal year 2008.

² As of the 2000 U.S. Census, the population of Navajo County was 97,470 and, according to Laws 2005, Ch. 284, §16, would have allotted the county one license of each type. However, the Department categorized the County as having a population between 100,000 and 499,999 people, which, according to Laws 2005, Ch. 284, §16, would have allotted the County three licenses of each type.

Source: Auditor General staff analysis of department data for bar, beer and wine bar, and liquor store licenses issued in fiscal years 2006 through 2009.

As illustrated in Table 6, for fiscal years 2006 through 2009, the Department reported generating nearly \$15.6 million in revenues from the sale of quota liquor licenses. As allowed by statute, the Department reported retaining nearly \$329,000, or 2 percent, of total revenues to pay for contractor costs to determine the fair market value of the licenses in each county and conduct a random public drawing when there have been more applicants for licenses in a particular county than the number of licenses available for issue. According to the Department, the remainder of the revenues, more than \$15.2 million, was distributed to the State General Fund.

Table 6: Quota Liquor License Receipts, Amount Retained, And Amount Remitted to State General Fund Fiscal Years 2006 through 2009 (Unaudited)

Fiscal Year	Quota Liquor License Receipts	Amount Retained by Department¹	Amount Remitted to State General Fund
2006	\$ 196,303 ²	\$ 97,796	\$ 98,507
2007	5,455,636	71,701	5,383,935
2008	6,954,293	79,200	6,875,093
2009	<u>2,975,355</u>	<u>79,975</u>	<u>2,895,380</u>
Total	<u>\$15,581,587</u>	<u>\$328,672</u>	<u>\$15,252,915</u>

¹ The Department retains some of the quota liquor license receipts to pay for its vendor costs to determine the fair market value of quota liquor licenses and conduct the annual random drawing.

² As permitted by the Department, licensees have several months to pay the fair market value fee after the license is awarded. Therefore, the Department receives some fees in fiscal years subsequent to the fiscal year in which the license was awarded. Because the Department resumed issuing quota liquor licenses in fiscal year 2006, receipts were significantly lower because there were no previous year fees received. Further, the Department issued only 7 quota liquor licenses in fiscal year 2006 compared to the 47 issued in fiscal year 2007.

Source: Auditor General staff analysis of the Department's quota liquor license revenue-tracking reports and the Arizona Financial Information System for fiscal years 2006 through 2009.

Department has developed process for issuing quota liquor licenses—In addition to conducting a random drawing prescribed by state law if there are more applicants than the number of available licenses, the Department has also instituted various other processes to award these licenses. As previously mentioned, the Department contracts with a vendor to conduct a public random drawing if there are more applicants than available licenses. Since fiscal year 2006, the Department has hired the same firm to conduct the lottery. According to a department official, each year, the Department submits all of the applications for a

quota liquor license to this firm, which conducts a public random drawing and then provides the list of winners and alternates to the Department for its use. Department officials reported that if there are the same or fewer applicants for a specific license type, those applicants are declared automatic winners. However, applicants who are awarded licenses must still proceed through the Department's regular licensing approval process, which includes additional license fees, a background check, local governing body approval of the application, and various other steps.

According to a department official, in fiscal year 2008, the Department revised its application process for new quota liquor licenses to generate greater interest in these licenses. He reported that, prior to this time, some of the Department's requirements to apply for new quota liquor licenses unfairly favored large, established businesses. Specifically, applicants for a new quota liquor license had to submit proof of already owning or leasing a business location and must have received local governing body approval of their application before applying for a new quota liquor license. However, a department official reported that the Department recognized that this process may have a negative impact on prospective and small business owners and revised the process for the fiscal year 2008 random drawing. For this random drawing, the Department allowed potential applicants to defer identifying a location and obtaining local governing body approval until after being awarded the opportunity to obtain a new quota liquor license. According to the lottery license applicant database, in fiscal year 2008, 73 percent of quota liquor license winners opted to defer identifying a business location until after being awarded a license. The Department also used this revised process for its fiscal year 2009 random drawing.

The Department's revised process allows applicants to identify a location and obtain local government approval after being selected in the lottery, instead of before.

