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MANAGEMENT LETTER NO. 03-616B

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To the Utah State Liquor Commission and
Ken Wynn, Director, Department of Alcoholic Beverage Control

The office of the Utah State Auditor has conducted an investigation in conjunction with the Department of Public Safety, State Bureau of Investigation (SBI), relating to certain actions taken by the now former Manager of Administrative Services (Manager) at the Department of Alcoholic Beverage Control (DABC). The time period included in our investigation was January 1999 through May 2003. However, one transaction investigated had implications back to November 1998 and we have also included this transaction in our report. The same type of improper activities uncovered by the investigation may have occurred prior to the time period we investigated, however, due to the difficulty of obtaining reliable documentation prior to 1999 and due to the statute of limitations for these types of activities, we chose not to investigate transactions prior to 1999.

BACKGROUND

The SBI received a complaint alleging that embroidery services were being performed and paid for by DABC but that the logos embroidered on the clothing belonged to another organization. When confronted with this information, the Manager admitted that he had used DABC funds to purchase items and embroidery services for a private organization with which he was involved. However, he stated that the organization had reimbursed DABC for the purchases. Upon review of the evidence the Manager provided regarding the reimbursements, we determined that the reimbursement checks received from the private organization had not been properly deposited to the DABC operating account but, instead, had been deposited into the DABC petty cash checking account that was under the direct control of the Manager. We also found that other sources of DABC revenue that should have been deposited to the DABC operating account were also being inappropriately deposited into the petty cash account. In addition, we found that some DABC revenues were deposited to the Manager's personal bank account that was entitled "DABC Candy Account." We also reviewed expenditures from the petty cash account and determined that there were many inappropriate disbursements both to the Manager and to others out of the account.

On May 21, 2003, we met with DABC Management and suggested that the Manager be placed on administrative leave, which was done on June 4, 2003. The Manager subsequently retired. The Salt Lake County District Attorney filed second-degree felony charges against the Manager to which the Manager plead guilty.

The Manager claims that the DABC revenues he diverted and received through disbursements to himself were used primarily to fund an employee gym at DABC and to buy gift certificates for employees. There is some evidence to support those claims; however, information provided by the Manager does not fully account for the transactions we have reviewed. Regardless, these expenditures represent a misappropriation of funds because State funds were used for unauthorized purposes.

FINDINGS SUMMARY AND OVERALL RECOMMENDATION

We believe that \$130,308 was misappropriated between November 1998 and May 2003. The total amount includes \$53,793 in DABC revenues that were deposited directly to the Manager's personal accounts and \$76,515 in improper disbursements from the petty cash account. In addition to the total amount above, the Manager used a Costco credit card in DABC's name for personal purchases. After the Manager's retirement, DABC paid off the \$6,256 balance on that card.

The control environment over cash receipting, clothing purchases, the petty cash account, and various other procedures at DABC were inadequate, which allowed the misappropriation and manipulation of funds to go undetected. We found that controls were either lacking in these areas or were not followed. It is very concerning to us that various employees were aware of certain procedures that we determined to be improper, but either did not recognize them as improper or did not feel comfortable questioning them. Management needs to create a strong control environment where good internal controls are established and followed. Management should communicate to the employees the importance of following internal controls to maintain a good control environment and should insist that established internal controls are followed. Management should also encourage their employees to question procedures they believe are improper without fear of reprisal.

Overall Recommendation:

We recommend that DABC implement, communicate, and insist on a strong control environment.

DABC's Response:

We agree with the finding and are taking steps to implement a strong control environment at DABC. We have hired a new Financial Director with extensive government auditing background to ensure that internal controls are implemented and properly functioning. We have started training for all DABC administrative personnel regarding the importance of internal controls at DABC and their responsibility to ensure that controls are complied with. The training will also stress the importance of knowing and complying with all State Finance and DABC policies and procedures. We are also reviewing the need for an internal audit function at DABC.

The improprieties, internal control weaknesses, and concerns we identified are described in the following findings in more detail.

