



REPORT OF
THE
STATE AUDITOR

Liquor Enforcement Division
Department of Revenue

Performance Audit
August 2003

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STATE OF COLORADO

Joanne Hill, CPA
State Auditor

OFFICE OF THE STATE AUDITOR

(303) 869-2800
FAX (303) 869-3060

Legislative Services Building
200 East 14th Avenue
Denver, Colorado 80203-2211

August 11, 2003

Members of the Legislative Audit Committee:

This report contains the results of the performance audit of the Liquor Enforcement Division and its Tobacco Enforcement Unit within the Department of Revenue. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, and the responses of the Department of Revenue.

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JOANNE HILL, CPA
State Auditor

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Department of Revenue
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Authority, Purpose, and Scope

This performance audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the Office of the State Auditor to conduct performance audits of all departments, institutions, and agencies of state government. The audit work, performed from November 2002 through June 2003, was conducted in accordance with generally accepted governmental auditing standards.

To evaluate the operations of the Liquor Enforcement Division, we gathered information through interviews, data analysis, and document review. In addition, we reviewed a sample of liquor license applications to verify compliance with statutory requirements and to ensure that license fees were credited to the proper account. We also conducted a survey of local licensing authorities to determine their licensing practices and their relationship with the Division. Further, we surveyed other states to determine best practices in the area of liquor licensing and liquor and tobacco enforcement. Finally as required by Section 39-28-102(2)(a), C.R.S., we examined the accuracy and completeness of the retailer information submitted to the Tobacco Enforcement Unit by tobacco products distributors and cigarette wholesalers.

We gratefully acknowledge the assistance and cooperation extended by management and staff at the Department of Revenue.

Overview

The Liquor Enforcement Division is located within the Business Enforcement Group at the Department of Revenue. The Division has the authority to grant or refuse licenses for the manufacture, distribution, and sale of alcoholic beverages and to suspend or revoke those licenses. The Division also enforces the State's prohibition on the sale of alcoholic beverages to individuals under the age of 21 and to those who are visibly intoxicated. Under Colorado's dual-licensing statute, the Division shares liquor licensing and enforcement responsibilities with local jurisdictions. Through its Tobacco Enforcement Unit, the Division also enforces state laws and federal mandates banning the sale of tobacco products to children under the age of 18.

For more information on this report, contact the Office of the State Auditor at (303) 869-2800.

Key Findings

Liquor Licensing

The Liquor Enforcement Division issues and monitors almost 12,000 liquor licenses and permits each year. We examined the Division's activities regarding license approvals and collection of required fees and found the following:

- **Inadequate financial controls over the collection and crediting of fee revenue to various State accounts.** We found that for at least the last three fiscal years the Division has potentially been over-crediting monies to the Liquor Authority Cash Fund. The apparent crediting errors occurred primarily because the Division did not reconcile its manually tracked license activity to its database of active licenses and then to its accounting records. Therefore the Division could not isolate individual licensing records to ensure payment of the correct fee and crediting of the money to the proper account. For Fiscal Year 2001 alone there was a discrepancy of about \$156,000 between the amount of fee revenue credited to the Cash Fund and the amount of fees shown to be due in the license files. We also identified inadequate controls over the processing of a high volume of small dollar amounts. In some cases the Division collected the wrong fee amount for the type of license sought.
- **Potential additional revenue could be collected from license applicants who owe taxes to the State.** Prior to the issuance of a renewal license, the Division verifies that the liquor licensee has paid certain business taxes. Since the inception of this policy in August 2002, the Department of Revenue has collected about \$1 million in delinquent taxes, penalties, and interest from 320 liquor license renewal applicants. However, the Division only verifies tax payments for renewal applicants. New and transfer-of-ownership license applicants can operate for one year without having to pay applicable taxes. In Fiscal Year 2003, these types of liquor license applicants represented 11 percent of all liquor licensees. In addition, the Division does not seek to collect delinquent taxes of less than \$1,000 even though these new or ongoing licensees should be current on all taxes due. We believe that the Division should examine the costs and benefits of expanding its tax collection efforts.
- **Some liquor license applicants may not have received a required public hearing or required physical inspection of the premises prior to license approval.** Statutes require that local authorities screen applications for new liquor licenses by conducting a criminal background check, holding a public hearing to assess the desires of the neighborhood, and inspecting the premises to ensure that it meets both building and liquor code requirements. To ensure compliance with these statutory requirements, the Division requires local authorities to complete a portion of the license application detailing that all statutory requirements have been met and requesting the date of the public hearing and physical inspection. In a sample of 18 new license applications, we found that the Division approved

the applications even though three lacked evidence that a public hearing had been held and six did not include any information regarding an inspection of the premises. Processing incomplete applications means that the Division may be giving final approval to applicants who do not meet statutory requirements for licensing.

Liquor Enforcement

The Division's primary liquor enforcement duty is to ensure that all liquor licensees comply with the State's prohibition on the sale of alcoholic beverages to individuals under the age of 21 or those who are visibly intoxicated. We reviewed the Division's enforcement activities and found the following:

- **The Division does not maximize the use of sting operations to reduce sales of alcohol to minors.** In a typical sting operation, an enforcement authority will hire and monitor a minor who attempts to purchase alcohol from a liquor licensee. National studies and experiences of other states indicate that consistent use of sting operations increases licensee compliance with laws prohibiting the sale of alcohol to minors. However despite this evidence, we found that the Division only conducted two sting operations in Fiscal Year 2002 and six in Fiscal Year 2003.
- **The Division does not ensure that all complaints are timely investigated.** Most complaints concern intoxicated patrons, conduct of the establishment (i.e., fights or disturbances), and sales to minors. We found that the Division could not provide accurate information about the actual number of complaints it receives because it lacks procedures for assuring that all complaints are entered into its investigation database. In addition, despite its policy to investigate all complaints within 60 days, we determined the Division failed to meet that standard for a number of complaints. Of the 256 cases resulting from complaints in Fiscal Year 2002, 72 or 28 percent were not investigated and closed within 60 days.

Tobacco Licensing and Enforcement

The Liquor Enforcement Division's Tobacco Enforcement Unit is responsible for enforcing state laws prohibiting the sale of tobacco products to children under the age of 18. Under federal law, Section 1926 of the Public Health Service Act also known as the Synar Amendment, the failure to maintain a statewide tobacco enforcement program can result in the loss of up to 40 percent of a state's federal Substance Abuse Prevention and Treatment (SAPT) Block Grant. For Colorado this would mean the loss of approximately \$9 million each year. Our audit resulted in the following key findings:

- **The statutory method of identifying tobacco retailers for enforcement purposes is inadequate.** In an effort to limit sales of tobacco products to minors, federal law mandates that states maintain a list of their tobacco retailers that contains at least 80 percent of the

universe. This list is used to select a statistically valid sample of tobacco retailers who must undergo unannounced federally required compliance checks to determine if they will sell tobacco to minors. The Tobacco Enforcement Unit has historically used standardized codes for various industry types to identify those retailers likely to sell tobacco. While this method meets federal requirements, it is inefficient because the resulting list contains a large number of retailers who do not sell tobacco or who are not accessible to youth (i.e., casinos and private clubs). To augment and increase the accuracy of the code-based retailer list, in 2001 the General Assembly required cigarette wholesalers and tobacco products distributors to submit to the Department a list of all retailers to whom they sold tobacco products in the preceding year. As required by Section 39-28-102(2)(a), C.R.S., we examined this statutorily required information and found it to be incomplete and inaccurate.

- **The Department of Revenue is renewing tobacco licenses for wholesalers and distributors with outstanding tax delinquencies.** Statutes require that cigarette wholesalers and tobacco products distributors obtain a license prior to operating in the State. Wholesalers and distributors are also required to collect and remit to the State a penny per cigarette tax and a 20 percent excise tax on the manufacturers' list price for other tobacco products. Unlike its liquor licensing authority, the Department does not currently have the authority to deny an initial or renewal tobacco license on the basis of a failure to pay required taxes. As previously noted, the Liquor Enforcement Division implemented a policy that requires renewal license applicants to pay all outstanding tax delinquencies prior to license renewal. This policy has led to the collection of about \$1 million in delinquent taxes and penalties. The Department should seek similar authority regarding tobacco licensees.

Our recommendations and the Department's responses can be found in the Recommendation Locator on pages 5 through 7 of this report.

RECOMMENDATION LOCATOR

| Rec. No. | Page No. | Recommendation Summary | Department of Revenue Response | Implementation Date |
|-----------------|-----------------|--|---------------------------------------|----------------------------|
| 1 | 22 | Ensure that liquor licensing fees are credited to the proper account by conducting regular reconciliations of license activity with fees collected, correcting crediting errors in a timely manner, and establishing review procedures. | Agree | July 1, 2003 |
| 2 | 23 | Strengthen liquor licensing fee procedures for the Cash and Document Processing Division. | Agree | July 25, 2003 |
| 3 | 25 | Evaluate the costs and benefits of expanding the Liquor Enforcement Division's tax liability collection efforts. As part of the evaluation, prioritize investigating new and transfer-of-ownership applicants, adding business income taxes to the list of those liabilities reviewed, and collecting all outstanding tax liabilities. | Agree | December 1, 2003 |
| 4 | 28 | Improve the liquor license application review process by enforcing procedures regarding incomplete applications, approving completed applications only, and working with local licensing authorities to ensure all applicants receive a physical inspection of their premises. | Agree | December 1, 2003 |
| 5 | 31 | Work with local authorities to develop guidelines for the application of the "good moral character" standard as required in law. | Agree | 2004 Legislative Session |

RECOMMENDATION LOCATOR

| Rec. No. | Page No. | Recommendation Summary | Department of Revenue Response | Implementation Date |
|-------------|-------------|--|--------------------------------------|--------------------------|
| 6 | 33 | Amend the liquor licensing fee methodology to establish an upper limit for revenues in excess of program costs and adjust fees downward when revenues exceed the target cap. | Agree | July 31, 2004 |
| 7 | 39 | Increase the number of compliance checks (sales-to-minor sting operations), and monitor whether sting operations increase sales-to-minor compliance rates. | Agree | December 1, 2003 |
| 8 | 41 | Develop complaint intake procedures and a formal complaint tracking system. | Agree | November 1, 2003 |
| 9 | 42 | Work with local authorities to ensure that all licensees who violate the State's liquor laws receive a repeat visit within a specified time frame. | Agree | December 1, 2003 |
| 10 | 44 | Determine the optimal number of inspections that should be conducted each month and then implement a methodology to target those licensees most in need of inspection. | Agree | December 1, 2003 |
| 11 | 49 | Improve the accuracy of cigarette wholesaler and tobacco products distributor tobacco retailer information. | Agree | 2004 Legislative Session |

RECOMMENDATION LOCATOR

| Rec. No. | Page No. | Recommendation Summary | Department of Revenue Response | Implementation Date |
|---------------------|---------------------|--|---|--------------------------------|
| 12 | 51 | Seek statutory authority to allow for the refusal of an initial or renewal cigarette wholesaler or tobacco products distributor license on the basis of failure to pay applicable taxes. | Agree | July 1, 2004 |
| 13 | 51 | Consider transferring licensing authority for cigarette wholesalers and tobacco products distributors to the Liquor Enforcement Division's Tobacco Enforcement Unit. | Agree | July 1, 2004 |
| 14 | 53 | Analyze the recent increase in the number of tobacco retailers selling to minors to determine if a pattern exists. | Agree | July 1, 2003 |

Liquor Enforcement Division

Background

The Liquor Enforcement Division (Division) is located within the Business Enforcement Group at the Department of Revenue. Working with local licensing authorities and law enforcement officials, the Division issues licenses to individuals and businesses that sell alcoholic beverages and enforces state laws prohibiting the sale of alcoholic beverages to individuals under the age of 21 or to those who are visibly intoxicated. Through its Tobacco Enforcement Unit, the Division also enforces state laws and federal mandates banning the sale of tobacco products to children under the age of 18.

Liquor Licensing and Enforcement

Title 12, Article 47 of the Colorado Revised Statutes (C.R.S.), commonly referred to as the Colorado Liquor Code, states that the Division shall “grant or refuse licenses for the manufacture, distribution, and sale of alcohol beverages as provided by law and suspend or revoke such licenses upon a violation of this article.” Article 46 (Fermented Malt Beverages) and Article 48 (Special Event Permits) of Title 12, add supplemental licensing and enforcement provisions for those particular activities.