Department uses contracted vendors to determine fair market value—According to A.R.S. §4-206.01(C), the Department must define the fair market value of the quota license by taking the average of comparable license sales made on the open market in the same county from the previous 12 months. However, if there are not three or more such sales, it must employ independent professional appraisers. For fiscal years 2006, 2007, and 2008, the Department contracted with three separate vendors to determine the fair market value of quota liquor licenses in each county. Each contractor independently uses other market analysis methods to calculate the fair market value of quota liquor licenses in each county. The Department reported that it then takes the average of the three vendors' fair market value assessments for each county and license type to determine the fair market value of the new quota liquor licenses the Department issues. The Department stated that this process has remained consistent since fiscal year 2006.

Table 7 illustrates the fair market values for each new quota liquor license type in each county for fiscal year 2008. The fair market value of these licenses can vary significantly from one county to another. For example, a liquor store license in Maricopa County was valued at \$235,800 in fiscal year 2008, while the same license was valued at \$49,800 in Pima County. According to the Department's vendor reports, the variation in pricing occurs for a number of reasons, including the number of available licenses and the price of comparable licenses on the market, the county's population density and rate of change, and the economic health, measured in wages and unemployment, within the county.

Table 7: Fair Market Values of Quota Liquor Licenses by County And Type of Quota Liquor License Fiscal Year 2008

County	Type of Quota Liquor License		
	Bar	Beer and Wine Bar	Liquor Store
Apache	\$ 22,567	\$ 6,667	\$ 47,600
Cochise	34,233	6,433	81,600
Coconino	80,833	9,833	57,900
Gila	34,900	5,233	50,267
Graham	22,667	5,133	40,267
Greenlee	17,133	6,867	23,367
La Paz	26,700	5,267	28,233
Maricopa	111,667	13,233	235,800
Mohave	103,333	13,733	180,967
Navajo	32,600	5,367	49,367
Pima	40,667	8,567	49,800
Pinal	43,167	6,700	66,700
Santa Cruz	31,333	5,500	61,333
Yavapai	69,800	8,767	162,767
Yuma	62,700	7,533	88,533

Source: Auditor General staff analysis of the Department's fiscal year 2008 quota license application forms.

Starting in fiscal year 2011, statute will require the Department to issue quota licenses based on population growth in each county.

Department will need to revise the number of quota licenses it issues starting in fiscal year 2011—Beginning in fiscal year 2011, the Department will need to alter how it determines the number of quota liquor licenses available to the public. According to A.R.S. §4-206.01(B), the Department will be required to issue quota liquor licenses based on population growth in each county, instead of total population. Specifically, the Department must issue these licenses based on each additional 10,000-person increase over the population in that county as determined by the most recent July 1 Department of Economic Security population estimate.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona Department of Liquor Licenses and Control (Department) should be continued or terminated.

1. The objective and purpose in establishing the Department.

The Department consists of both the Office of Director of the Department and the Arizona State Liquor Board (Board). The Department's mission is *"to license the liquor industry and assure compliance of liquor laws in the State of Arizona using education, knowledge, communication, collaboration, adjudication and enforcement that result in better health, safety and welfare of Arizona's citizens and their community."* To that end, the Department's primary responsibilities are to license all liquor manufacturers, suppliers/wholesalers, and retailers that do business in the State; investigate suspected noncompliance with state liquor laws; impose sanctions for liquor law violations; and conduct audits of some licensed establishments to ensure they maintain the required food-to-liquor sales ratios. In addition, the Department provides training to local law enforcement agencies regarding state liquor laws and is required to maintain for public inspection a record of liquor licenses and any persons having a legal or equitable interest in such licenses.

The Board's primary responsibilities are to grant or deny liquor license applications that have been referred to the Board because of city or county, public citizen, or department protest; adopt rules to carry out the provisions of Title IV (the state liquor law); and hear licensee appeals of licensing and disciplinary decisions made by the Department's Director.

2. The effectiveness with which the Department has met its objective and purpose and the efficiency with which it has operated.