1. CIRCUMVENTED CASH RECEIPTING CONTROLS

DABC revenues were improperly deposited to either the DABC petty cash account that was controlled by the Manager or to one of three personal accounts held by the Manager. The revenues were outside the bounds of normal operations for the agency and consisted of various rebates and refunds, proceeds from a recycling program, reimbursements from employees, unauthorized sales of DABC property, manipulation of cash proceeds from vending machine sales, and other miscellaneous sources. It is inappropriate for these DABC revenues to be deposited to any account other than the main operating account. It is unclear how the Manager had access to some of the revenue items. However, we determined that in some cases, the checks (or cash from vending machine sales) were given directly to the Manager by either DABC personnel or by entities outside of the agency. In the case of recycling revenues, the checks were made payable to the Manager in care of DABC which allowed him to deposit the revenues directly to his personal accounts. Also, the Manager had a personal bank account entitled DABC Candy Account which allowed him to easily deposit checks payable to DABC. It appears that the established cash receipting controls were circumvented since cash/checks were deposited into inappropriate accounts. We identified the following DABC revenues that were deposited improperly to accounts other than the DABC operating account:

Rebates	\$ 37,011
Clothing purchase reimbursements	27,619
State recycle incentives	16,698
Proceeds from sales of DABC property	2,495
Personal checks issued by employees, cashed using proceeds from vending sales *	7,151
Reimbursements from employees for personal items purchased with DABC funds *	2,665
Petty cash replenishment deposited to the Manager’s personal account	446
Refunds and miscellaneous	1,663
Cash deposits (may be from vending machine sales) *	7,412
Change fund increases	<u>11,700</u>
Total diverted revenue identified	<u>\$ 114,860</u>

** We believe that we have identified the majority of diverted revenues, however, we did not attempt to quantify all cash based transactions and reimbursements from employees that were deposited to improper accounts due to the difficulty in identifying these transactions.*

Of the total above, we determined that \$53,793 was deposited directly to the Manager’s personal bank accounts. The remainder was deposited to the DABC petty cash account and then used to fund improper disbursements as discussed in Finding No. 2. The Manager has breached his duty as a fiscal officer of the State by allowing these revenues to be deposited to improper accounts. Furthermore, by diverting these revenues from the DABC operating account, there was no control or oversight over how the diverted funds were spent.

Recommendation:

We recommend that DABC follow established cash receipting controls to ensure that cash/checks are deposited into the proper account and that only authorized personnel handle the cash/checks. We also recommend that DABC take steps to recover all misappropriated funds.

DABC's Response:

*We agree. The receipts that were misappropriated were unusual and unexpected cash receipts that were not processed with normal cash receipts. **Cash receipts from the sale of alcohol were not misappropriated.** We have established control over all cash receipts by centralizing all administration cash receipting. All DABC mail is now received and opened by one person, and access to checks and cash (including candy sales) will be limited to authorized individuals. All cash receipts are now entered into the Carillon accounts receivable program which creates a log of all entered receipts. Periodically, we will have someone independent of the cash receipting function verify that all receipts on the log are deposited into appropriate DABC accounts and are properly entered in the accounting system .*

We have contacted the Salt Lake District Attorney's Office to ask that any misappropriations are included in court ordered restitution. We have also contacted State Risk Management to initiate a claim against DABC's insurance coverage.

2. INADEQUATE PETTY CASH CONTROLS

DABC had internal control weaknesses over petty cash that allowed manipulation and misuse of funds. The State Auditor's Office issued findings in 1999 regarding control weaknesses and noncompliance with State Policies and Procedures over the petty cash account managed by the Manager. We found many of the same weaknesses in a subsequent audit in 2001. DABC subsequently reduced the balance in the account to \$500 and discontinued use of the account early in 2002. In our current investigation, we were informed that top management often signed blank checks at the request of the Manager. Furthermore, the independent reconciliation of the petty cash account did not include any kind of reasonableness review of deposits made to the account or checks written from the account. These weaknesses allowed the Manager to use the account for many non-petty cash related transactions. As discussed in Finding No. 1, certain DABC revenues were deposited inappropriately to this account instead of the agency's operating account and then the funds were disbursed from the petty cash account for unauthorized purposes. We also noted that the full amount of each check was not always deposited; instead, cash was received back. In total, this amounted to a substantial amount of cash (\$12,920). For all deposits where cash was received back, the deposit slips were signed by the Manager. Also, the petty cash account was used on occasion to provide advances to employees, pay certain non-business related bills for the Manager and other employees, and in general was often used to expedite processes and circumvent State policies. These uses are inappropriate for a petty cash account. As noted in Finding No. 1 and No. 8, in some instances the petty cash account was not reimbursed for the advances and

payments of personal bills. We have summarized below the different types of disbursements from the petty cash account that we believe were improper and represent a misappropriation of funds. These improper disbursements were generally funded by the diverted revenues noted in Finding No. 1. However, we did note that the Manager deposited \$7,505 in personal checks to this account between 1999 and 2001 but there is no documentation to indicate what the \$7,505 was for.

