Secretary of State
AUDIT REPORT

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Oregon Liquor Control Commission: Review of Inventory Management and License and Permit Regulation

Summary

PURPOSE

The purpose of this audit was to determine if the Oregon Liquor Control Commission (OLCC) was managing state liquor inventory appropriately; was detecting and denying unqualified applicants for liquor licenses and permits; and was regulating agents, licensees, and permit holders uniformly.

RESULTS IN BRIEF

Approximately 80 percent of agent-operated liquor stores did not meet OLCC's goal for inventory turnover for the most recent evaluation period. To attain OLCC's goal, agent stores would need to either reduce inventory by $2 million or increase sales volume by $51 million, or some combination of both. To properly manage the state's liquor inventory, however, OLCC first needs to ensure that its inventory turnover goals are reasonable and appropriate. Once the goals are established, OLCC needs a system to evaluate performance against the goals and correct deficiencies when they occur.

During our review, we noted the following:

- OLCC's inventory turnover goal was not based on any analysis or industry standard.
- OLCC's current system for evaluating agent-operated liquor stores does not readily identify or communicate operational problems.
- OLCC does not consistently pursue compliance from deficient stores.

In the area of license and permit regulation, it appears that OLCC is effectively denying unqualified applicants for liquor licensees. However, OLCC could improve its process for detecting and subsequently denying service permits to applicants who are not honestly disclosing their criminal histories. Finally, the regulatory division appears to calculate fines and penalties for liquor licensees and permit holders consistently and in compliance with state laws.

RECOMMENDATIONS

To improve oversight and management of agent-operated liquor stores, we recommend that OLCC:

- Reevaluate inventory turnover goals and determine if sales and inventory targets are meaningful, reasonable and justifiable. Track store performance in relation to these and other significant goals, and hold stores accountable for their achievement.
- Modify the store evaluation process so that it can identify and communicate accurate store conditions. These modifications should include redesigning the overall rating scheme such that a significantly low rating in one area will be reflected in the store's final overall rating.

To improve the approval and renewal process for service permits, we recommend that OLCC:

- Analyze the results of the testing of service permit applications thus far and determine whether the non-disclosure rate is acceptable. Monitor these results and modify the amount of testing as necessary. Finally, consider increasing the penalty for applicants who do not honestly report their criminal histories.

OLCC'S RESPONSE

We have received your draft audit report for the Oregon Liquor Control Commission. Before commenting on your recommendations, I would like to express our appreciation for the professionalism shown by your audit team led by Chuck Hibner. We have always received excellent guidance from your Division and this audit was no exception.

Thank you for your recommendations for improving the Store Operations division and the Service Permit section. We found the performance audit process to be particularly helpful. We look forward to working with you in the future.

See OLCC's specific response to each recommendation in the body of the report.

Background

The mission of the Oregon Liquor Control Commission (OLCC) is to effectively regulate the sale, distribution and responsible use of alcoholic beverages in order to protect Oregon's public health, safety and community livability.

The authority for OLCC can be found in ORS 471.730, which outlines the function, duties and powers of OLCC for regulating and merchandising liquor. Specifically, the law allows OLCC to do the following:

- Control the manufacture, possession, sale, purchase, transportation, importation and delivery of alcoholic liquor; and

- Grant, refuse, suspend or cancel licenses and permits for the sale or manufacture of alcoholic liquor, or other licenses and permits in regard thereto, and to permit, in its discretion, the transfer of a license of any person.

A department of approximately 200 fulltime employees currently supports the five-member commission.

In order to sell, distribute, and manufacture alcoholic beverages in Oregon, a person or business must obtain a license from OLCC, which is renewed annually. OLCC issues several types of licenses including those authorizing private businesses to sell beer and wine by the drink or in the package. Additionally, the Liquor Control Act, passed in 1953, authorizes OLCC to issue "dispenser" licenses for the sale of hard liquor by the drink in restaurants and private clubs. As of January 2000, OLCC estimated that it had 13,573 total licenses outstanding.

In order to serve alcoholic beverages in Oregon, bartenders and other alcohol servers must have service permits. Service permits are renewed every five years and, as of January 2000, OLCC estimated that it had 77,100 service permits.

As of March 2000, the OLCC was overseeing and providing merchandise to 234 retail liquor stores for the express purpose of selling hard liquor products. Contract agents operate these stores and received compensation from these sales that averaged 8.54 percent of sales.

OLCC's fiscal data for 1999-2001, through August 31, 2000 (14 months) showed income of $271.7 million in liquor sales, $3.6 million in license fees, and $14.7 million in privilege taxes on beer and wine.

OLCC had a cost of operation for the period of $41.3 million (this includes $22.4 million in agent compensation) and a net revenue available for distribution of $114.6 million.