The Department has effectively met some of its prescribed purposes and objectives through licensing and enforcement. For example, according to A.R.S. §4-112, the Department is required to maintain effective liaison with the

Department of Public Safety and all local law enforcement agencies to help enforce liquor laws. In February 2009, the Department collaborated with the City of Scottsdale Police Department and the Department of Public Safety to enforce compliance with state liquor laws at the FBR Open golf tournament. In addition:

- **Department met overall licensing time frame for most applications reviewed**—The Department processed most of the initial license applications auditors reviewed within the 105-day overall time frame required by administrative code. According to the Department's Administrative Rule R19-1-317, the Department must conduct an administrative review of a license application within 75 days of receipt to verify that the application is complete, and a substantive review of the application within 30 days, for an overall time frame of 105 days for both reviews. For a stratified sample of 18 of the 1,267 license applications issued in fiscal year 2008, auditors found that 4 did not contain sufficient information to determine the processing time. Of the remaining 14 applications, 8 were processed within the overall time frame of 105 days, and 6 were processed between 107 and 140 days. However, when accounting for factors outside of the Department's control, such as waiting for the applicant to submit additional required information or the local governing body to process the application, the Department conducted its processing of the 14 license applications within the 105-day time frame.
- **Department appropriately granted licenses to applicants reviewed**—According to A.R.S. §4-202, licenses should be granted only to applicants who have not been convicted of a felony within 5 years of submitting the application, and who have provided background information and a full set of fingerprints to the Department. Auditors' review of a stratified sample of 15 license applications received in fiscal year 2008 found that for all 15 applications, the Department had granted licenses only to qualified applicants.
- **Department increased auditing efficiency**—To help ensure that restaurants that serve alcohol comply with the requirements of their license, the Department has increased the number of audits it performs of licensed restaurants. According to A.R.S. §4-205.02, an establishment that serves alcohol may qualify for the less-expensive restaurant liquor license rather than a bar or liquor store license if it derives at least 40 percent of its gross revenues from the sale of food. As of April 2009, the Department had 2,874 active restaurant licensees. Prior to fiscal year 2008, the Department conducted approximately 30 licensed restaurant audits annually to verify the percentage of alcohol sales to food sales. However, in fiscal year 2008, the Department reported completing 61 audits and set a goal to complete nearly 100 audits in fiscal year 2009.

Additionally, the Department has implemented a risk-based approach to identify licensed restaurants for audit. The Department annually requires licensed restaurants to report their percentage of food sales versus liquor sales and provide documentation to support these percentages. From this information, the Department determines which licensees are most at risk for not complying with the 40 percent food revenue requirement and conducts audits of these licensees.

According to the Department, the increased number of audits and its implementation of a risk-based approach to identify licensees for audit has resulted in increased fine revenues. Specifically, the Department reported collecting \$55,500 in fines for fiscal year 2008 from restaurant audits, compared to \$13,000 in fines for fiscal year 2007. In addition, department restaurant audits identified 133 violations in fiscal year 2008 compared to 32 violations in fiscal year 2007.

However, the audit found that the Department should improve the effectiveness and efficiency of its investigation and disciplinary practices. Specifically:

- **Improve its enforcement presence through investigations**—The Department should improve the efficiency and impact of some of its investigative activities. Specifically, auditors' observations of officer shifts found that officers spent significant time driving in their assigned areas looking for licensed establishments to visit, passing numerous licensed establishments but not stopping to investigate or visit them, and traveled back and forth between the opposite ends of their assigned areas during the same shift. Although the Department finds these activities acceptable, any reduction in the amount of time officers spend driving offers the potential to visit and/or investigate more licensees, which is important because each officer's geographic area has hundreds of licensees. Additionally, 75 percent of the 44 investigations observed were performed covertly, meaning officers did not identify themselves to the licensee. Further, the Department's practice has been to not notify licensees by letter, for example, that an officer had conducted a covert investigation. Therefore, most licensees are unaware that an investigation occurred. Although announcing covert investigations beforehand would defeat their purpose, not informing licensees afterwards lessens the deterrent effect of reminding licensees that officers are conducting these investigations.

In response to audit work and budget reductions, the Department has taken steps to enhance its investigations approach, including revising department officer assignments and schedules, and increasing enforcement visibility by requiring officers to conduct twice the number of routine license inspections each month. In addition to these steps and to further enhance its enforcement efforts and presence, the Department

should develop specific guidance regarding investigative priorities and expectations; establish monitoring requirements for its investigations supervisors; notify licensees of all investigation results, including covert investigations; and perform focused investigative followups (See Finding 1, pages 13 through 21).