Checks payable to Bank – subsequently cashed	\$ 3,139
Checks payable to Cash	6,550
Checks payable to the Manager	20,108
Checks applied to Costco credit card	6,570
Checks payable to DABC – we believe these checks were cashed at liquor stores	5,350
Advances to an employee – the employee reimbursed the Manager and the reimbursements were deposited into the Manager’s personal bank account	11,290
Checks payable to Harmons	9,548
Checks payable to Bank and applied to the Manager’s personal loan	1,040
Cash received back from deposits of DABC revenue	<u>12,920</u>
Total improper disbursements identified	<u>\$ 76,515</u>

The lack of independent review and oversight on the account resulted in the misuse of funds without detection by the agency.

Recommendation:

We recommend that DABC management close the petty cash account and return the remaining account balance to the State. In addition, we recommend that DABC ensure that employees and management are educated about the importance of internal controls and ensure that the weaknesses noted in the now inactive petty cash account do not exist in other areas of DABC.

DABC’s Response:

We agree. We have closed the petty cash impress account and have returned the balance to the state. We have started training for all administrative personnel who manage other petty cash accounts to remind them of their personal responsibilities and to review the State Finance Policies regarding DABC petty cash funds. We now require that petty cash funds are independently reconciled on a regular basis and will closely review all requests for reimbursement for propriety and compliance with State policy. We will review activity annually to ensure that balances are appropriate for the level of activity. In addition, during training we will encourage DABC employees to question activity that they consider inappropriate or not in compliance with State or DABC policies.

3. MANIPULATION AND MISUSE OF EMPLOYEE FUND BANK ACCOUNT

DABC revenues were diverted and deposited directly into the DABC Candy Account and then the funds were used for improper purposes (as discussed in finding No. 1). Also, many

electronic transfers were made between this account and the Manager's other personal accounts. The Manager opened the DABC Candy Account with DABC management's knowledge and consent for the purpose of obtaining a loan to purchase vending machines for the employees and later also for the intent of purchasing gym equipment for the employees. The fund was intended by DABC to be a self-sufficient employee account funded by the proceeds of candy sales and user fees for the gym. However, the account ultimately functioned as the Manager's personal account which was used to misappropriate State funds. As discussed in Finding No. 4, we determined that the fund was not self-sufficient. The creation of employee owned accounts to fund activities with the employee's own money at state agencies is not unusual or necessarily prohibited; however, the account should be clearly identified as an employee account to ensure that it is not mistaken for an official account by outside parties. Also, the agencies should ensure that controls are in place that would prevent the employees in control of the account from manipulating and misusing them. Controls could include having rotating responsibility over the bank account and bookkeeping and having an independent person reconcile the bank statement.

Recommendation:

We recommend that DABC ensure that employees understand that it is inappropriate to establish bank accounts that could be mistaken for official state accounts. We also recommend that internal controls are established over employee fund bank accounts to avoid manipulation and misuses.

DABC's Response:

We agree. We have established proper internal controls over the employee candy fund activity. We have contacted State Finance to determine how to operate and account for the vending operations at DABC (see response to finding #4 below). We have also started training with all administrative personnel to inform them of the severe consequences of opening bank accounts that could be mistaken for official state accounts.

4. LACK OF CONTROLS OVER VENDING MACHINES AND MISUSE OF PROCEEDS

DABC has an inappropriate arrangement regarding their vending machines. DABC has allowed the employees to operate the vending machines as a profit-making venture. The operation was supposed to be self-supporting with the proceeds used to restock the machines and then any profit could be used for the benefit of the employees. This arrangement violates several State policies and contributed to a weak control environment where State funds were misused. We noted the following problems:

- a. There were no controls in place over the cash proceeds from candy sales to ensure that the money was protected from misuse. As noted in Finding No. 1, the Manager had access to the cash and there was no review or accountability as to how funds were spent. Also, employees often cashed personal checks using this cash and subsequently the

checks were deposited to the petty cash account over which the Manager had complete control.

- b. We determined that the candy purchases for the machines were generally paid for from DABC's operating account and not from profits from candy sales. Approximately \$5,000 was spent on candy for calendar year 2002 alone. The agency was not reimbursed for these purchases. It appears that this occurred under the direction of the Manager and that other management was not aware that State funds were being used to purchase candy. Since the candy was purchased with State funds, any proceeds from the sale of the candy are considered State funds and should have been subject to State policies.
- c. The State Legislature has indicated that State food services, including vending machine operations should be offered as a business opportunity to the blind and visually impaired. *Utah Code*, Section 55-5-7, requires agencies to, "Attempt in good faith to make an agreement with the Division of Services for the Blind and Visually Impaired to operate the food service . . ." DABC has not attempted to comply with this law.
- d. Proceeds from the sale of candy as well as from diverted revenue were used to purchase gift certificates for DABC employees. Over the four-year period reviewed, approximately \$28,700 in gift certificates were purchased. The funds that were used to purchase gift certificates are considered State funds and are, therefore, subject to State policies. According to State Finance Policy FIACCT 05-03.06, giving employees cash equivalents, such as gift certificates, is prohibited due to income tax implications for the State and the employees.