The department distributed this revenue as follows:

1999–01 Revenue Distribution as of August 31, 2000 ($ million)	
General Fund	$60.0
Cities	$21.4
Mental Health	$7.1
City Revenue Sharing	$15.0
Counties	$10.7
Wine Advisory Board	$.2
TOTAL	$114.6

Audit Results

Opportunities to Improve Inventory Management Practices

Agent-Operated Liquor Stores Are Not Meeting Inventory Turnover Goals

Our testing of 1999 sales and inventory data concluded that 188 of the 233 stores (80 percent) did not meet the inventory turnover goals as set by OLCC. To attain OLCC's goal, agent stores would need to reduce inventory by $2 million, or increase sales volume by $51 million, or some combination of both.

Achievement of inventory turnover goals is one of the primary evaluations a store receives. A store with a certain amount of inventory must reach a certain level of sales to attain the goal. Theoretically, the established inventory turnover goal should be the point where a store's sales potential and inventory costs are optimized.

Agent stores with turnover ratios that are too low or too high should be carefully examined. Low figures could identify stores with excessive inventory or stores that have not reached the sales potential for their area. Conversely, high figures might be indicative of stores that do not carry enough inventories to meet sales demand. In order to complete this analysis, store management and OLCC need to understand the sales potential for a given store operation.

Inventory Turnover Goals Need to Be Reevaluated

The establishment of meaningful benchmarks and measures is of paramount importance in any evaluation system. The rational or justification for performance guidelines should be readily apparent, easy to explain, and understood by those affected and those expected to enforce it.

During the course of this review, we found that OLCC's inventory turnover goals were not based on any analysis or industry standard. We were told by OLCC that it set the existing turnover benchmarks so that system-wide inventory turnover would equal one turn per month, or 12 turns annually.

To test the reasonableness of this number, we compared OLCC's benchmark to an industry standard. We found that OLCC's inventory turnover benchmark was four inventory turns higher than the median private sector value reported in the 1998-1999 Dunn and Bradstreet Key Business Ratio publication. We would not interpret from this limited analysis that the benchmarks as set by the OLCC are too high. We do feel, however, since the department's intent is to use inventory turnover guidelines to help identify problems with inventory management, that it should establish a performance basis for these benchmarks.

Agent Evaluation System Should Be Reviewed

We found that the weighting of categories in the present evaluation system should be reviewed to ensure that problems are adequately identified and communicated to agents. The present evaluation scoring system is weighted such that a store could be significantly deficient in one category, such as inventory turnover, and still show as a satisfactory or better operation.

As our analysis of turnover demonstrated, this system design tends to conceal performance problems and does not provide proper identification and the opportunity (or the incentive) for correction of performance deficiencies. Of the 167 agent stores that did not meet inventory turnover goals and received 1998 evaluations, only five received an overall rating of "unsatisfactory" or "needs improvement."

Process for Correcting Deficiencies Should Be Strengthened

We also noted that OLCC's store operation division, which oversees the rating process, does not appear to aggressively pursue compliance from agent stores when performance deficiencies are noted.

The agents' contract requires the agents to adhere to the standards set forth by OLCC, one of which is inventory management. The contract also allows OLCC to send notices of violation in instances of non-compliance as a primary mechanism to inspire agent adherence. Contract termination is possible upon a third such notice within a 36-month period. Our review of the 66 notices issued from July 1998 to June 2000 did not find any notices that were issued to an agent failing to comply with inventory turnover standards.

OLCC's store operation management advised us that this was due in part to OLCC's regular involvement with stores on a variety of business issues, including store evaluations. They see maintaining a good relationship as central to their roles and responsibilities, and see providing a critical store evaluation as a threat to a productive relationship.

We recommend that OLCC:

- Reevaluate its inventory turnover goals and determine if sales and inventory targets are meaningful, reasonable and justifiable. Track store performance in relation to these and other significant goals, and hold stores accountable for their achievement.
- Modify the store evaluation process so that it can identify and communicate accurate store conditions. These modifications should include redesigning the overall rating scheme such that a significantly low rating in one area will be reflected in the store's final overall rating.

Agency Response: *We are in agreement that the Commission could improve the oversight and management of agent-operated liquor stores. In fact, we have already taken steps to improve many of the processes reviewed by the audit team. The Commission instituted a new, performance-based, agency evaluation process in the Fall of 2000. The revised evaluation measures how well a store is complying with operating procedures, laws and policies governing the sale of liquor. It identifies areas that need corrective action and outlines an action plan that the agent is expected to follow. The number of years of an agent's contract renewal is now based on the results of their annual evaluations. The Commission will continue to refine the evaluation criteria as needed to make it as meaningful as possible.*

More recently, the Stores Division has been working closely with liquor stores to reduce their inventories and make the turnover goals more meaningful. State inventories have declined by $3.76 million (at retail) from March 2000 to March 2001. As of the end of March 2001, 133 of the 236 stores (56%) met their turnover goal. The Commission intends to reevaluate each store's turnover goal in the near future, compare them against industry standards, and make adjustments as necessary.