- **Improve the collection and use of investigative information**—The Department collects a variety of information related to its investigative activities, but some of this information is inaccurate and incomplete. For example, although officers complete weekly logs that document their investigative activities, information on these weekly logs is inaccurate and inconsistent. Further, although officers typically enter some investigative information into a department database, which serves as the Department's main source of investigations information, not all types of investigations are entered into this database, and the system is unable to generate some useful management reports. As a result, the Department does not have complete and accurate information to help guide and direct its investigative efforts. For example, the Department is unable to track who has been investigated and what types of investigations are being conducted, and therefore cannot use this information to determine investigative priorities and activities.

The Department is in the process of implementing a new Electronic Licensing Information System (ELIS), which will replace its current database. The Department anticipates that ELIS should be operational by October 2009 and will help the Department to better manage investigations information. However, unless the Department develops and implements policies and procedures to ensure that all investigative information is accurately collected and entered into ELIS, the new system will not be any more accurate or complete than its current system (See Finding 1, pages 13 through 21).

- **Improve enforcement of state liquor law violations**—Although the Department typically disciplines licensees who violate state liquor laws, several of its policies weaken its ability to discipline repeat and serious violators. These include penalty guidelines to help consistently determine fine amounts, policies for reducing fines for minor first-time violations, and violation grouping policies to help identify repeat violators. However, weaknesses in these policies mean that some licensees can continue operating without receiving consistently strong discipline even if they have a history of serious violations. For example, auditors found that the Department may discount penalties for some serious first-time offenses, such as underage and over-service violations, and it does not always escalate fines against licensees who committed more than one serious violation within a 2-year period because the violations are in separate violation groups. According to a 2005 National Highway Traffic Safety

Administration report, key factors in deterring liquor law violations are the certainty, swiftness, and severity of a penalty.¹ Therefore, consistent with its statutory authority, the Department should strengthen its disciplinary policies, especially for serious and repeat violations (See Finding 2, pages 23 through 31).

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

The Department has generally operated in the public interest in the following areas:

- **Providing a Web site**—The Department has a regularly updated Web site that provides information to the public about licensees, department activities, and department training programs. The Web site offers the public a means of reviewing license information for active licenses and recently issued licenses, as well as pending applications and interim permits.² The Web site also provides general licensing information for license applicants and access to application forms and links to applicable statutes and rules. In addition, the Web site provides information about the Board, including board responsibilities and decisions.
- **Developing an Internet-based licensing system**—The Department is implementing a Web-based license management system that will allow license applicants to obtain licenses and licensees to renew their licenses through the Department's Web site. The Electronic Licensing Information System (ELIS) will also provide updated database capabilities for the Department and assist with the storage and analysis of licensing, investigations, and disciplinary information. The Department reported that this system should be implemented in October 2009.
- **Requiring training on state liquor laws**—The Department requires licensees and managers of licensed establishments to take a department-approved training course in liquor handling and laws and the Department is in the process of expanding this requirement to include more individuals. As authorized by A.R.S. §4-112(G)(2), the Department can require applicants; licensees; employees who serve, sell, or furnish alcohol; managers; and managing agents to take department-approved training courses in liquor handling and laws. Based on this authority and prior to granting a license, the Department requires establishment owners (licensees) and managers to complete a department-approved liquor law training course. Auditors' review of a stratified sample of 15 license applications received in fiscal year 2008 found that, for all 15 applications, the licensees and their designated managers completed the required training. In addition, the Department has initiated administrative rule changes that would require licensees, managers, managing agents, controlling persons, and any employee who

¹ NHTSA, 2005

² Interim permits are available for temporary use by the transferee of a transferable license or an applicant for a nontransferable spirituous liquor license to continue operation until the license application is approved.

sells, serves, or furnishes spirituous liquor to a retail customer to complete training and a department-approved examination. However, in January 2009, just before the Department's open meeting to seek final comments on rule changes from the public, the Governor halted ongoing rulemaking efforts to ensure her appointees have the opportunity to review any new or pending rules. In addition to the training requirements for licensure, the Department may require training as part of disciplinary action for liquor law violations. For example, a licensee who violated A.R.S. §4-244.22 with five counts of underage patrons on the premises without a parent was fined \$7,500 and required to complete training. The Department's Web site provides contact information and locations for approved trainings.