Colorado operates with a dual-licensing statute, meaning both the State and local jurisdictions share responsibility for issuing liquor licenses and enforcing statutory requirements. The Division divides its responsibilities into two administrative sections, licensing and enforcement. The licensing unit issues and maintains active licenses for all vendors that meet statutory requirements, and collects all associated fees. The enforcement unit trains licensees and local law enforcement regarding statutory requirements, inspects licensed vendors, and investigates statutory violations.

Beginning in Fiscal Year 2003, the Division's liquor licensing and enforcement activities became fully cash-funded. As detailed in the following table, in Fiscal Year 2003 the Division collected approximately \$5.4 million in licensing fees. Almost \$2 million of this amount (37 percent) went to the Licensing Authority Cash Fund (Cash Fund) to support liquor licensing and enforcement activities. The remainder went to the Old Age Pension Fund and the State's General Fund.

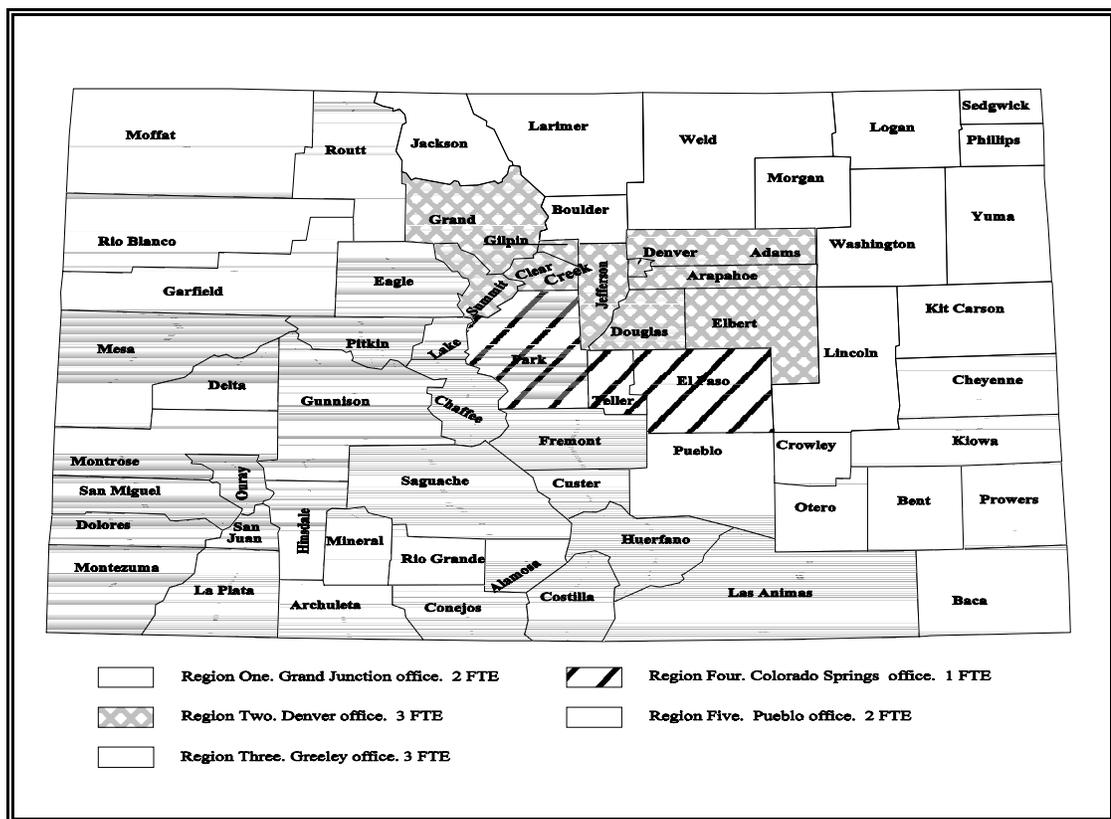
| Allocation of Liquor License Collections Fiscal Years 2001 Through 2003 | | | | |
|---|--|--|--------------|----------------------------|
| Fiscal Year | Licensing Authority Cash Fund | General Fund and Old Age Pension Fund | Total | Licenses Issued |
| 2001 | \$1,616,370 | \$3,254,731 | \$4,871,101 | 11,505 |
| 2002 | \$1,595,540 | \$3,210,109 | \$4,805,649 | 11,947 |
| 2003 | \$1,976,377 | \$3,423,711 | \$5,400,088 | 12,319 |
| Source: Department of Revenue Final Report of Collections for June 2001-2003 and Liquor Enforcement Division licensing data. | | | | |

In Fiscal Year 2002 the Division issued about 12,000 licenses and permits in over 30 separate categories ranging from retail liquor licenses to hotel and restaurant licenses to permits for special events. In most cases, applicants initially submit their applications to the local licensing authority for consideration. Statutes require the local licensing authority to perform criminal background checks on applicants and to conduct public hearings regarding whether the proposed establishment meets the needs and desires of the community. If these are approved, the local licensing authority forwards the application and appropriate fees to the Department of Revenue's Cash and Document Processing Division. Cash and Document Processing staff credit fees to the appropriate funds and send the license application to the Liquor Enforcement Division for processing. The licensing unit's responsibilities are to ensure that local licensing authorities have met their statutory requirements, to identify any interests in other liquor licenses that may be prohibited, and to confirm that businesses have paid all required taxes such as sales and withholding taxes. The Division has the sole responsibility for approving applications for wholesalers and manufacturers as well as master licenses (i.e., individuals who own liquor businesses in several different jurisdictions). The Division dedicates 6 FTE to its licensing activities.

Additionally, the Division dedicates 11.5 FTE to its liquor enforcement unit, which ensures that all licensed establishments comply with state liquor laws. Eight enforcement officers and three supervisors conduct investigations and sting operations to prevent the sale of alcohol to minors and to visibly intoxicated persons. In Fiscal Year 2002 these officers performed about 800 investigations and two undercover sting operations covering 36 establishments in response to concerns about violations. In Calendar Year 2002 the Division also conducted over 2,000 inspections

and another almost 500 routine contacts. Additionally, in Fiscal Year 2002, the Division provided 203 training classes.

The Division divides its liquor enforcement staff into five regional offices. Each office reviews all complaints and performs investigations and inspections within its own respective territory. Three enforcement investigators each work in the Denver and Greeley offices, two each in the Grand Junction and Pueblo offices, and one in the Colorado Springs office. The following map details the territories that are assigned to each regional office.

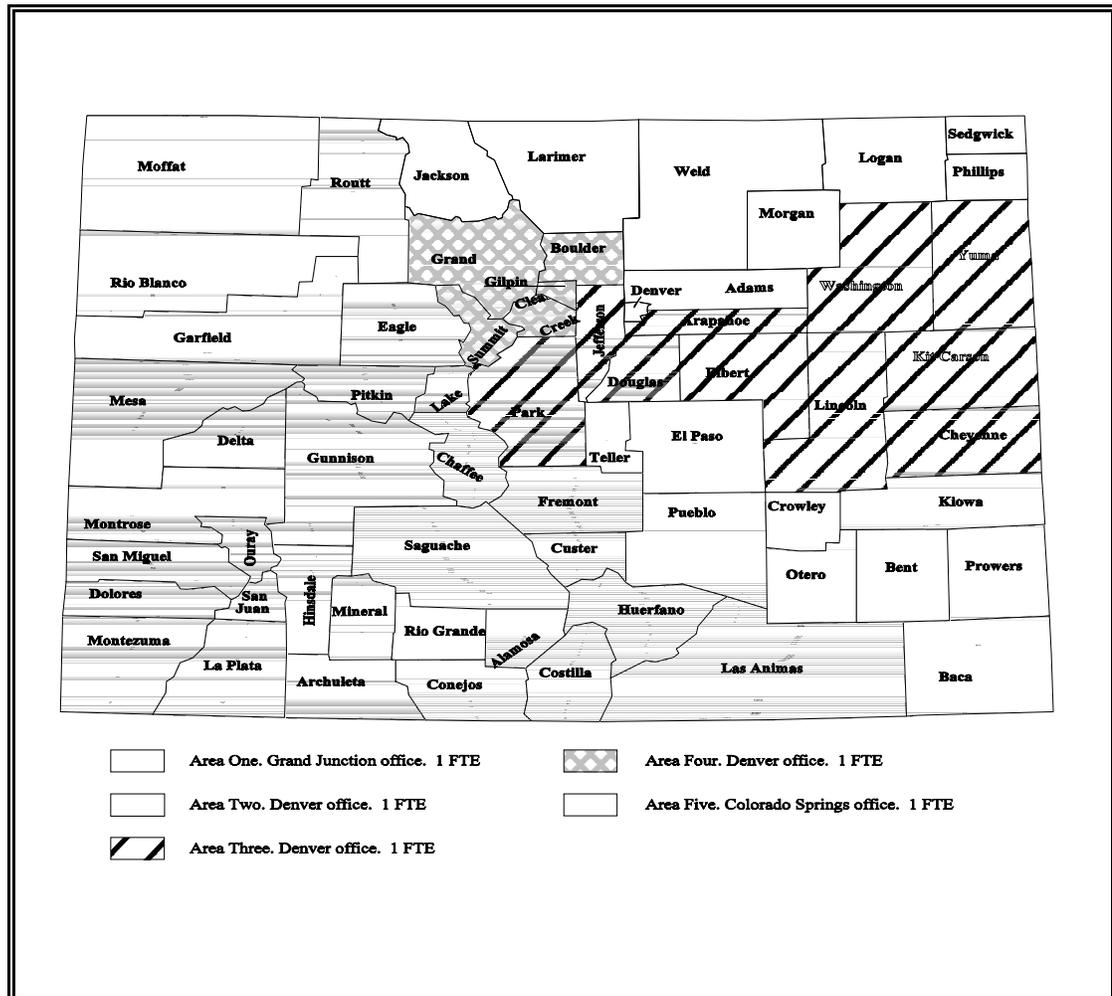


Tobacco Enforcement Unit

Federal law, known as the Synar Amendment (Section 1926 of the Public Health Service Act), requires states to maintain statewide enforcement programs that prevent the sale of tobacco products to children under the age of 18 (minors). The Amendment also dictates that states conduct annual random, unannounced compliance checks (Synar checks) at a statistically valid sample of outlets selling tobacco products. If more than 20 percent of the outlets in the sample sell tobacco products to a minor, the state faces the loss of up to 40 percent of its federal

Substance Abuse Prevention and Treatment (SAPT) Block Grant. Colorado receives approximately \$22 million in SAPT funding each year, which provides over 50 percent of the Department of Human Services' Alcohol and Drug Abuse Division's funding for prevention and treatment programs. A 40 percent reduction for failure to meet these federal requirements could result in Colorado losing approximately \$9 million in federal funds each year.

House Bill 98-1387 further charged the Liquor Enforcement Division with the responsibility for enforcing Colorado's tobacco control laws in compliance with federal mandates. The Division's Tobacco Enforcement Unit administers state laws regarding the sale of tobacco products to minors. The Tobacco Enforcement Unit has 7 FTE, including 5.5 investigators and 1.5 administrative staff. These staff perform a combination of inspections and field contacts at tobacco retailers, educational and training seminars for retailers, and compliance checks to determine if a retailer will sell tobacco to a minor. As with the Liquor Enforcement Division, the Tobacco Enforcement Unit assigns five of its investigators to cover specific areas of the State. The remaining .5 investigative FTE provide assistance throughout the Denver metro area. The following map details the Tobacco Enforcement Unit's investigative regions.



Liquor Enforcement Division Funding

The Division uses a combination of funding to support its regulatory activities regarding liquor and tobacco. Liquor licensees pay both local and state licensing fees. None of the local fee revenue supports the Division’s activities. Local liquor licensing authorities retain 15 percent of the licensing fees collected to cover their costs, and they remit the balance to the State's General Fund to support the Old Age Pension Fund. Similarly, a portion of state liquor licensing fees fund the Division’s activities. The Division collects a separate state licensing fee, of which the first \$50 is credited to the Licensing Authority Cash Fund (Cash Fund) to support the liquor-related licensing and enforcement activities. The balance of the state licensing fee is credited to the General Fund, of which 85 percent is allocated for the Old Age Pension Fund. Also included in the Cash Fund are processing fees for services such as new applications, duplicate licenses, or changes of ownership.