Recommendation:

We recommend that DABC comply with State law by offering operation of the vending machines to the Division of Services for the Blind and Visually Impaired. In the event the Division declines to operate the machines, we recommend that DABC develop appropriate internal controls to ensure that the proceeds from candy sales are properly safeguarded and that State funds are not used to purchase candy unless the proceeds are deposited back into a state account. Also, gift certificates should not be purchased for employees using State funds or proceeds of candy sales due to income tax implications. We also recommend that any remaining cash proceeds from candy sales be turned over to the State.

DABC's Response:

We agree. We have contacted the Division of Services for the Blind and Visually Impaired and completed their "Request for Services" form. They have performed an on-site visit but have declined to operate the vending machines at DABC. We are now working with State Finance to determine how to operate and account for the vending operations at DABC. We will ensure that the vending operations at DABC comply with all State Policy. In the meantime, DABC has established proper internal controls over the vending operations and is closely monitoring its activity. We have also contacted the State Auditors to determine how

much funds are payable back to the State for inappropriate candy purchases. In addition, DABC will no longer provide gift certificates to employees in accordance with State policy.

5. **STATE FUNDS INAPPROPRIATELY SPENT ON EMPLOYEE GYM**

State funds were inappropriately used to fund DABC's employee gym. The original intention was for the employees to fund the gym, in part, through user fees; however, soon after the gym was installed, the employees quit paying their user fees, so the agency discontinued charging the fees. Consequently, the fees that were collected did not represent a significant portion of the cost of the facility. As described in Finding No. 1, diverted funds were used to purchase equipment and to service a loan that was taken for the purpose of buying gym equipment. It is inappropriate to spend State funds on gym equipment for the benefit of the employees. Also, a portion of the equipment was purchased with recycle incentive funds. DABC believes that the use of recycle incentive funds to purchase gym equipment is appropriate according to State policy FIACCT 02-09.00; however, we do not believe that it is appropriate to spend recycle incentive funds on any expenditure that would not be considered an appropriate use of other public funds.

Recommendation:

We recommend that DABC consider selling the equipment and use the proceeds to replace the funds that were misused or diverted. If DABC decides to keep the gym, we recommend that any future costs associated with the gym be funded by user fees. Finally, we recommend that DABC only use recycle incentive funds as would be appropriate for other public funds.

DABC's Response:

DABC will dispose of excess employee gym equipment and return the proceeds to the State. Because the gym is important for injury avoidance and employee morale, an employee group will be created to operate and manage the gym. DABC will ensure that the employee group has proper internal controls and will monitor its activity for compliance with State policy. Access to the gym will be limited to employees who pay dues. DABC will also comply with State policy regarding recycle incentive funds.

6. **MANIPULATION OF CHANGE FUND TRANSACTIONS**

DABC has inadequate controls over liquor store change funds. We reviewed transactions involving increases and decreases in the change funds (funds on hand to give change to customers) between the DABC main office and State liquor stores. In general, the Manager requested funds from the State to increase change funds for the stores. When the check came from the State, the check was deposited into the DABC petty cash account controlled by the Manager. Individual checks were then issued from the petty cash account to the individual stores to increase their change funds. Change funds should not be funneled through a petty

cash account. We found that the State funds intended to increase the store's change funds were often used for other purposes and then were replaced by other diverted revenues as described in Finding No. 1. The change fund increase checks should be issued directly from State Finance to the store managers where the funds are needed. On several occasions there were long delays, ranging from five weeks to six months between the time the State issued check was deposited to the petty cash account and the time the store received the funds. In addition, we noted one instance where the Manager borrowed money using the DABC Candy Account and used the loan proceeds to make the change fund increases at the liquor stores because the money that had been intended for the change funds was used for other purposes.

Recommendation:

We recommend that change fund increase checks be issued directly from State Finance to the store managers or that other controls be implemented to control change fund increases.

DABC's Response:

We agree. All future change fund increases will go directly to store managers who are responsible for the change funds.