The Department's existing and proposed training requirements appear to be consistent with literature supporting the need for liquor law training. Literature suggests that beverage service training can play an important role in achieving improved compliance with liquor laws. Specifically, according to a summary of the proceedings of a symposium presented at the 2004 Research Society on Alcoholism, participants discussed the important role of beverage service training and that this type of training may be a prerequisite to more effective enforcement efforts, such as those suggested in Finding 1 of this report.¹ This is because once licensees understand their responsibilities to comply with liquor laws, communities and states are more willing to enforce licensee compliance with those laws. Additionally, according to a 2006 Arizona Governor's Office survey, 84 percent of Arizonans support better training for restaurant workers to identify underage drinkers.²

- **Improved cash handling**—In addition, the Department has improved its cash handling. The Office of the Auditor General's 1998 performance audit and sunset review of the Department (See Report No. 98-20) reported several deficiencies in the Department's cash-handling processes, which placed state monies at risk for loss and/or theft. The Department has addressed many of these deficiencies, including immediately endorsing all checks and money orders upon receipt, securing monies in a safe at night, limiting the number of employees who have access to this safe, regularly reconciling the receipt and deposit of monies, and developing policies and procedures for handling cash and cash-like receipts. However, auditors identified two additional improvements that the Department should make to its procedures. Specifically, although the Department locks all received and processed checks in a safe at night and some in a locked drawer during the day, it should lock all checks and monies during the day. In addition, the Department should stop circulating copies of checks and/or sensitive bank account information along with the license application as applications are processed. Instead, department staff should note the appropriate payment information, such as the amount and date of payment, on the application.

1 Wagenaar, Toomey, & Erickson, 2005

2 Social Research Laboratory, 2006

4. The extent to which rules adopted by the Department are consistent with the legislative mandate.

General Counsel for the Auditor General has reviewed an analysis of the Department's rulemaking statutes by the Governor's Regulatory Review Council staff, performed at auditors' request, and believes that the Department has either established or is in the process of adopting all rules required by statute.

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

Although the Department has not made major changes to its administrative rules for more than 10 years, it began an effort to update its rules in September 2006 and reported that it has met with individuals and representatives of various organizations as part of this effort. Specifically, the Department sought to amend its rules regarding the license application and to update its training requirements and exam. To solicit public input on these changes, the Department reported facilitating eight community forums with various representatives from organizations and other community stakeholders. For example, the Department met with representatives from the Arizona Licensed Beverage Association, the Beer and Wine Distributors of Arizona, the Arizona Hotel Lodging Association, the Arizona Restaurant Association, the City of Tempe, and the City of Scottsdale. In January 2009, the Board scheduled an open meeting to receive final public comment and discuss its amended rules before sending them to GRRC for review. However, in January 2009, just before the Department's oral proceeding, the Governor halted ongoing rulemaking efforts to ensure that her appointees have the opportunity to review any new or pending rules. As a result, the Department has not taken any further action on its proposed rule changes.

The Board has also complied with the State's open meeting laws. The Board has posted public meeting notices and agendas at least 24 hours in advance at the required locations, maintained digital recordings of meeting minutes, and filed with the Secretary of State the required statement of where meeting notices will be posted. In addition, auditors observed one board meeting and found that the Board followed its agenda, used executive session appropriately, and provided meeting minutes upon request.

The Department has also sought public input before issuing establishment licenses. According to A.R.S. §4-201, information about a potential license must be posted for a period of 20 days in a conspicuous place on the front of the premises where the business is proposed to be conducted. Additionally, the Department posts information about license applicants on its Web site. This information allows those who reside, own, or lease property within a 1-mile radius who may be opposed to the issuance of the license an opportunity to

send letters protesting the license to city representatives or to the Board. If a city or county, public citizen, and/or the Department protest a license application, the case will be referred to the Board for hearing and the Board will decide whether to grant or deny a license. For example, during its October 2008 meeting, the Board conducted hearings for six contested license applications. Based on these hearings, the Board granted two licenses and denied one license, while one license application was withdrawn and one was vacated, and the Board postponed the consideration of the other license application.