The Division's Tobacco Enforcement Unit receives a combination of general fund monies and a grant from the Tobacco Education, Prevention, and Cessation Program (Program). The Program is funded through the 1998 Master Settlement Agreement between the tobacco industry and 46 states, 5 commonwealths and territories, and the District of Columbia to resolve all past, present, and future tobacco-related health claims at the state level. In Fiscal Years 2003 and 2004 the Tobacco Enforcement Unit also received a grant from the Department of Human Services' Alcohol and Drug Abuse Division to help support its tobacco enforcement activities. The following table details the Liquor Enforcement Division's funding for the last four years.

| Appropriations, Expenditures and FTE Staffing Liquor and Tobacco Enforcement Fiscal Year 2001 - Fiscal Year 2004 | | | | |
|--|--|--|--|--|
| Source | Fiscal Year 2001 (actual) | Fiscal Year 2002 (actual) | Fiscal Year 2003 (actual) | Fiscal Year 2004 (appropriated) |
| Liquor Appropriations | | | | |
| Licensing Authority Cash Fund (Fees) | \$1,286,103 | \$1,507,872 | \$1,792,800 | \$2,123,082 |
| General Fund (Liquor) | \$539,605 | \$239,593 | \$0 | \$0 |
| Sub-Total Liquor | \$1,825,708 | \$1,747,465 | \$1,792,800 | \$2,123,082 |
| Liquor FTE | 20.5 | 19 | 19 | 19 |
| Tobacco Appropriations | | | | |
| General Fund (Tobacco) | combined with Liquor | \$151,602 | \$146,410 | \$156,922 |
| Tobacco Settlement Grant ¹ | N/A | \$357,555 | \$278,282 | \$300,000 |
| Substance Abuse Grant ² | N/A | N/A | \$50,000 | \$60,000 |
| Sub-Total Tobacco | N/A | \$509,157 | \$474,692 | \$516,922 |
| Tobacco FTE | 2.5 | 7.5 | 7.5 | 7.0 |
| Total Division Appropriations | \$1,825,708 | \$2,256,622 | \$2,267,492 | \$2,640,004 |
| Total Expenditures | \$1,818,047 | \$2,215,184 | \$2,233,907 | |
| Source: Fiscal Year 2001-2004 Long Bill and Long Bill Supplementals and Senate Bill 02-207 | | | | |
| ¹ This money is a grant from the Tobacco Education, Prevention, and Cessation Program administered by the Colorado Department of Public Health and Environment. | | | | |
| ² The Alcohol and Drug Abuse Division within the Department of Human Services provided the Tobacco Enforcement Unit with money from the federal Substance Abuse Prevention and Treatment Block Grant. | | | | |

Audit Scope

Our audit focused on liquor licensing and enforcement activities and tobacco enforcement requirements. We reviewed the Liquor Enforcement Division's procedures for processing and issuing liquor licenses. Our review included a survey of local licensing authorities and licensing authorities in other states to determine best practices. We also examined procedures for processing and allocating liquor licensing fees. In addition, we analyzed the Division's liquor enforcement methods for efficiency, thoroughness, and effectiveness. Finally, we monitored compliance with federal tobacco enforcement requirements regarding the prohibition on sales of tobacco products to minors. As required by Section 39-28-102, C.R.S., we reviewed the completeness and accuracy of tobacco retailer lists provided by licensed tobacco wholesalers and distributors.

Liquor Licensing

Chapter 1

Introduction

All applicants for liquor licenses with the exception of manufacturers, wholesalers, and public transportation systems, must be approved on both the local and state level. The following narrative describes the main responsibilities of each level.

Local Level Responsibilities

- **Background checks.** According to Section 12-47-307(3)(c), C.R.S., local licensing authorities must collect fingerprints and conduct criminal background checks on those officers and individuals with principal interests in the licensed business. Section 12-47-307(1)(a), C.R.S., allows for the denial of a liquor license if a principal or officer does not demonstrate "good moral character."
- **Public Hearings.** For new licensees, Sections 12-47-301(2)(a) and 12-47-311(1), C.R.S., require local authorities to hold a public hearing. Section 12-47-311(1), C.R.S., further dictates that the public hearing be held no less than 30 days after the license application has been submitted for consideration. The purpose of the public hearing is to ensure that the new establishment meets the reasonable requirements of the neighborhood and is consistent with any expressed desires of the local adult population.
- **Building Inspections.** Sections 12-47-309(3) and 12-47-312(4), C.R.S., detail the need for local licensing authorities to obtain building plans and inspect the physical location of the proposed licensee to ensure that it meets both building and liquor code requirements. For example, a hotel and restaurant licensee must have a functional kitchen to ensure that it can serve meals as required.

State-Level Responsibilities

Once a license is approved by the local licensing authority, the license application is forwarded to the Division. Section 12-47-202, C.R.S., gives the Division the

authority to "grant or refuse licenses for the manufacture, distribution, and sale of alcohol beverages as provided by law and suspend or revoke such licenses upon violation." The Division reviews the application to ensure that local authorities have conducted the required criminal background checks and public hearings. Exceptions to this process include state-only licenses such as manufacturers, wholesalers, and public transportation systems that do not operate within the boundaries of a single local government.

The Division checks all applications for compliance with additional statutory requirements including:

- **Financial Disclosure.** Principals and officers must disclose interests they maintain in other liquor-licensed establishments in Colorado. Statutes limit the number of licenses individuals may hold for certain types of establishments. For example, any owner or part owner of a brew pub license cannot have an interest in a wholesaler's license.
- **Payment of Taxes.** For renewal licenses, the Division requires that business owners must be current on all sales, withholding, excise, and gaming tax payments. According to Division staff, if a delinquency exceeds \$1,000, the Division can either deny a renewal license or withhold it until taxes are paid.

Consistent with its statutory authority, the Division can deny applicants who were approved by the local licensing authority. Section 12-47-305(1), C.R.S., gives the Division the right to deny a license if it believes the business premises do not meet licensing requirements, if the character of the applicant could result in violations of the law, or if the area where the business is located already has an adequate number of liquor licensees. If the Division determines that an application complies with all appropriate requirements and that the applicant has submitted all required fees, Division staff send the license to the respective local authority who forwards it to the licensee.

Liquor Licensing Fees

The Division monitors almost 12,000 liquor licenses and permits each year. This includes issuing over 10,000 new, renewal, and transfer-of-ownership liquor licenses, and processing about 1,800 special event permits. Liquor license applicants must pay application and processing fees to both the local licensing authority and the Division. Local and state licensing fees vary by type of license and are set by statute. For example, retail liquor store license applicants pay \$150 in local licensing fees if the retailer is located within a municipality and \$250 if located outside the municipal limits, in addition to \$100 in state licensing fees. A hotel and restaurant license costs

\$500 each year in local fees and \$75 in state fees. In addition, Section 12-47-501(2), C.R.S., gives the Division the authority to create and collect fees for specific services such as processing new applications, name change requests, transfers of business ownership, or requests to modify liquor establishment premises. The following table shows the various local and state fees:

| State and Local Liquor Licensing and Processing Fees | | | |
|--|--------------------------|-----------------------------------|---------------------------|
| Fee Type | Fee Range | Recipient of Funds | Breakdown of Funds |
| Local License Fees | \$25-\$500 ¹ | Local Governments | 15% of fee |
| | | Old Age Pension Fund ² | 85% of fee |
| State License Fees | \$50-\$1050 ¹ | Licensing Authority Cash Fund | \$50 |
| | | General Fund | 15% of remainder of fee |
| | | Old Age Pension Fund ² | 85% of remainder of fee |
| State Processing Fees | \$5-\$900 ³ | Licensing Authority Cash Fund | 100% of fee |
| Source: Sections 12-46-104, 12-46-105, 12-47-501, 12-47-502, and 12-47-505, C.R.S., and the Liquor Enforcement Division's fee schedule. | | | |
| ¹ Amounts set by statute according to type of license. | | | |
| ² State Constitution and statute require that 85 percent of state and local licensing fees be credited to the Old Age Pension Fund. | | | |
| ³ Amounts for various services determined by the Liquor Enforcement Division. | | | |

Financial Controls

Depending on the type of license and the applicable processing fees, the amount of money collected must be potentially credited to three separate accounts. By statute, \$50 of each statutorily set state licensing fee and the entire amount from Division-established processing fees is credited to the Licensing Authority Cash Fund (Cash Fund). The Cash Fund is used to pay the cost of the Division's liquor licensing and enforcement activities. As noted previously, statutes also require that 15 percent of the balance of the state licensing fee, after deducting the \$50 Cash Fund share, goes to the General Fund and 15 percent of all local licensing fee revenues remain with the local licensing authority. The same statute, Section 12-47-502, C.R.S.,

dictates that the balance of funds, 85 percent of all local licensing fee revenue and the remaining 85 percent of state licensing fee revenue, be credited to the Old Age Pension Fund.

The type of liquor license and the applicable processing fees require differing amounts to be credited to either the Cash Fund or the General Fund in each case. As a result, the Division must be able to track the specific types of licenses it processes and ensure that the proper amount is credited to the appropriate fund. We found that the Division has had problems accurately tracking its licensing activity, and as a result, too much money may have been credited to the Cash Fund.

Lack of Reconciliation

Until recently the Division manually tracked the almost 12,000 licenses and permits that it issues each year. For Fiscal Year 2002 the Division's licensing records indicated that it should have collected and credited approximately \$1,382,000 to the Cash Fund for all licensing and application fees. However, the Department of Revenue's Final Report of Collections shows that the Division credited \$1,451,000 to the Cash Fund for these fees. As a result, the Cash Fund received about \$69,000, or about 5 percent more revenue than the Division's licensing records would indicate. In Fiscal Year 2001 the Division had a similar discrepancy. The Cash Fund was credited with about \$156,000, or 11 percent more than the Division's internal records support. Projections for Fiscal Year 2003 indicate that monies credited to the Cash Fund will exceed amounts supported through manually tracked licensing records by just over \$81,000, or by about 6 percent.

Due to inaccuracies in the licensing database and the processing of fees, it is difficult to reconcile the Cash Fund to the Department's Final Report of Collections and to the licensing records. The apparent overcrediting of monies to the Cash Fund appears to have occurred primarily because the Division did not reconcile its manually tracked license activity to its licensee database and then to its accounting records. Therefore, it could not isolate individual licensing records to determine if licensees overpaid or if the Division credited incorrect amounts to the Cash Fund and the State's General Fund. The inadequate controls over the processing of a high volume of small dollar amounts increase the risk of errors. For example, in March 2003 the Division identified two separate instances of incorrectly processed licenses for serving liquor on public transportation systems (i.e., commercial airplanes based in Denver). In just these two instances, the Cash Fund was credited with \$7,200 more than it should have received. The Department has not yet corrected this error and credited the money to the General Fund. The Department needs to periodically reconcile its licensing data to the Cash Fund receipts and then to the Final Report of

Collections to ensure proper crediting of revenue to the appropriate fund, including timely correction of any identified errors.

Lack of Review

We reviewed a sample of liquor license files from the last three calendar years. We found inconsistencies between the documentation of fees received from the license applicants and the dollar amounts recorded in the Department of Revenue's Revenue Accounting System. In addition, we noted instances where an applicant either submitted too little money or too much money for his or her license. The Division approved the licenses despite the underpayments. If an applicant overpays, the Division includes a refund form with the license, which the licensee must then submit to get back any overpayment. For example, for a sample of 162 new, transfer, or renewal applications, we identified either documentation or payment errors in 24 cases (15 percent). Although most of the errors we identified had been corrected, the license files do not reflect the corrections and therefore still contain inaccurate information. We found that there is inadequate oversight of the processing of license applications. Record-keeping errors are identified only if a problem is brought to the Division's attention.