7. SEPARATION OF DUTIES WEAKNESS OVER CLOTHING PURCHASES

The Manager had too much involvement and control over clothing purchases at DABC. The Manager should not be directly involved in the ordering process nor should he be dealing personally with the clothing vendor salesperson. DABC management was aware that the Manager was performing these duties. We also noted in prior audits that purchases were occasionally split in order to fall below the level that would require competitive bidding procedures. The Manager's involvement in clothing purchases resulted in a lack of direct supervisory approval of clothing purchases. As noted in Finding No. 1, some clothing items were purchased and paid for by DABC but were then sold to at least two non-state entities. We identified \$27,619 in clothing purchases that the Manager was involved in that were not properly reimbursed to the State. As discussed in Finding No. 1, this is a misuse of State funds. In addition, it appears that clothing purchases over the four years reviewed were excessive when compared to other agencies that purchase clothing for employees. DABC spent approximately \$652,000, while a comparable agency with a comparable number of employees spent \$257,000 over the same period.

Recommendation:

We recommend that DABC separate the duties of purchasing and approval of purchases to avoid a situation where an individual is allowed to perform purchasing procedures without adequate review. We also recommend that DABC limit clothing purchases to a reasonable amount.

DABC's Response:

We agree. We are providing training to purchasing personnel and store managers to ensure that only necessary and reasonable clothing and supplies are purchased. In addition, all future clothing purchases will be reviewed and approved by top management prior to purchase.

8. **STATE FUNDS USED FOR PERSONAL GOODS OR SERVICES**

We noted many instances where employees were allowed to purchase items or services from State vendors using DABC accounts. In general it appears that employees reimbursed DABC for the personal purchases. However, as noted in Finding No. 1, some reimbursements from employees were diverted (instead of being reimbursed to the DABC operating account where the purchases were originally made from, employee reimbursement checks were deposited into the petty cash account or DABC Candy Account) and the funds were misused. This practice is subject to manipulation and abuse and contributed to the misuse of State funds discussed in Finding No. 1. Also, using State funds to purchase personal items could also lead to improper avoidance of sales taxes.

Recommendation:

We recommend that DABC not allow employees to make personal purchases using State funds.

DABC's Response:

We agree. Purchasing personnel have been informed to stop all personal employee purchases. In addition, training for all DABC administrative personnel will explain that State policy does not allow personal purchases.

9. **INAPPROPRIATE SALE OF SURPLUS PROPERTY**

DABC inappropriately sold obsolete equipment rather than turning it over to the State Division of Surplus Property. As noted in Finding No. 1, one source of diverted revenue came from the sale of DABC property. We were able to determine that at least some of the items sold were obsolete price marking guns. All obsolete or surplus property should be transferred to the Division of Surplus Property for proper disposal as required by *Utah Code*, Section 63A-9-801(4). The improper sale of DABC equipment resulted in misuse of State funds and noncompliance with State law.

Recommendation:

We recommend that DABC ensure that all obsolete and surplus property is properly transferred to the Division of Surplus Property for proper disposal.

DABC's Response:

We agree. In the future, all disposals of DABC equipment will be handled by the Division of Surplus Property.

10. **UNAUTHORIZED CREDIT CARD**

DABC has established a credit account at Costco. The Manager used the DABC Costco credit card as well as another Costco credit card established under the name of DABC. It was understood by the accounts payable personnel that the Manager was personally responsible to make the payments on this second account. It appears that other DABC management were not aware of this second account. As discussed in Finding No. 2, we noted several payments that were made on the unauthorized account through the petty cash account. It appears that all of the items purchased on the second account during 2002 were personal type purchases. Also, after the Manager retired, there was a balance owing on the account of \$6,251. DABC paid this amount in full due to non-payment by the Manager.

Recommendation:

We recommend that DABC close the second Costco account and pursue repayment of the \$6,251 from the Manager. We also recommend that DABC ensure employees understand that it is improper to establish a debt account in the name of the agency for personal use.

DABC's Response:

We agree. All but one DABC Costco account have been closed. We have established controls over the remaining Costco account to ensure that the purchases are necessary and reasonable. We have also taken steps to recover these funds (see response to finding #1 above).

The procedures we employed in the investigation were more limited than would be necessary to express an audit opinion on compliance or on the effectiveness of DABC's internal control or any part thereof. Accordingly, we do not express such opinions. Alternatively, we have identified the procedures we performed and the findings resulting from those procedures. Had we performed additional procedures or had we made an audit of the effectiveness of DABC's internal control, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of DABC management and is not intended to be and should not be used by anyone other than this specified party.

We appreciate the courtesy and assistance extended to us by the personnel of DABC during the course of the engagement, and we look forward to a continuing professional relationship. If you have any questions, please call Debbie Empey, Audit Director, at 538-1342.

Sincerely,

Auston G. Johnson, CPA
Utah State Auditor

cc: Doug Townsend, SBI Agent
Anne Cameron, Deputy District Attorney