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

The Department has sufficient statutory authority to investigate and resolve complaints within its jurisdiction. The Department reports receiving complaints through word of mouth, department hotline, e-mail, U.S. mail, and voice mail. The Department has established a goal to complete 80 percent of investigations, including complaint investigations, within 45 days. According to the Department, in fiscal year 2008, it received 701 complaints.¹ Following an investigation, because department investigators are also certified peace officers, they may write either administrative citations against the licensee and/or criminal citations to individuals. In response to a substantiated violation, the Department may impose discipline, which can include a warning, penalties/fines, license suspension, and/or license revocation. In addition, licensees may appeal disciplinary actions to the Board.

However, the Department should improve its tracking and monitoring of complaints and complaint investigations. Although the Department has a central phone line where complaints are received and maintains a complaint log, at least one officer reported that he personally receives complaints that are not entered into the database or tracked by the Department. As a result, the Department should develop and implement policies and procedures for recording and tracking all complaints and complaint investigations (See Finding 1, pages 13 through 21).

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

The Department has authority to enforce its enabling statutes and may be represented by the Attorney General's Office. A.R.S. §§4-210.01 and 4-212 authorize the Department to impose discipline against various unlawful acts. This authority includes imposing a civil penalty of not less than \$200 nor more than \$3,000 for each violation; a requirement that the licensee or other person attend a training program approved by the Department; and applying to the superior court for a temporary restraining order and other injunctive relief

¹ Auditors' review of investigations statistics from various sources revealed that insufficient controls were in place to establish the reliability of the investigations information, including complaint investigation statistics, for any information other than background information.

prohibiting specific acts such as selling or dealing in spirituous liquor without a valid license, permit, or registration. Additionally, A.R.S. §41-192 authorizes the Attorney General's Office to prosecute actions and represent the Department. The Department and Board currently share an Assistant Attorney General for consultation and assistance on a daily or as-needed basis.

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

The Department's enabling statutes have been amended several times since 2006. These changes include a 2006 addition to the statutes, A.R.S. §4-205.08, authorizing a separate license for domestic microbreweries and a 2006 amendment to A.R.S. §4-213 to describe circumstances under which restaurants not meeting the requirement of at least 40 percent in food sales can still be allowed to continue operating with a restaurant license. Additionally, A.R.S. §4-202 was revised in 2007 to prohibit the issuance of an interim permit or restaurant license to any person who, at the same location, has been required to surrender a restaurant license until 12 months after the surrender date.

Although the Department reports that it has not proposed legislation since 2006, it may request statutory changes in the future. According to the Department, it plans to request statutory changes to increase several of its licensing fees at a future time, pending approval of the Governor's Office. These fees are established in statute and, according to the Department, most have not been increased for at least 20 years. While assessing its budget situation in 2008, the Department evaluated its license fee structure and presented a proposal to the Governor's Office in August 2008. The proposal showed that the Department's fees are often lower when compared to the licensing fees required in other states. For example, the cost of a first-time restaurant liquor license in Arizona, including the application and issuance fees, is \$2,100. In contrast, according to the Department's 2008 comparison, a first-time restaurant license in California costs either \$6,000 or \$12,000, depending on where the establishment is located; \$6,512 in Texas (a 2-year license); and only \$200 in New Mexico. Annual restaurant license renewal fees for these states range from \$585 in Arizona; \$553 to \$847 in California, depending on the population of the city where the licensed establishment is located; \$2,012 to \$5,012 in Texas for a 2-year renewal (fee decreases for second and third renewals); and \$1,050 in New Mexico. However, the Department reported that because of changes at the Governor's Office, the proposal has not yet been considered, and the Department plans to wait for the Governor's response before requesting any statutory changes.

9. **The extent to which changes are necessary in the laws of the Department to adequately comply with the factors in the sunset law.**

This audit did not identify any needed changes to department statutes.

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

Terminating the Department and not otherwise regulating the production, distribution, and sale of alcoholic beverages could harm the public health, safety, and welfare. According to the U.S. Department of the Treasury Alcohol and Tobacco Tax and Trade Bureau, all 50 states have regulated liquor following the end of national Prohibition, when the 21st Amendment to the Constitution provided states with broad powers and authority to regulate the sale and distribution of alcohol within their borders. All 50 states created their own unique system of alcohol beverage regulation generally classified as either a "control" model or a "license" model.¹ Although 18 states are control states, meaning they act as the sole wholesalers of distilled spirits and may have some retail and licensing responsibilities, Arizona is one of 32 license states that do not sell alcoholic beverages, but rather regulate the distribution and sale of alcoholic beverages through the issuance of licenses. In addition, the Department protects the public by investigating and enforcing violations of state liquor laws, such as those designed to prevent underage consumption and the over-service of alcohol. According to the National Institutes of Health, all 50 states have established the age of 21 as the minimum legal drinking age, and the National Institute on Alcohol Abuse and Alcoholism indicates that the enforcement of these laws has had positive effects, primarily in decreasing traffic crashes and fatalities, and suicide, and decreasing consumption by those under age 21.² Further, the U.S. Department of Transportation estimates that such laws prevent 1,000 traffic deaths each year.³