Fee Processing

Another factor contributing to potential errors in the Cash Fund is lack of coordination between divisions. As of April 2003, all liquor license applications are first submitted to the Department's Cash and Document Processing Division (CDP), which processes the fees and credits the payment to the appropriate fund. To ensure that monies are placed in the proper fund account, the Division provided CDP with detailed instructions regarding each type of licensing and processing fee and the amount that should be credited to either the Cash Fund or the General Fund. We reviewed these instructions and found that for some licensing fees, the instructions were inaccurate or incomplete. For example, the instructions incorrectly directed that licensing fees for public transportation systems be applied entirely to the Cash Fund when, in fact, these fees should be split between the Cash Fund and the General Fund. Additionally, CDP has not established a formal system of communication with the Division in the event that an application is accompanied by the wrong fee amount.

The Division needs to ensure that its instructions to CDP are in compliance with statutes. The Division should also work with CDP to develop a protocol for CDP to follow when fees submitted do not match the amount due for a particular type of liquor license. Periodically monitoring CDP liquor licensing transactions will help to ensure that fee payment procedures are being followed and that funds are posted

to the correct account. Finally, the Division also needs to reconcile receipts reported by CDP with the Division's liquor licensing records to ensure that the proper amount of fees is being collected.

Division staff are aware of discrepancies between the manual accounting of licensing activity and the amount credited to the Cash Fund and the General Fund. In July 2002 the Division began the development of an electronic tracking system. This system became fully operational in July 2003. The new tracking system has the ability to obtain reports from the Department's Revenue Accounting System, which allows Division staff to compare licensing activity with revenue credited to the Cash Fund and the General Fund. In coordination with its new electronic tracking system, the Division needs to implement procedures for the periodic reconciliation of licensing activity to funds received. This will ensure that the Division is receiving the proper amount of licensing fees while also making sure that these fees are credited to the appropriate account. In addition, the Division needs to set an appropriate time period for reconciling licensing records with the amounts credited to the Cash Fund and the General Fund to ensure that any errors are corrected in a timely manner. Further, the Division should develop a review method to reduce the amount of documentation errors in licensing files.

Recommendation No. 1:

The Liquor Enforcement Division should improve its tracking of liquor licensing activity to ensure that fees are credited to the proper account by:

- a. Using the licensing information in its electronic tracking system to conduct a reconciliation of fees received to fees required for all licensing activities on a regular basis.
- b. Ensuring that all crediting errors are corrected in a timely manner.
- c. Developing a review method for licensing applications and licensee files that reduces the number of documentation and payment errors.

Department of Revenue Response:

Agree. Implementation date: July 1, 2003. The Division agrees with this recommendation. As noted by the Auditors, the Division recognizes the need for such a system. In coordination with our Information Technology Division, we recently developed an electronic system to track licensing activity and to ensure that the fees received are the proper fees required.

Additionally, the Division initiated a reconciliation policy requiring a monthly review of its activity, identification of posting errors, and correction in a timely manner. The Division has also implemented a checklist for application review and provided additional training for staff when performing application review to reduce the number of documentation and payment errors.

Recommendation No. 2:

The Liquor Enforcement Division should strengthen its liquor licensing fee procedures for the Cash and Document Processing Division by:

- a. Providing the Cash and Document Processing Division with correct information regarding the dollar amount for each liquor licensing and processing fee and the amount of the fee that should be credited to the Cash Fund and the General Fund.
- b. Working with the Cash and Document Processing Division to develop formal procedures that can be used to notify the Liquor Enforcement Division of problems with license applications.

Department of Revenue Response:

Agree. Implementation date: July 25, 2003. The Division agrees with this recommendation and has already corrected and verified the information provided to Cash and Document Processing (CDP) to ensure the Division's fee schedules are correct and fees received are posted to the correct accounts. The Division has also coordinated a formal process with CDP so that problem applications will be reported and coordinated with the Division.

Collection of Delinquent Taxes

Section 12-47-307(1)(a)(VI), C.R.S., gives the Division the authority to deny a liquor license to an applicant whose character, record, or reputation is unsatisfactory. In the case of *Mr. Lucky's, Inc. v. Dolan*, in 1979 the Colorado Supreme Court held that an unsatisfactory record for a liquor license applicant can include violations of statute such as the failure to pay required taxes. Beginning in August 2002, the Division began verifying that liquor licensees have paid certain taxes prior to renewing their license. This process assists the Department of Revenue in collecting outstanding taxes while also ensuring that licensees meet the requirements for retaining a liquor

license. Between August 2002 and June 2003, the Department collected about \$1 million in outstanding taxes, penalties, and interest from 320 renewal applicants. These 320 applicants represent about 4 percent of all renewal applications submitted from August 2002 through June 2003. The Division also denied the renewal applications for six licensees on the basis of outstanding taxes.

As part of the renewal application process, Division staff review the tax records of the licensee using the Department of Revenue's Automated Accounts Receivable Audit Program System. This system automatically checks for tax delinquencies in the areas of corporate income, sales, state withholding, liquor excise, and gaming taxes. The Division focuses on those licensees for whom a formal tax liability to the State has been established and debt collection efforts, such as the seizure of property, may legally begin. If the system detects such a tax liability, the Division places the renewal application on hold and forwards the information to the staff tax investigator. The Division notifies licensees that they must pay all outstanding taxes, penalties, and interest prior to receiving their renewal license. Once payment is made to the Department, the Division issues the renewal license. If the licensee fails to either respond to the Notice or pay the outstanding taxes, the Division issues a Notice of Proposed Denial, allowing the business 15 days to respond and request a hearing. If this opportunity is also ignored, the Division denies the license renewal.

We believe that the Division can further improve its tax collection processes. Specifically, we found that:

- **The Division investigates outstanding tax liabilities only in cases of liquor license renewals.** The Division does not search for tax liabilities for either new applicants or those obtaining a license through a transfer-of-ownership. Therefore, new liquor licensees and transfer-of-ownership licensees can operate for one year without paying all applicable taxes. For example, a renewal applicant who owes taxes may apply for a new license under a different business name and/or location, thus avoiding the tax investigation. In Fiscal Year 2003 there were a total of 1,367 new and transfer license applicants, reflecting 11 percent of all liquor licensees. This means that a significant portion of the State's liquor licensees can avoid an outstanding tax liability check for at least one year of their operation.
- **The Division does not investigate delinquent business income taxes.** As stated previously, the Division focuses its search on sales, withholding, gaming, and liquor excise taxes. It currently takes the Division approximately four days to process an application. We do not believe that determining whether an applicant also has outstanding business income tax

liabilities would significantly increase that time because this information is available electronically.

- **The Division currently does not make an effort to collect delinquent taxes below \$1,000.** Division staff reported that this threshold exists because they believe that the cost to investigate exceeds the revenues collected. However, these are ongoing or new licensees who should be current on all taxes due regardless of their amount.

We believe that the Division should ensure that all current and potential liquor licensees pay all applicable business taxes prior to either initial licensure or renewal of a license. The Division's policy to check for outstanding taxes has resulted in collection of \$1 million since its inception in August 2002, all of which goes to the General Fund. Division staff reported a corresponding administrative workload increase, since all licensees with outstanding tax liabilities must be formally notified of the potential denial of their renewal liquor license and offered the opportunity to request a formal hearing. The workload could further increase if the Division begins to check for outstanding tax liabilities for all new and transfer-of-ownership applicants. The Division should evaluate the costs and benefits of expanding its delinquent tax collection activity.

Recommendation No. 3:

The Liquor Enforcement Division should evaluate the costs and benefits of its tax liability collection efforts. As part of this evaluation, the Division should prioritize:

- a. Investigating the tax liabilities of all new license and transfer-of-ownership applicants.
- b. Adding business income taxes to the list of tax liabilities reviewed by the Division.
- c. Collecting all outstanding tax liabilities owed by licensees or applicants.

Department of Revenue Response:

Agree. Implementation date: December 1, 2003 (Date that supplemental budget requests are due to the Joint Budget Committee). The Division agrees with this recommendation and will conduct a cost-benefit analysis to assist us in determining the appropriate approach to expanding our collection efforts.

Liquor License Applications

The majority of liquor license applicants must obtain approval from both their local licensing authority and the State's Liquor Enforcement Division. The only exception to dual licensing is for entities that receive state-only licenses such as manufacturers, wholesalers, and public transportation systems, since they may operate within the boundaries of several local entities. By statute, local licensing authorities are responsible for performing certain duties when considering new license applicants. These include collecting fingerprints and conducting criminal background checks on officers and individuals with principal interests in the licensed business, and holding public hearings regarding the reasonable needs and desires of the neighborhood. Local licensing authorities are also responsible for obtaining building plans and inspecting physical locations to ensure that they meet both building and liquor code requirements. As the State's liquor licensing authority, the Division must ensure that statutory requirements have been met prior to giving final approval for a new license. Additionally, except in the cases of concurrent review, where applications are reviewed simultaneously by both the Division and the local licensing authority, and state-only licenses, the Division cannot process the application until it has been formally approved by the local licensing authority. We found that the Division is processing and approving incomplete applications received from local authorities, which increases the risk of approving licenses for establishments that should not be licensed.

To ensure that local licensing authorities perform their statutory responsibilities, the Division requires local authorities to complete and submit a separate form with each new liquor license application. The form contains a list of the statutory requirements and requests information from the local licensing authority detailing that the required criminal background checks, public hearings, and building inspections have been completed. For example, the Division should know the date of the public hearing because the statute requires that it be held no less than 30 days from the date of the application. The form requests that the local licensing authority provide the date of the hearing to enable the Division to maintain documented assurance of local compliance with this statutory requirement. The application form also includes a section for the local licensing authority to acknowledge its approval of the license application and to attest that the local licensing authority complied with all statutory requirements.

We reviewed a sample of new license applications submitted to the Division by local licensing authorities during the last three calendar years. We found that:

- Three of eighteen applications reviewed did not include the actual date that the local licensing authority held the required public hearing.

- Six of eighteen applications reviewed did not show the date of the inspection of the licensed premises.

Sections 12-47-309(3) and 12-47-312(4), C.R.S., detail the need for local licensing authorities to obtain building plans and to inspect the physical location of an applicant to ensure that it meets both liquor and building code requirements. Division staff estimate that the majority of local licensing authorities do not conduct an initial inspection of the premises to ensure compliance with liquor code requirements. These inspections are important because they confirm that the applicant is applying for the correct type of liquor license. For example, a hotel and restaurant licensee must have an operating kitchen facility.

Local licensing authorities may not have the expertise to inspect for liquor code requirements. For example, a small local authority may send a fire marshal to inspect the premises for the fire safety and city zoning codes, in addition to liquor license requirements. Since the fire marshal does not specialize in liquor enforcement, the inspection may not cover all aspects of the liquor code. The Division needs to know when local licensing authorities lack the expertise to conduct liquor code inspections. In addition, while the Division believes these inspections are important, it does not necessarily inspect the premises if the local authority fails to do so. For a sample of 14 liquor applications missing evidence of inspection by the local licensing authority, 8 (57 percent) had not been subsequently inspected by Division staff. The Division had no record that these eight establishments were ever inspected even though a license was issued.

By processing incomplete applications, the Division may be giving final approval to new liquor applicants who do not meet statutory requirements and should not be licensed. As the State's licensing authority, it is the Division's responsibility to ensure that liquor license applicants meet all statutory requirements for receiving a license. Although the Division has a procedure for returning incomplete applications to local licensing authorities, our audit work demonstrated that this policy is not always followed. The policy focuses on the lack of a local authority signature, but Division representatives informed us that it applies to any application that is not completely filled out. The Division needs to ensure that staff understand that all incomplete applications must be returned to the local licensing authority until those authorities demonstrate that building inspections, public hearings, and background checks have been completed. Division staff also reported that some incomplete applications may be more effectively handled by telephone contact with local authorities rather than by returning the application. If this is the case, the Division should modify its policy to provide clear guidelines to staff regarding the most appropriate method of handling various omissions or errors in liquor license applications.

Recommendation No. 4:

The Liquor Enforcement Division should improve its application review process by:

- a. Enforcing current procedures for returning incomplete applications to the local licensing authority until the local licensing authority provides the required information.
- b. Reevaluating current procedures to determine if more cost-effective and efficient methods of handling incomplete applications are appropriate.
- c. Approving completed applications only.
- d. Working with local licensing authorities to ensure that all license applicants receive a physical inspection of their premises that covers liquor code requirements.