Also, since January 2001, the Commission has been working more aggressively with agents to ensure compliance with operating procedures, laws, rules and policies. Letters of Warning and Notices of Violation are being issued to agents who fail to comply with any provision of the contract. Agents who receive three Notices of Violation within a 36-month period are given Notices of Termination.

Reliance on Self-Disclosure Should Be Reevaluated

We reviewed the licensee and permit holder approval and renewal process and determined that the licensee process was effectively detecting and denying unqualified applicants. However, our review of the permit holder process determined that the OLCC's reliance on service permit applicants to disclose their criminal histories on the application form, as a primary means of detection, is not effective.

Currently, OLCC does not perform a criminal background check for service permit applications, unless an applicant discloses a criminal history on their application.

Starting in November of 1999, OLCC began randomly checking criminal histories for up to 10 percent of the applicants for new service permits or renewals of service permits. Our analysis of the year 2000 data showed that 49 of the 1,413 reviewed (3.5 percent) did not fully disclose their criminal histories on their applications. OLCC

subsequently denied these service permits on the basis of failure to disclose this information. Of the denials, not all would have been denied due to the nature of the criminal history, since not all offenses qualify for denial.

The consequences for failing to disclose criminal history may not be sufficient to deter applicants, especially given the small chance of discovery. Since the permit renewal cycle is five years and only 10 percent of the applicants are reviewed each year, on average, each applicant will be subject to review only once every 50 years. Also, the current penalty for making a false statement is denial of the permit and loss of the $23 application fee. If an applicant has a disqualifying criminal history, the small chance of being caught may be worth the potential loss of the $23 application fee.

OLCC compiles the results from its random checks on a monthly basis. However, management does not review this data to determine if the rate of non-disclosure is acceptable. If the rate is found to be unacceptable, OLCC will need to explore options for increasing compliance, such as expanding the amount of testing done or increasing penalties.

We recommend that OLCC:

- Analyze the results of the testing thus far and determine whether the non-disclosure rate is acceptable. Monitor these results and modify the amount of testing as necessary.
- Consider increasing the penalty for applicants that do not honestly report their criminal histories on their permit applications.

Agency Response: *We also agree that the current process for verifying service permit applicant criminal history disclosure is not perfect. The current system reflects a conscious decision to direct the program's limited staff resources toward other higher priority compliance issues. Nevertheless, based on the audit report recommendation, the Regulatory Program will analyze the non-disclosure rate to determine if practices or policies need to be modified. The program will also institute a process for the quarterly review of the non-disclosure rate. In addition, the Regulatory Program will review the existing rules that pertain to service permit applications, and will consider initiating rule-making to address deficiencies.*

Rule Enforcement and Penalty Issuance Appears Consistent with State Law

Our testing involved reviewing the calculation of fines and penalties, and cancellations for cause for a sample of licensees and service permit holders. Our review found that this division appears to be enforcing the rules and issuing penalties consistently and in keeping with state law.

Agency Response: *We are pleased that the report found the Regulatory Program's sanction process to be fair and consistent. We have spent considerable energy on the sanction process. The Commission is committed to ensuring that all licensees who face a fine or suspension are treated in a fair and consistent manner.*

Objectives, Scope and Methodology

The objectives of our audit were to:

- Evaluate OLCC's inventory management practices to see if inventory turnover goals were properly set and adequately monitored, and whether corrective actions were taken, where appropriate.
- Determine if OLCC's evaluation system for agent-operated liquor stores was fair and identified stores with operational problems;
- Determine if OLCC's approval and renewal process was effectively detecting and denying unqualified applicants for liquor licenses and permits; and
- Determine if the regulation of agents, licensees, and permit holders met statutory requirements and was uniformly applied.

To accomplish these objectives, we reviewed applicable laws, rules, policies and procedures. We interviewed department staff and management. We conducted interviews with local stakeholders and reviewed audit reports prepared by other states.

We selected a sample of license and permit holders to determine if they originally met and continue to meet the requirements necessary for holding their respective licensees and permits. We also reviewed criminal history data from the Law Enforcement Data System as maintained by the Oregon State Police.

We selected a sample of agents and reviewed the evaluations prepared for the most current period as well as for prior periods as available.

We reviewed and recalculated penalties for a sample of licensees and permit holders that had significant regulatory activity.

We utilized financial and inventory data as provided by the department in our analysis of inventory and sales management practices.

We conducted this audit according to generally accepted government auditing standards. We limited our review to the areas specified above.

This report, which is a public record, is intended to promote the best possible management of public resources. Copies may be obtained by mail at Oregon Audits Division, Public Service Building, Salem, Oregon 97310, by phone at 503-986-2255 and 800-336-8218 (hotline), or internet at Audits.Hotline@state.or.us and http://www.sos.state.or.us/audits/audithp.htm.

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The courtesies and cooperation extended by the officials and staff of the Oregon Liquor Control Commission were commendable and much appreciated.

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