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 audit found that the current level of regulation the Department exercises is generally appropriate.

1 Alcohol and Tobacco Tax and Trade Bureau, n.d.

2 NIAAA, 2008; NIH, n.d.

3 NIH, n.d.

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.

The Department uses contractors to perform certain services. For example, the Department has contracted with an information technology firm to provide project management and oversight of the implementation of its new e-Licensing and database system, ELIS. In addition, the Department has entered into a contract with an organizational design company that provides technology solutions and will provide various services for the Department, such as technical direction and, according to department staff, assistance with data migration from the Department's current database to ELIS. Further, the Department uses private vendors on an annual basis to establish fair market value pricing for new quota liquor licenses that it issues to only a limited number of applicants per county each year and another vendor for conducting a random number drawing for these licenses if there are more applicants than available licenses (see Other Pertinent Information, pages 33 through 38, for more information).

The audit did not identify any additional opportunities to contract for services.

APPENDIX A

Methodology

Auditors used various methods to study the issues addressed in this report. These methods included interviewing board members, department staff, and representatives of various liquor professional associations; attending a board meeting; reviewing statutes, rules, and department policies and procedures; and reviewing the *Arizona Agency Handbook* published by the Attorney General's Office. In addition, the following specific methods were used:

- To assess the adequacy and efficiency of the internal controls supporting the Department's investigation process, auditors accompanied six officers on four separate investigative shifts between October 2008 and January 2009, analyzed 60 weekly logs representing each officer for the month of November 2008 and the weekly logs associated with the auditors' observations of the four investigative shifts, and reviewed an October 20, 2008, download of the Department's Licensing Control System (LCS) database. Initial review of the investigations information in the database found that information in the database is not complete. Thus, auditors determined that the investigations information would not be reliable for audit use and no further data review was performed. Additionally, auditors reviewed the request for proposal, vendor contract, and project management information, and attended several project development meetings related to the Department's development of its new database, the Electronic Licensing Information System (ELIS). Auditors also reviewed applicable literature regarding effective law enforcement (See Appendix B, pages b-i through b-ii, for more information about literature reviewed).
- To determine the appropriateness and consistency of the Department's disciplinary actions and the adequacy of the internal controls supporting its disciplinary process, auditors analyzed an October 20, 2008, download of information from the Department's LCS database, consisting of licensing and compliance information from calendar year 2004 through October 20, 2008, to assess the reliability of this information. Auditors compared selected information from a random sample of 30 of the 1,119 compliance cases opened by the

Department between January 1, 2007 and October 20, 2008, to information in the database, and compared information from 19 compliance cases listed in the database to appropriate case file documentation. Based on this test work, auditors determined that the compliance information in LCS was sufficiently reliable for audit use. Therefore, auditors reviewed and analyzed a January 8, 2009, download of the LCS database, which contained 2,495 compliance cases the Department closed between January 1, 2004 and December 31, 2008, and analyzed a judgmental sample of 40 compliance cases involving 14 licensees that consisted of either repeat or serious violations of state liquor laws that the Department closed between January 2004 through December 2008. Auditors also interviewed officials from nine states' liquor departments, boards, or commissions.¹ Finally, auditors reviewed various surveys and studies on the negative effects of underage drinking and over-service and related alcohol enforcement policies (See Appendix B, pages b-i through b-ii, for more information about literature reviewed).