Department of Revenue Response:

Agree. Implementation date: December 1, 2003. The Division agrees with this recommendation. The Division will reevaluate its procedures for handling incomplete applications and establish quality control procedures to ensure that only completed applications are processed. In addition, the Division will work with local licensing authorities statewide to ensure the submission of thorough, complete applications and will work with the local licensing authorities to facilitate license premises inspections to cover liquor code requirements.

Background Investigations

Section 12-47-307(1)(a)(II) through (VI), C.R.S., prohibits any person, corporation, partnership, or association who is not of "good moral character, record, or reputation" from obtaining a liquor license. Under the State's dual-liquor licensing process, both the Division, as the State's liquor licensing authority, and local licensing authorities have the statutory mandate to determine whether an applicant is of "good moral character, record, and reputation." The Colorado Supreme Court has held that "record" includes a documented failure to comply with state tax laws. Further, in 1979 the Colorado Supreme Court in *LDS Inc. v. Healy* ruled the term "reputation" to be unconstitutionally vague. As a result, Division staff reported that they base their licensing decisions on the applicant's "moral character and record" omitting any consideration of the applicant's "reputation." We found that the Division does not

have any definition of "good moral character" on which to base its liquor licensing decisions, nor has it provided any written guidance to local licensing authorities. Division representatives reported that if local licensing authorities request guidance, they provide verbal guidance and refer them to previous case law or Section 24-5-101, C.R.S. For the vast majority of liquor applicants, the decision about whether the license applicant is of "good moral character" is made by the local licensing authority.

Section 24-5-101, C.R.S., does give some direction to agencies when considering "good moral character" as part of a licensing process but does not provide a specific definition. The statute allows an agency to consider the past criminal history of the license applicant as a factor but does not allow denial of the license based solely on a general category of crime, such as a felony or other offense involving moral turpitude.

We also searched the statutes to determine if other licensing statutes contained a definition of "good moral character" and found numerous uses of the standard, but very few that give specific guidance regarding what is or is not "good moral character." The common themes running through the examples we found are either a previous denial of a similar license by another jurisdiction or a listing of the types of crimes that bear a relationship to the regulated activity. For example, for gaming licenses, Section 12-47.1-506, C.R.S., states that:

in considering whether a person is of good moral character for purposes of issuing any license pursuant to this article . . . the commission may, in addition to all other information, consider whether that person has been denied a gaming license by this or any other jurisdiction . . . or whether a person has ever withdrawn an application for any type of gaming license anywhere.

Additionally, the child care licensing statutes, Section 26-6-108(2), C.R.S., list specific crimes, including child abuse and domestic violence, that automatically disqualify individuals from employment or licensure as child care providers, regardless of when the crime was committed.

A February 1996 article in *The Colorado Lawyer* discusses the law regarding the denial of licenses on the basis of a finding that the applicant was not of "good moral character." The article noted that licensing authorities have wide discretion in denying or revoking licenses, but that "discretion is not unlimited when standards are so vague as to be a denial of due process." The article recommended that the General Assembly consider listing the relevant factors for liquor licensing rather than depending on a vague standard of "good moral character."

Since the statute details that a liquor license should not be given to an applicant who is not of "good moral character," it is important that the Division work with the local licensing authorities to develop informational guidelines. Under Colorado's dual-licensing system, the local licensing authorities have the responsibility to give initial consideration to most liquor license applicants. These authorities' duties include conducting the statutorily required criminal background check and making a determination as to whether an applicant's previous criminal behavior means the applicant lacks the required "good moral character." Without a consistent interpretation of "good moral character," some applicants may be unfairly denied a liquor license, while others who should be denied a license obtain one.

We surveyed 43 local licensing authorities and found that over the last several years only one local jurisdiction had denied an application on the basis of a required criminal background check. This licensing authority reported that an applicant was denied on the basis of a conviction for sexual assault. At the same time, this local authority approved the application for another liquor license applicant with a sexual assault conviction after the applicant submitted evidence of rehabilitation. We also examined a sample of approved new license applications at two Front Range local licensing authorities and the Division. At each jurisdiction, we identified applicants with criminal histories who had received licenses. Identified crimes included convictions for domestic violence, driving under the influence, violation of a restraining order, assault, reckless endangerment, disorderly conduct, and public drunkenness. Licensing officials reported that the existence of a criminal history does not guarantee denial of a license, but instead decisions are made on a case-by-case basis using the discretion of the licensing authority. We note that Section 24-5-101, C.R.S., does not preclude applicants convicted of a felony or other offenses involving moral turpitude from applying for and receiving a license. The statute states that the fact that such applicant has been convicted of a felony or other offense involving moral turpitude, and pertinent circumstances connected with such conviction, shall be given consideration in determining whether the applicant is of "good moral character." No written standards exist to guide decisions on whether a particular type of conviction impacts the "good moral character" standard.

We found very few records detailing actual denials of liquor licenses. Most applicants facing denial for any reason withdraw their application because a denial creates a "record" under Section 12-47-307(1)(a)(VI), C.R.S., that can be used by a licensing authority when making future licensing decisions. A withdrawal does not provide a similar "record." Both Division staff and local licensing authorities reported that many applicants question whether a criminal conviction can preclude them from obtaining a liquor license. If a licensing authority indicates a certain criminal conviction might prevent the issuance of a license, the applicant may withdraw the application. In other cases, local authorities will notify an applicant that on the basis of a criminal history check or other factors, the recommendation will

be for denial. At that time, the applicant withdraws the application. Division and local licensing staff reported that local licensing authorities do not retain any records of withdrawn applications despite the fact that Section 6-17-104, C.R.S., requires the retention of all records for three years. Therefore, the Division may not have any way to determine which convictions local licensing authorities believe prevent a finding of "good moral character."

To avoid inconsistent decisions regarding whether to approve or deny a liquor license, the Division needs to work with local licensing authorities to determine which convictions or other factors result in a license denial for lack of "good moral character." Local licensing authorities are already required by statute to provide the Division with annual information regarding license suspensions and revocations. The Division could issue a position statement, use its rule-making authority, or seek statutory authority to require local licensing authorities to provide information on why specific license applications were denied. This could be accomplished by simply requiring that the basis for denial be included on the application form and submitting the denied application to the State in the same manner as those already submitted for approval. From these data the Division could generate a list of crimes or other factors that local licensing authorities believe preclude a finding of "good moral character." This information can then be used by the Division to establish broad, written guidelines that can be used by local licensing authorities when independently considering the denial of a liquor license on the basis of character. The local licensing authorities should also be informed that they need to retain information regarding applications that have been withdrawn for the statutorily required three years. This would provide the Division with another source of information that could be used to define "good moral character." Representatives from local licensing authorities expressed support for guidelines to help determine whether a license applicant meets the "good moral character" standard.

Recommendation No. 5:

The Liquor Enforcement Division should facilitate the consistent application of the "good moral character" standard by:

- a. Issuing a position statement, using its rule-making authority, or seeking statutory authority to require local licensing authorities to annually submit specific information on the number of licenses denied and the reason for the denial including any criminal convictions or other factors that prevented a finding of "good moral character."
- b. Using denial records to distribute written guidelines that local licensing authorities can independently use in applying the "good moral character" standard as part of the application process.

Department of Revenue Response:

Agree. Implementation date: 2004 Legislative Session. The Division agrees with this recommendation and will determine the appropriate method to require local licensing authorities to annually report any license application denials to the Division similar to the existing statutory requirement found in Section 12-47-601, C.R.S. The Division will collect baseline data for one year immediately following implementation of the chosen alternative to assist in the development of guidelines for use on making a determination of "good moral character."

Fee Methodology

We examined the Division's funding and found that the Division's fee structure is not aligned with its costs. Beginning with Fiscal Year 2003, the Division's liquor licensing and enforcement activities became totally cash-funded. To support its operations, the Division receives \$50 from each statutory licensing fee as well as all monies derived from Division-established processing fees. Section 12-47-501(2), C.R.S., requires that the Division's fees reflect all direct and indirect costs of the Liquor Enforcement Division and the state licensing authority in the administration and enforcement of the State's liquor laws. Statutes also require all liquor licensing fees be reviewed annually and adjusted to cover all related liquor licensing and enforcement costs. Each year, the Division tracks its projected revenues for the upcoming fiscal year on the basis of actual licensing activity from the current fiscal year plus any planned fee increases. This projected amount is then compared with the projected expenditures, including both direct and indirect costs, for the ongoing fiscal year. If the comparison shows a deficit, the Division seeks a fee increase; if the projections show a surplus, the fees remain unchanged.

Section 24-35-401, C.R.S., directs the Division to revert monies in the Cash Fund at the end of the fiscal year in excess of 10 percent of the Division's annual appropriations. Each year, the Division calculates the dollar amount of the 10 percent cushion on the basis of the Division's authorized spending authority. This authorized spending authority includes the Cash Fund authority as detailed in the Long Bill as well as the Division's share of indirect costs and central POTS. For example in Fiscal Year 2003, the Division had total authorized expenditures of almost \$1.8 million, which meant the 10 percent cash reserve was almost \$180,000. The Division uses the 10 percent reserve as a working capital cash fund advance to begin each new fiscal year and therefore seeks to annually generate fee revenues of at least 110 percent of its spending authority. We also note that although

Section 24-75-203(2), C.R.S., allows the State Controller to authorize the State Treasurer to give agencies an interest-free working capital cash advance, representatives from both the State Treasurer's and State Controller's Offices indicated that several agencies use their statutorily authorized reserve as a working capital advance rather than seeking a loan.

We found that the Division consistently reverts money to the General Fund. By statute, a reversion takes place only after the Division has received revenues that exceed its spending authority plus the 10 percent reserve. After covering its projected costs plus restoring the 10 percent reserve each year, the Division reverted money to the General Fund in each of the last four fiscal years. For Fiscal Year 2000 the Division reverted about \$42,000, or just over 3 percent of its fee revenue. In Fiscal Year 2001 the Division reverted almost \$330,000, or about 20 percent of the total amount collected in fees, with an additional reversion of about \$53,000, or about 3 percent of Cash Fund fees in Fiscal Year 2002. For Fiscal Year 2003 we estimate that the Division will revert over \$153,000 or about 8 percent of its Cash Fund fee revenues to the General Fund. These consistent annual reversions indicate that the Division may be overcharging regulated entities. The Division's fee methodology is based on changing fee rates only if projected expenditures exceed revenues. The Division increases fees when revenues are short, but takes no action to reduce fees when revenues exceed costs. Although it is difficult to set fees to cover the exact costs of licensing and enforcement, the Division needs to amend its fee methodology to set a target upper limit regarding reversions. If the Division's fee collections exceed the target, it should reduce its fees.

Recommendation No. 6:

The Department of Revenue and its Liquor Enforcement Division should amend its fee methodology to set an upper limit for reversions. Once the Division reaches this upper limit, it should adjust its fees downward accordingly.

Department of Revenue Response:

Agree. Implementation date: July 31, 2004. The Division agrees with this recommendation to establish an upper limit target for fee reversions to the General Fund. The Division will work to determine an appropriate upper limit target by analyzing historical data for its licensing activity, revenues, costs, and reversions.

Liquor Enforcement

Chapter 2

Introduction

The primary duty of the Division's enforcement unit is to ensure that all liquor licensees comply with the State's liquor laws. These include the State's prohibitions on sales of alcoholic beverages to persons under the age of 21 and to those who are visibly intoxicated. Currently the Division has eight investigators and three supervisors who oversee the activities of approximately 12,000 liquor licensees or permit holders. We evaluated the Division's oversight efforts. We identified improvements that we believe will allow the Division to better utilize its existing resources to ensure compliance with state liquor laws.