- To obtain information on the Department's process and internal controls for issuing new quota liquor licenses, auditors reviewed the Department's data and documentation pertaining to its issuance of quota liquor licenses in fiscal years 2006 through 2009, independent vendor appraisal reports on the fair market value of quota liquor licenses, vendor documentation related to the quota liquor license random drawing, and department quota license revenue documentation.
- To gather information for the sunset factors, auditors reviewed and analyzed a random sample stratified by 6 of 17 different license types and representing work performed by each of the five customer service representatives. Specifically, auditors analyzed 18 of 1,267 new license applications the Department approved in fiscal year 2008. Additionally, auditors reviewed an analysis of the Department's administrative rules performed by the Governor's Regulatory Review Council staff, invitations and attendance logs for public forums to discuss rule changes, the Department's proposal for statutory change, which was submitted to the Governor's Office of Strategic Planning and Budget, and the Department's compliance with open meeting laws, including reviewing its statement of disclosure filed with the Arizona Secretary of State's Office as of June 12, 2008, and six board meeting notices and agendas. Auditors also reviewed information from the Master List of State Government Programs, the U.S. Department of the Treasury Alcohol and Tobacco Tax and Trade Bureau, and the Department's Web site.
- To develop information for the Introduction and Background, auditors reviewed the Auditor General's 1998 performance audit and sunset review of the Department of Liquor Licenses and Control (see Report No. 98-20); gathered and analyzed information about the Department from the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* for fiscal years

¹ Auditors interviewed officials from nine western states and/or states that issue licenses similar to Arizona's. These states were Alaska, California, Colorado, Florida, Idaho, Oregon, Texas, Utah, and Washington.

2007 through 2009, and *AFIS Management Information System Status of General Ledger–Trial Balance* screens for fiscal years 2007 through 2009; and reviewed various department documents and various surveys and studies on the negative effects of underage drinking and overservice and the importance of the enforcement of liquor laws (See Appendix B, pages b-i through b-ii, for more information about literature reviewed).

APPENDIX B

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AGENCY RESPONSE



**STATE OF ARIZONA
DEPARTMENT OF LIQUOR LICENSES AND CONTROL**

**JANICE K. BREWER
GOVERNOR**

**JERRY A. OLIVER, SR.
DIRECTOR**

July 21, 2009

Debbie Davenport, Auditor General
State of Arizona Office of the Auditor General
2910 North 44th Street, Suite #410
Phoenix, Arizona 85018

**RE: RESPONSE TO THE AUDITOR GENERAL'S JUNE 29, 2009 CONFIDENTIAL DRAFT REPORT
CONCERNING THE DEPARTMENT OF LIQUOR LICENSES AND CONTROL'S ("DLLC") PERFOR
MANCE AUDIT AND SUNSET REVIEW**

Dear Ms. Davenport:

First, on behalf of the Department of Liquor Licenses and Control (DLLC), I would like to extend our appreciation to you for the dedication and commitment, time, and research your staff contributed in conducting DLLC's performance audit and sunset review.

Secondly, in furtherance of the Joint Legislative Audit Committee's procedures, below, please find DLLC's comments on the recommendations presented in the draft preliminary report prepared by your office:

Recommendation 1.1 a - d (page 21 of preliminary draft report)

DLLC Comment: 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 1.2 a - e (page 21 of preliminary draft report)

DLLC Comment: 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 2.1 a - f (page 30-31 of preliminary draft report)

DLLC Comment: 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 2.2 (page 31 of preliminary draft report)

DLLC Comment: 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

July 21, 2009
Debbie Davenport, Auditor General

Page 2 of 2

In addition, DLLC acknowledges the 12 sunset review factors, in accordance with A.R.S. §41-2945, and will implement a method for handling cash and cash receipts as recommended on on page 44 of the preliminary report draft.

Furthermore, in the June 29, 2009 correspondence, you stated that, if necessary, the Office of the Auditor General would furnish DLLC with a revised final report which would require a final response from DLLC by August 5, 2009. Because DLLC agrees to implement the recommendations proposed in the preliminary report draft, revisions to the draft will not be necessary. Resultantly, DLLC submits this letter as its final response to the draft performance audit and sunset review conducted by the Office of the Auditor General during the calendar years of 2008 and 2009.

Finally, if you require more information prior to our next meeting, please contact me at 602-542-9020.

Sincerely,

Jerry A. Oliver. Sr.
Director

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07-11	Arizona Supreme Court, Administrative Office of the Courts—Juvenile Detention Centers	09-04	Arizona Sports and Tourism Authority
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