The Division's oversight activities include:

- **Inspections.** Division staff use random inspections as a proactive measure to ensure licensees are complying with liquor laws. During an inspection, the investigator performs an examination of the premises and reviews the licensee's conduct to ensure statutory requirements are met. Inspections can result in licensees' receiving a warning or administrative sanction. In Calendar Year 2002 investigators conducted about 2,000 inspections.
- **Investigations.** The Division investigates complaints from the public and follows up on violations noted during inspections or routine field contacts. When conducting an investigation of a liquor licensee, the Division investigator may announce his or her presence or may work undercover to observe the operations of the business. Investigations that document violations of the State's liquor laws can result in criminal summons and/or administrative penalties for the licensee and its employees. Division staff report that the investigators spend most of their time conducting investigations. In Fiscal Year 2002 Division investigators opened 830 investigations and completed or closed 710.
- **Routine Field Contacts.** During a routine field contact, an investigator conducts an unannounced visit to a licensee to observe his or her operations. The investigator does not formally notify the licensee of the contact until the end of the visit. If violations are identified, the investigator may immediately

perform a full-scale inspection of the premises. In Calendar Year 2002 investigators made 465 routine field contacts.

- **Compliance Checks (Sting Operations).** Section 12-47-901(1)(a), C.R.S., prohibits the sale of alcoholic beverages to persons under the age of 21. Division staff may use an underage person to visit retail liquor businesses in a specific area to attempt to purchase alcoholic beverages. Division staff report that they closely supervise these attempted purchases. Sting operations may occur as a result of complaints from the public or requests from local law enforcement authorities. In Fiscal Year 2002 the Division, working with local law enforcement officials, performed two sting operations covering 36 liquor licensees.
- **Training Classes.** Division investigators also periodically offer training classes to both liquor licensees and local government authorities. The classes provide information on the State's statutory requirements regarding the sale of alcoholic beverages. Training classes are also given to employees of licensees to help them identify false identifications and the signs of intoxication. In Fiscal Year 2002 investigators taught 203 training classes, of which 134 were to liquor licensees at various locations around the State.

Section 12-47-904, C.R.S., provides the Division with the authority to issue a criminal citation as well as impose administrative sanctions against a licensee and/or an employee who violates liquor laws. Criminal citations usually arise from the sale of alcoholic beverages to minors and include a summons to appear in court. Criminal citations are issued against the employee who sold the alcohol to the minor, and an administrative summons is issued to the licensee. Citations are handled by the local district attorney and can lead to a maximum penalty of a \$1,000 fine and 12 months' imprisonment. The Division imposes administrative penalties ranging from a warning to suspension or revocation of the liquor license. Section 12-47-601, C.R.S., gives the Division the authority to suspend, for up to six months, or revoke a liquor license for violations of the State's liquor laws.

When investigators observe an administrative violation, the investigator provides the licensee with a Show Cause Order. The Order outlines the violation and sets a date for an administrative hearing. Most licensees avoid a formal hearing by attending a pre-conference meeting and agreeing to a Stipulation and Agreement. In a Stipulation and Agreement, the licensee acknowledges the violations and agrees to a specific penalty, usually a set number of days for which the licensee will not sell alcoholic beverages. In certain instances, the Division can allow a licensee to pay a fine in lieu of suspension. The amount of the fine is equivalent to 20 percent of the licensee's gross revenues from the sale of alcoholic beverages for the period of the proposed suspension, but not less than \$200 nor more than \$5,000. In Fiscal Year

2002 the Division collected \$27,000 in fines, all of which went to the State's General Fund as required by Section 12-47-601(4), C.R.S. If the licensee does not agree to a Stipulation, a formal hearing will commence. In Fiscal Year 2002 only 2 licensees out of the 82 who faced administrative penalties requested a formal hearing. In Fiscal Year 2002 the Division completed investigations involving 710 licensees. Licensees received warning letters in 344 cases (49 percent), administrative or criminal penalties in 223 cases (31 percent), and had no substantiated violation in 143 cases (20 percent).

Sales to Minors

Section 12-47-901(1)(a), C.R.S., prohibits selling, serving, giving, or procuring any alcoholic beverage to or for any person under the age of 21 (minor). Selling alcohol to a minor results in criminal charges for the employee selling the alcohol as well as administrative penalties for the licensed business. The Division and local law enforcement authorities conduct compliance checks (sting operations) to ensure that licensees are not selling alcoholic beverages to minors. In a typical sting operation, the Division or local law enforcement authority hires a minor to purchase alcoholic beverages from a licensee. All minors are accompanied by either Division investigators or local law enforcement officers. In addition, Division guidelines state that minors must meet specific age, record, and physical appearance requirements to ensure consistency and reduce the risk of abuse by parties conducting sting operations. Sting operations can target specific licensees or areas of the State where either local law enforcement or public complaints indicate businesses are selling alcohol to minors.

We found that the Division conducts very few sting operations. As noted previously, only two sting operations covering 36 liquor licensees were conducted in Fiscal Year 2002 for the State's 12,000 liquor licensees and permit holders. Three sting operations involving 116 licensees were conducted in Fiscal Year 2001. During the last four months of Fiscal Year 2003, the Division performed six sting operations covering 141 licensees. The Division makes minimal use of sting operations, even though 328 of the 830 investigations opened in Fiscal Year 2002 (40 percent) involved the sale of alcohol to a minor. Division staff believe that the majority of local authorities are performing sting operations. However, we surveyed 45 local liquor enforcement authorities and found that 78 percent are not conducting sting operations. Research indicates that if Colorado is to deal effectively with sales to minors, the number of sting operations needs to be increased. Further, the Division should track the noncompliance rate found as a result of sting operations and monitor whether regular sting operations are an efficient and effective method for reducing the sale of alcoholic beverages to minors.

A study, based on information from Fiscal Years 2001 and 2002, conducted by the Pacific Institute for Research and Evaluation describes a correlation between the percentage of a state's liquor licensees subject to sting operations and the statewide sales-to-minor compliance rates. The study concludes that a "minimum of 25 percent of a state's licensees must be inspected each year to ensure over 80 percent statewide compliance." For this study, the term "inspection" refers to minor sting operations. According to the study, sting operations covering 10 percent of the state's licensees can guarantee sales-to-minor compliance rates of only 60 to 70 percent statewide. The same study also found that, on average for the 11 states surveyed, the states that conduct state-level enforcement perform stings on approximately 29 percent of their liquor licensees each year.

In addition, we reviewed two reports regarding studies conducted by other jurisdictions that correlate sales-to-minor compliance rates with the number of stings conducted on the licensee. The results of these studies show that:

- A 60 percent increase in compliance with laws prohibiting the sale of alcohol to minors was achieved within five months for one large city by increasing sting efforts. This study states that "stings are essential to gain compliance."
- A sample of liquor licensees in one state showed that the sales-to-minor compliance rates increased by 77 percent in three years after the state conducted annual underage sting operations.

A study conducted by the state of Louisiana found that its overall sales-to-minor noncompliance rate was reduced by 79 percent for on-premise (tavern) sales and 65 percent for off-premise (liquor store) sales from 1998 to 2002. This study attributes the decrease in noncompliance to multiple segments of the state's enforcement efforts including mandatory training, compliance checks (sting operations), and agent presence. In each of the last two years, Louisiana's Office of Alcohol and Tobacco Control has conducted between 5,000 and 11,000 alcohol and tobacco compliance checks. In 2002 compliance checks at a random sample of 10 percent of licensed alcohol retailers found that Louisiana's noncompliance rate was 7.6 percent for the sale of alcohol to minors. The Louisiana study also outlined types of licenses that had the greatest rates of noncompliance (i.e., liquor stores, supermarkets, and bowling alleys). We believe that the Division should systematically conduct a similar assessment of Colorado's licensees to track overall compliance with the illegal sale of alcohol to a minor.

The Division's *Model Guidelines Concerning Compliance Checks for Underage Alcohol Sales* notes that sting operations are an established, common, and widely used method for responding to concerns regarding the sale of alcoholic beverages to minors. Further, the *Guidelines* state that sting operations help determine the level

of compliance with state law and result in an increase in voluntary compliance with liquor laws. Given the Division's favorable opinion regarding sting operations and the increased compliance rates achieved by other states, we believe that the Division should increase its use of sting operations and monitor any change in statewide compliance rates in Colorado.

Recommendation No. 7:

The Liquor Enforcement Division should increase its compliance checks (sting operations) in areas where local authorities are not performing sting operations, determine the rate of noncompliance found during sting operations, monitor whether regular sting operations increase sales-to-minor compliance rates, and make adjustments to the number of sting operations as appropriate.

Department of Revenue Response:

Agree. Implementation date: December 1, 2003. The Division agrees with this recommendation and recognizes the need to increase the number of compliance checks performed in areas where local enforcement efforts are void. The Division will survey local jurisdictions and identify those not performing compliance checks. On the basis of these findings, the Division will perform compliance checks in these areas within existing fiscal limitations. Noncompliance rates will continue to be tracked by the Division to determine the effectiveness of the compliance checks performed.

Complaints

As we have already noted, enforcement staff spend most of their time conducting investigations. In Fiscal Year 2002, 80 percent of the Division's investigations led to either criminal charges or administrative penalties against the licensee. Investigations are undertaken because (1) an inspection indicates a problem and/or (2) the Division has received a complaint from the general public or law enforcement authorities about specific licensees. Division staff informed us that most complaints received concern intoxicated patrons, conduct of the establishment (fights, disturbances, etc.), and sales to minors. Complaints usually come in the form of a telephone call or an email sent to the Division headquarters or one of its regional offices.

In our 1995 *Liquor Enforcement Division Department of Revenue Performance Audit*, we noted that the Division was not following up on all complaints received in a timely manner. We recommended that the Division improve its procedures to ensure that all complaints are resolved in a timely manner. The Division agreed with our recommendation. Additionally, the Division has promulgated Policy 200.1 ("Investigations and Reporting") which states:

It is the policy of the Division to investigate ALL complaints received from sources outside the Liquor Enforcement Division, even those received from anonymous sources. Complaints are to be investigated and closed within 60 days of receipt unless extenuating circumstances exist.

This policy also states that "Complainant information will be fully recorded, when available . . . a copy of the complaint form will be recorded and attached to the Monthly Activity Report for the month in which the complaint was received, even if the investigation has not been completed." We found that the Division could not provide accurate information regarding the actual number of complaints it receives. Division staff acknowledge that they lack procedures for ensuring that all complaints are entered into the Division's investigation database. Without these procedures, complaints may be lost or misplaced and therefore never investigated. Although the Division does not have a complaint tracking system, it does have a case management system into which investigators may enter the source of the case. It is important to note that many of the cases in this system may arise from a single complaint; therefore, we were unable to determine the actual number of complaints received in Fiscal Year 2002.

In addition to the number of complaints, we found that the Division does not have information on the timely investigation of complaints. Although we found the case management system to be ineffective for tracking complaint information, as well as inaccurate for the total number of complaints received, we were able to use it to sample some complaints from Fiscal Year 2002. Despite the Division's policy that all complaints be investigated and closed within 60 days of receipt, we found that of the 256 cases resulting from complaints entered into the case management system during Fiscal Year 2002, 72, or 28 percent, were not investigated and closed within 60 days.

The Tobacco Enforcement Unit within the Liquor Enforcement Division has implemented a formal complaint tracking system that could be used as a model for liquor enforcement activities. Uniform data for each complaint are tracked electronically in a database so that the Tobacco Enforcement Unit staff can ensure that all complaints are investigated. The Tobacco Enforcement Unit maintains a 120-day time frame for investigation of complaints and uses its database

to remind investigators to conduct an investigation within that time frame. In addition, the Tobacco Enforcement staff track the results of the complaint investigation including any resulting penalty. We believe that the Liquor Enforcement Division should implement a similar procedure to track all complaints received including a prescribed method for inputting all complaints into the investigation database. A formal complaint tracking system would also provide the Division with information regarding licensees who have repeated complaints filed against them and whether the complaints result in violations. The Division could then use this information when deciding penalties and to target future enforcement efforts.

The Division identified violations in 163, or 64 percent, of the cases resulting from complaint investigations entered into the case management system in Fiscal Year 2002. Penalties ranged from a verbal warning to a Stipulation and Agreement to a criminal prosecution. The Division does not have a policy requiring violators to be revisited to ensure violations have been corrected. Instead, Division staff report that information regarding all penalty actions taken against a licensee are forwarded to local authorities who can then monitor the licensee and report any concerns to the Division. Division staff reported that a repeat visit would take place if the Division received another complaint. As we discuss in the next section, the Division does not have a methodology that targets inspections toward those licensees with previous violations. The Tobacco Enforcement Unit requires that all violators be revisited within 120 days. This ensures that violations are corrected or that violators face additional penalties. We believe that the Division should work with local authorities to ensure that liquor licensees receive a repeat visit within an established time frame to determine if violations have been corrected.

Recommendation No. 8:

The Liquor Enforcement Division should develop formal intake procedures that ensure all complaints are entered into the investigation database. In addition, the Division needs to develop a formal tracking system that assigns, tracks, and monitors complaints in a timely manner, and documents the results of the investigation for each complaint.

Department of Revenue Response:

Agree. Implementation date: November 1, 2003. The Division agrees with this recommendation to formally track all complaints received. Because the Division's current case management system cannot be expanded to handle all complaints, the Division has already taken steps to develop a new complaint

tracking system. The new system will electronically record all complaints received, assign and monitor complaints, and record their resolution.

Recommendation No. 9:

The Liquor Enforcement Division should work with local authorities to ensure that all licensees who have been identified as violating the State's liquor laws receive a repeat visit within a certain time frame to ensure that all violations have been corrected.

Department of Revenue Response:

Agree. Implementation date: December 1, 2003. The Division agrees with this recommendation and as noted by the Auditors, currently coordinates the results of its enforcement efforts with local police and county sheriffs. The Division will also work with local authorities, police, and sheriffs to ensure that all identified violations have been corrected within a reasonable amount of time.

Inspections

Division staff use inspections to proactively educate licensees regarding statutory requirements including prohibitions on sales to minors and visibly intoxicated persons. Inspections, along with complaints, represent another method used by investigators to determine if a liquor licensee should undergo a formal investigation. Each investigator conducts 20 inspections per month. Inspections help Division staff identify licensees who are violating liquor laws and therefore who require additional monitoring.

During an inspection, investigators enter a licensee's premises, announce themselves, and inspect the business to ensure statutory compliance. Investigators may examine everything from a licensee's books and alcohol stock to the registration of owners and managers. On the basis of the requirement that each of its eight investigators inspect 20 licensees per month, the Division should inspect at least 1,900 licensees each year, or about 16 percent of all licensees and permit holders. At this rate, it would take over six years to inspect all existing licensees. We found that, in Calendar Year 2002, Division staff inspected just over 2,000 licensees (17 percent). The Division has never conducted a workload analysis to determine the optimal number of licensees that should be inspected each month to improve voluntary compliance with the State's liquor laws.

As part of our audit work, we examined a random sample of 34 licensee files to determine if they had ever been inspected by the Division. The sample contained a combination of businesses who were newly licensed in Calendar Year 2002 and those who received a renewal license in Calendar Year 2002. We found:

- Twenty-two (65 percent) have never been inspected by the Division.
- Nine (60 percent) of the fifteen new licensees were not inspected during their first year of operation.

Although inspections are an opportunity to proactively educate licensees regarding the State's liquor laws and increase voluntary compliance, we found that the Division does not have any method for selecting those licensees who should undergo an inspection. We contacted 11 other states to determine their inspection selection methods. Three states reported using random methods when picking licensees for inspections. Another four states inspect all of their liquor licensees each year. One state mandates inspections of 40 percent of its licensees each year. Three states use a risk-based method that targets those licensees that they believe are at the highest risk to violate the law such as special events and those about whom they receive a high number of complaints.

We believe that the Division should target its inspections toward those licensees who are most likely to violate liquor laws while at the same time ensuring that all licensees receive an inspection from either the Division or local authorities during a Division-determined set time frame. For example, Division staff reported that a new licensee may not have received training from the Division and may be unfamiliar with statutory requirements. The same is true for a transfer-of-ownership licensee who gets a license but not necessarily the knowledge or experience regarding Colorado liquor laws. Special event permit holders are, according to the Division staff, also at high risk to violate the liquor laws. In 2002 the Division issued about 1,800 special event permits. Special events tend to occur over very short time periods with a high volume of liquor sales and potentially inadequately trained staff.

The Division can use existing oversight methods to target its inspections. These include the Division's centralized databases that contain information on those licensees who previously received an inspection or investigation and the resulting outcome, including violations. By querying these systems, investigators can determine the enforcement and inspection history of individual licensees or those within a specific area of the State. This would allow the Division to target its inspections toward those licensees who have previous violations or who have never received an inspection. The Division should also work with local law enforcement to determine which licensees have been inspected by the local authorities and the outcome of those inspections. Such coordination would allow the Division to focus

on those licensees not inspected by local authorities or those who require additional monitoring because the local authorities identified violations.

Inspections offer the Division the opportunity to educate liquor licensees while also identifying those licensees who have violated the law and therefore require additional monitoring. We believe that the Division needs to identify the optimal number of monthly inspections that encourage voluntary statewide compliance. Once that determination is made, the Division needs to develop a methodology for choosing those licensees who will undergo an inspection. This methodology should target those licensees who are most likely to violate the law, such as new licensees or special events permit holders, while also ensuring that all licensees receive an inspection within a set time frame from either the Division or local authorities.

Recommendation No. 10:

The Liquor Enforcement Division should establish the optimal number of inspections that should be undertaken each month to encourage voluntary compliance with the State's liquor laws. Once the Division has established this number, it should implement a methodology that targets those licensees most in need of an inspection but that also requires all licensees to receive an inspection within a certain time frame from either the Division or local authorities.

Department of Revenue Response:

Agree. Implementation date: December 1, 2003. The Division agrees with this recommendation and will develop a formal method to determine the optimal number of inspections necessary to improve compliance, and will adjust the current standard of 20 as appropriate. The Division will also survey local jurisdictions to identify those that do not perform inspections and will target those jurisdictions to provide effective coverage without duplication.

Tobacco Licensing and Enforcement

Chapter 3

Introduction

We examined the methods used by the Liquor Enforcement Division's Tobacco Enforcement Unit to enforce state laws in compliance with federal mandates prohibiting the sale of cigarettes and tobacco products to children under the age of 18 (minors). To meet federal requirements, the Tobacco Enforcement Unit has implemented a statewide enforcement program that uses a combination of compliance checks and inspections of retailers selling tobacco to reduce sales to minors. We found that the Tobacco Enforcement Unit should determine whether improvements can be made in the methods it uses to create an accurate tobacco retailer list. We also determined that the Department of Revenue's Taxpayer Services Division, which licenses cigarette wholesalers and tobacco products distributors, needs to ensure the payment of outstanding tax obligations prior to allowing these licensees to renew their licenses. Finally, the Tobacco Enforcement Unit needs to determine why the tobacco sales to minors increased in Fiscal Year 2003.

Tobacco Retailer List

Federal law, Section 1926 of the Public Health Service Act, also known as the Synar Amendment, mandates that every state enact a law prohibiting the sale or distribution of tobacco products to children under the age of 18 (minors). In addition, the federal government requires that states have an effective enforcement program that reduces the extent to which minors can obtain tobacco products. Federal regulations require states to conduct annual random, unannounced inspections of retailers selling tobacco products. Random inspections known as Synar checks, must cover a range of retailers to measure overall state levels of compliance with laws prohibiting the sale of tobacco to minors. Retailers subject to random compliance checks must be chosen using a methodology that reflects both the distribution of the state's population of minors as well as statewide distribution of retailers. Federal regulations also require that a state's list of retailers, from which the random sample is chosen, contains at least 80 percent of the universe of tobacco retailers. The regulations allow the states to develop the retailer list using a method of their choice.

Industry Codes

The Tobacco Enforcement Unit develops a list of the State's tobacco retailers, using a combination of five liquor industry codes and nine North American Industry Classification System (NAICS) codes. These codes identify specific types of retailers who, in the experience of Tobacco Enforcement staff, sell tobacco products. The five liquor industry codes are those for retail liquor stores, liquor-licensed drugstores, businesses with a 3.2 percent malt liquor on-premise license, businesses with a 3.2 percent malt liquor off-premise license, and businesses with a 3.2 percent malt liquor on/off-premise license. The nine NAICS industry codes are supermarkets and grocery stores, convenience stores, pharmacies and drugstores, gasoline stations with convenience stores, other gasoline stations, news dealers and newsstands, department stores with general merchandise, warehouse clubs and supercenters, and tobacco stores.

Using these codes provides up-to-date retailer information, since liquor licensee data are updated quarterly while NAICS revises its figures twice a year. For Fiscal Year 2003 the list developed using these 14 codes contains the names and addresses of just over 5,000 retailers. Overall, the Tobacco Enforcement Unit believes using this combination of liquor license and industry codes provides Colorado with a retailer list that contains about 89 percent of all outlets that sell cigarettes or tobacco. To test the accuracy of the code-based retailer list, Tobacco Enforcement staff drove the streets in five Front Range counties and compared the retailers on the list with those actually located in those five counties. Staff found that the list contained 89 percent of the tobacco retailers operating in those counties. The 89 percent exceeds the federal requirement that a state's list of tobacco retailers contain 80 percent of the retailer universe.

The use of liquor license and industry codes does have a significant drawback in that the resulting retailer list includes a large number of retailers who do not sell tobacco products or are not accessible to minors. Tobacco Enforcement staff put every retailer who falls under one of the 14 liquor license or industry codes on its retailer list. However, on the basis of staff's experience, an estimated 20 to 30 percent of those retailers do not sell tobacco products, are not accessible to minors, or are out-of-business. As a result, the sample selected for federally required Synar compliance checks of retailers is larger than would otherwise be necessary. To meet federal funding requirements, Tobacco Enforcement Unit investigators must perform compliance checks on a certain number of retailers who actually sell tobacco. Visits to businesses that are closed, do not sell tobacco, or are not readily accessible to minors, such as private clubs and casinos, do not count as part of the Synar sample. In Fiscal Year 2002, 328 of the retailers visited for Synar compliance checks, or about 29 percent, did not sell tobacco, were out-of-business or were not accessible to minors.

Wholesaler and Distributor Retailer Information

The General Assembly passed Senate Bill 01-73, which requires cigarette wholesaler and tobacco products distributor licensees seeking renewal of their license to provide "a list of the names, addresses, and Colorado sales tax license numbers of all persons who purchased tobacco products for resale from the wholesaler or distributor during the twelve-month period immediately preceding the filing of a renewal application." The purpose of obtaining information from cigarette wholesalers and tobacco products distributors is to cost-effectively augment the Tobacco Enforcement Unit's existing procedures for developing a list of tobacco retailers and to ensure that Colorado knows the name and location of as many of those retailers who sell tobacco as possible. As required by Section 39-28-102(2)(a), C.R.S., we examined the accuracy and completeness of the information submitted to the Tobacco Enforcement Unit by tobacco products distributors and cigarette wholesalers.

We concluded that using the information provided by the wholesalers and distributors is not a cost-effective method for obtaining accurate information regarding the State's tobacco retailers. First, the Tobacco Enforcement Unit must compile the information provided by over 300 wholesalers and distributors into one master list. This is a time-consuming process, since most of the information is provided in hard-copy format, and different wholesalers and distributors might sell products to the same retailers, requiring elimination of duplicates from the master list. Second, the wholesalers and distributors do not always provide the statutorily required information. Third, Tobacco Enforcement staff must individually verify the information submitted to ensure that it includes the correct sales tax numbers, addresses, and business names so that the list details the actual name and location of each tobacco retailer.

The Fiscal Year 2003 master list developed from the information provided by wholesalers and distributors contains the names of over 7,200 retailers and is 113 pages in length. Tobacco Enforcement Unit staff attempted to verify the submitted information. Staff checked all of the information on the first 18 pages containing 1,152 entries. Staff found that the listing for only five retailers tested, less than 1 percent, contained completely accurate information. About 311 (27 percent) of those tested were out-of-business, 224 (19 percent) had the wrong sales tax number, 412 (36 percent) did not have a sales tax number listed, and the remainder had the wrong business name, address, or the computer could not locate the retailer on the basis of the information submitted. Tobacco Enforcement Unit staff verified only a limited number of entries on the remaining pages.

We also tested the accuracy of the information in the master list by examining a random sample of 300 tobacco retailers listed after page 18 of the master list. For our

sample, we identified 121 retailers (40 percent) whose information was not accurate. Inaccuracies we noted included incomplete sales tax numbers, wrong addresses, and different business names as well as 78 retailers for which the State no longer had a matching sales tax number (i.e., the retailer was no longer in business). Our findings independently confirm a significant level of inaccuracy and incompleteness in the master list, as noted by the Tobacco Enforcement Unit.

Finally, the compilation and verification of the master list is time-consuming and expensive. In Fiscal Year 2003, Tobacco Enforcement Unit staff spent approximately 660 hours to compile the master list and test the accuracy of all of the information on the first 18 pages. Due to its lack of cost-effectiveness and accuracy, the Tobacco Enforcement Unit does not use the information provided by the wholesalers and distributors.

Licensing Tobacco Retailers

Retailer licensing offers a possible option for cost-effectively obtaining an accurate list of the State's tobacco retailers to either augment the industry code-based list or as a stand-alone method for developing a retailer list. According to information from the National Cancer Institute, as of December 31, 2001, 35 states had some form of licensing for tobacco retailers. We contacted six western states including several that border Colorado to determine whether or not they license tobacco retailers. Four of the six states we contacted license their tobacco retailers at either the state or city level. Two specifically use the licensing information to develop a tobacco retailer list for both overall enforcement and for selection of their Synar sample. Both of these states require retailers to pay for their license at a cost of \$25 to \$30 every two to three years. These two states also require retailers to obtain a license before selling tobacco products and have statutory penalties for failure to obtain a license. Developing a list using licensing information minimizes the amount of wasted time visiting retailers who do not sell tobacco products.

Colorado does not license tobacco retailers. The General Assembly has previously considered and rejected a proposal to require a sales tax endorsement for tobacco retailers. As proposed, the endorsement was an alternative to having a separate license. Under the proposal, when retailers obtained their sales tax license, they would have also signed an endorsement on the license application notifying the Department of Revenue that the retailer sold tobacco products. Retailers would not have been charged any additional fee above the cost of their sales tax license.

Federal mandates require that the State have an accurate list of tobacco retailers from which to choose a statistically valid sample for random compliance checks. The Tobacco Enforcement Unit needs to determine whether the accuracy of the currently

required information from wholesalers and distributors can be improved or whether this requirement should be eliminated. Suggested improvements to wholesaler and distributor reporting requirements could include electronic submission of retailer information, penalties for failure to provide accurate information, and requiring the information to be submitted more frequently. At the same time, the Tobacco Enforcement Unit should determine whether other methods exist to improve the accuracy of its industry code-based list or if retailer licensing offers the most cost-effective solution for obtaining an accurate list of the State's tobacco retailers. Once a decision is made, the Department of Revenue should implement the method through its rule-making authority or obtain statutory authority if necessary.

Recommendation No. 11:

The Tobacco Enforcement Unit should determine whether the current information submitted by cigarette wholesalers and tobacco products distributors can be improved. If it cannot be improved, the Tobacco Enforcement Unit should seek statutory authority to eliminate this requirement. At the same time, the Tobacco Enforcement Unit should consider methods for improving the accuracy of its industry codes-based tobacco retailer list and implement any identified changes either through rules or by amending the statute.

Department of Revenue Response:

Agree. Implementation date: 2004 Legislative Session. The Division agrees with this recommendation. The Division will consider alternatives to improve the accuracy of the information provided by tobacco wholesalers and distributors, including statutory change if necessary. If the Division determines that requiring information from tobacco wholesalers and distributors is not the best solution, the Division will seek statutory change to eliminate the requirement. The Division will also review alternatives to improve the tobacco retailer list, including statutory change to require retailer licensing, and will implement changes as appropriate.

Cigarette and Tobacco Taxes

The Taxpayer Services Division within the Department of Revenue issues licenses for cigarette wholesalers and tobacco products distributors. Sections 39-28-102 and 39-28.5-104, C.R.S., require that anyone applying to operate as a cigarette wholesaler or tobacco products distributor must first obtain a license. Licenses are

renewed annually with the payment of a \$10 fee. Sections 39-28-104, 39-28.5-102, and 39-28.5-106, C.R.S., require licensees to collect and remit statutorily required taxes on cigarettes and tobacco products. We found that the Taxpayer Services Division does not ensure the payment and remittance of all applicable taxes prior to issuing or renewing a cigarette wholesaler or tobacco products distributor license.

Colorado's cigarette tax is a penny per cigarette. The tax is paid by the wholesaler through the purchase of tax stamps, which must be placed on every pack of cigarettes sold in Colorado. Wholesalers purchase the cigarette tax stamps on a monthly basis from the Department of Revenue. According to Department representatives, only licensed wholesalers can purchase the stamps. Verification of licensing is done by Department staff at the time of the stamp purchase. Wholesalers pay for the stamps on a monthly basis and receive a discount if all payments are made prior to the 10th day of the month. Senate Bill 03-317 reduced this discount from 4 to 3 percent for payments received between July 1, 2003, and June 30, 2005. A Taxpayer Services Division representative reviews a monthly report that details any discrepancies between the amount of cigarette stamps purchased by a licensee and the amount paid. However, a Taxpayer Services Division representative noted that an outstanding tax balance would not preclude a licensee from renewing its license. As long as the licensee completes the application and pays the \$10 fee, the license will be renewed, even if the licensee has failed to pay all of the taxes owed to the State.

Section 39-28.5-106, C.R.S., requires that tobacco products distributor licensees file an excise tax return on a quarterly basis. Returns must be filed, even if the licensee owes no taxes. The excise tax payment on tobacco products is paid by the tobacco products licensee and represents 20 percent of the manufacturers' list price (i.e., the price listed on the invoice). The Taxpayer Services Division does not verify the submission of quarterly tax returns or the payment of the 20 percent excise tax before renewing the license. At our request, the Taxpayers Services Division tested a sample of 58 tobacco products distributor licensees out of a total of 238 licensees to determine whether they submitted quarterly excise tax returns and payments during Calendar Year 2002. For the sample, the test found that 10 licensees (17 percent) did not submit all required quarterly tax returns. Six licensees (10 percent) had outstanding tax delinquencies including sales, employee withholding, and tobacco excise, totaling \$23,000 with about \$5,000 of the outstanding taxes having been incurred prior to license renewal in July 2002. As with a cigarette wholesale license, a tobacco products distributor license will be renewed as long as the application is completed and is accompanied by the \$10 fee.

Sections 39-28-102 and 39-28.5-104, C.R.S., give the Department of Revenue the authority to revoke a license for a violation of statutory requirements. These violations include the failure to pay required taxes on cigarettes and tobacco products or to submit quarterly excise tax returns. The Department has not sought to use this

authority to revoke the license of any cigarette wholesaler or tobacco products distributor on the basis of failure to pay taxes.

Statutes do not currently provide the Department of Revenue with the authority to deny either an initial or renewal license for a cigarette wholesaler or tobacco products distributor for failure to pay required taxes. We believe that the Department should seek statutory authority to deny a license, including a renewal license, for failure to pay taxes. As discussed previously, the Liquor Enforcement Division has similar authority for liquor licenses. Since inception of this approach during Fiscal Year 2003, the Department has collected over \$1 million in tax delinquencies. We believe that providing the Department with similar authority regarding cigarette wholesalers and tobacco products distributors will ensure that wholesaler and distributor licensees pay all of their required taxes. In addition since the Tobacco Enforcement Unit is already responsible for enforcing the State's tobacco laws, the Department of Revenue should consider transferring licensing authority to it as well.

Recommendation No. 12:

The Department of Revenue should seek statutory authority to allow the Department to refuse an initial or renewal cigarette wholesaler or tobacco products distributor license on the basis of the applicant's failure to pay outstanding tax delinquencies.

Department of Revenue Response:

Agree. Implementation date: July 1, 2004. The Department agrees with this recommendation. The Department will seek statutory change to permit the Department to deny new and renewal licenses for tobacco wholesalers and distributors when total final tax liabilities exist. Final tax liabilities are those that have reached the distraint warrant stage (which indicates it is now a matter of public record), and the taxpayer is not disputing the tax amount.

Recommendation No. 13:

The Department of Revenue should consider transferring licensing authority for cigarette wholesalers and tobacco products distributors to the Liquor Enforcement Division's Tobacco Enforcement Unit, since it has the responsibility for enforcing the State's tobacco laws.

Department of Revenue Response:

Agree. Implementation date: July 1, 2004. The Department agrees with this recommendation and will evaluate the benefits of transferring the licensing authority to the Liquor Enforcement Division. Although this function has historically resided within the taxation line of business and the necessary processes and controls are already in place, if it is determined that there would be added benefit to affect such a change the Department will pursue the transfer.

Tobacco Compliance Checks

As noted previously, the federal Synar Amendment requires the states to adopt and enforce laws prohibiting the sale of tobacco products to children under the age of 18 (minors). Failure to meet federal standards can result in a loss of up to 40 percent of a state's federal Substance Abuse Prevention and Treatment (SAPT) Block Grant. In Colorado, the Alcohol and Drug Abuse Division (ADAD) within the Department of Human Services annually receives about \$22 million from the SAPT Block Grant. SAPT monies are used to pay over 50 percent of the cost of the State's alcohol and drug abuse prevention and treatment programs. A 40 percent reduction in SAPT funding could cost Colorado approximately \$9 million in federal funds each year.

House Bill 98-1387 named the Liquor Enforcement Division as the lead agency for the enforcement of state laws prohibiting the sale of tobacco products to minors. The Division has delegated tobacco enforcement duties to its Tobacco Enforcement Unit. To ensure the State has the federally required statewide enforcement program that limits the ability of minors to obtain tobacco products, Tobacco Enforcement Unit staff conduct a combination of administrative inspections of tobacco retailers, field contacts or short visits to retailers, educational and training seminars, and compliance checks to determine if a retailer will sell tobacco to a minor. Tobacco Enforcement Unit staff also perform the federally required annual random, unannounced compliance checks at a statistically valid sample of tobacco outlets throughout the State. These Synar compliance checks are used by the federal government to determine the effectiveness of the State's tobacco enforcement program. If more than 20 percent of the retailers in the sample sell to a minor, the State faces the loss of a portion of its federal SAPT Block Grant. In Fiscal Year 2002 the Tobacco Enforcement Unit conducted Synar compliance checks at 817 tobacco retailers, and 52, or 6 percent, of the retailers in the sample sold to a minor. For Fiscal Year 2003 the number and percentage of violations identified increased significantly. The

Tobacco Enforcement Unit conducted Synar checks at 924 retailers and 104 sold tobacco to the minor. This is a noncompliance rate of 11 percent.

Synar compliance checks indicate the overall compliance of tobacco retailers in regard to selling tobacco products to minors. On the basis of a statistically valid sample, the number of retailers willing to sell to minors doubled between Fiscal Years 2002 and 2003. Due to the potential negative financial impact on the State of continued increases in noncompliance with tobacco laws, the Tobacco Enforcement Unit needs to analyze this increase in violation rates to determine if any pattern exists to explain the increase and then work to reduce it.

Recommendation No 14:

The Department of Revenue's Tobacco Enforcement Unit needs to analyze the increase in the number of tobacco retailers selling to minors between Fiscal Year 2002 and Fiscal Year 2003 to determine if any pattern exists.

Department of Revenue Response:

Agree. Implementation date: July 1, 2003. The Division agrees with this recommendation. In January and February 2003, Tobacco Enforcement Unit staff suspected that the noncompliance rate for sales-to-minors in Colorado was rising. This was evidenced in retailers' comments suggesting that they sold tobacco to minors because they thought the enforcement program in Colorado had been cut.

In March 2003, the noncompliance rate in Colorado was determined to be 12 percent (double the previous year's rate). We immediately began discussion with the Colorado Synar Director and ADAD to attempt to address the issue. ADAD contributed \$50,000 to provide overtime and other resources to the Tobacco Enforcement Unit. These resources were utilized from April 18, 2003, through June 30, 2003, to increase investigator contacts with retailers statewide. More than 900 compliance checks, field contacts, and inspections during this time period were conducted with the additional funding. As a result of this effort, noncompliance rates have begun to decline. Current research indicates that the Synar sampling noncompliance rate is now 11 percent.

It would appear that the level of field activity directly contributes to noncompliance rates. Long-term solutions to this problem are being formulated.

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