Key Points of Report

An Audit Report on Management Controls at the Alcoholic Beverage Commission

April 1998

Overall Conclusion

The Alcoholic Beverage Commission (Commission) has management controls which provide reasonable assurance that goals and objectives are met. However, improvements are needed in fleet management, the Internal Affairs Department, and some administrative functions. Also, a study should be conducted to determine how much additional revenue could be earned from taxing all cigarettes imported from Mexico.

Key Facts and Findings

- The Commission appears to have controls in place to implement the strategy of detecting and deterring violations of the Alcoholic Beverage Code. However, improvements could be made by (1) using available information to monitor fleet assignments, (2) ensuring the independence of the Internal Affairs Department, and (3) enhancing communication on how to file a complaint with the Internal Affairs Department.

- The Commission should improve controls in a variety of areas to ensure effective and efficient operations. Improvements to the budgeting process, the performance appraisal system, training, staffing analysis, and human resources performance measures would enhance the Commission's operations. Improvements in processes used in the Internal Audit Department would also enhance operations.

- A study should be conducted to determine how much additional revenue could be earned from taxing all cigarettes imported from Mexico. Collecting additional revenue would require a change to the Tax Code. Currently, travelers are allowed to bring one carton of cigarettes per day per person across the border free of tax. Preliminary estimates indicate that if 5 of every 10 estimated smokers cross the border with a tax-free carton of cigarettes, additional annual revenue of $17 million could be earned. Alternatively, if an administrative fee were charged on cigarettes and 5 of every 10 estimated smokers cross the border with a tax-free carton of cigarettes, additional annual revenue of $2 million could be earned.

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This management control audit was conducted in accordance with Government Code, Sections 321.0132 and 321.0133.

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Appendices

Section 1:

Controls Appear Adequate to Implement the Strategy to Deter and Detect Violations of the Alcoholic Beverage Code, But Some Improvements Are Needed

The Alcoholic Beverage Commission (Commission) appears to have controls in place to implement the strategy of detecting and deterring violations of the Alcoholic Beverage Code. However, improvements could be made by using available information to monitor fleet assignments, ensuring the independence of the Internal Affairs Department, and enhancing communication on how to file a complaint with the Internal Affairs Department.

Section 1-A:

The Commission Should Use Available Information for Fleet Management

The Alcoholic Beverage Commission does not effectively monitor the use of its fleet. Currently, the Commission has 264 vehicles in its fleet costing over $3.7 million. Information on fleet utilization is available, but the Commission does not use it to determine how effectively the cars are being used by peace officers. Information on fleet use is only analyzed by the Commission to determine when cars should be replaced. Potential savings are possible by analyzing the use of cars and determining if cars can be pooled. This analysis could also assist management in monitoring activities of peace officers by monitoring the number of miles driven and the number of trips recorded.

Vehicle usage detailed reports indicated that for 47 personally assigned vehicles tested, 39 had down time. Test work did not determine if the down time was attributable to vacation, sickness, training, or conferences. The down time ranged from 1 day a month that a vehicle was reported as unused to 18 days in one month. The down time varied each month for each officer in the 12-month period tested. Effective monitoring of the fleet would include investigating this down time to ensure the efficient use of the vehicles. Monitoring should also include determining if officers' down time is conducive to sharing vehicles to reduce the size of the fleet.

According to Commission policy, peace officers in the Enforcement Division routinely receive a vehicle to perform their jobs. This includes certified peace officers stationed at headquarters. The Commission has expressed concerns about increased undesired consequences and loss of benefits to the public if fewer vehicles are assigned to individual peace officers. Additional concerns are that officers will not be able to respond adequately to emergency situations without individually assigned vehicles, and that the pooling concept may not be economically feasible for the Commission since it does not have facilities for storage of vehicles. However, because vehicle use has not been effectively monitored, the Commission has not demonstrated that the current vehicle allocation and use are efficient and effective.

Additionally, it appears that information concerning vehicle mileage and use in the computerized system at the Commission is not compatible with the vehicle usage detailed reports submitted by each peace officer. Historical reports generated from the system did not match the hand-written vehicle mileage usage logs. For example, the computer printout shows that a peace officer did not drive his vehicle for an entire month; however, the vehicle usage detailed report for the month indicated that the officer drove his vehicle for over 1,000 miles. Therefore, the Commission's computer system does not produce accurate reports to monitor vehicle usage. The Commission was not aware of this because as of January 1998, no historical reports for 1997 had been generated. It is important that this information be used in the fleet management process.

Recommendation:

Vehicle down time should be investigated and determinations should be made concerning the effective assignment of vehicles and options for use of car pools. The information system problems should be corrected to ensure that the data generated by the computer system is the same as the individual vehicle mileage logs. Supervisors and executives should use this computerized information for effective fleet management.

Management's Response:

A report compilation problem with the report generating component of our system existed at the time of the auditors' visit and caused the inaccuracies in the reports used by the auditors for their analyses. The compilation error has since been fixed. The problem with the system was one of report compilation, not one of data integrity.

The system's report compilation problems have been fixed. Additional Change-1's (program change requests) have been submitted to correct similar errors in the compilation logic of the system's inquiry screens and for enhancements in report and inquiry logic that would permit "by driver" reports and inquiries (the system currently permits only "by vehicle" and "by organizational unit" reports and inquiries).

As recommended by the auditors, the automated reports will be made available to field supervisors. Most of the reports were designed for that purpose. Only confusion as to which organizational unit (the General Services Department's Fleet/Communications Section or HQ Enforcement) was responsible for ordering and distributing these reports has kept them from being used as designed. This confusion has been eliminated and, henceforth, the reports will be distributed to field supervisors monthly by the enforcement division's headquarter's staff.

In addition, the enforcement division managers and supervisors will continue to monitor CPO vehicle use and to seek new ways to use its vehicle assets more effectively and efficiently. With respect to pooling, however, it must be noted that the agency has studied the issue and reported to the legislature in its legislative appropriations request for the fiscal year 1998 through fiscal year 1999 biennium that while it could maintain its current operating levels with a .75:1 ratio of cars to agents, *such a ratio would come at a cost of less flexibility and lost coverage (the amount of territory and licensed premises that agents can cover when necessary at peak periods or during emergencies). The agency also reported that any thing less than that ratio would force the division to cut operating levels. Faced with the alternatives, the legislature chose to fund vehicle replacement at the level necessary to maintain a 1:1 ratio of cars to agents.*

Section 1-B:

The Internal Affairs Department Should Be Improved to Ensure Its Effective Operation Within the Commission

The Internal Affairs Department's (Internal Affairs) current reporting structure does not provide Internal Affairs the independence it needs to conduct its investigations. Currently, Internal Affairs reports to the Enforcement Division, and Internal Affairs does not appear on the Commission's organizational chart. This organizational placement gives the impression that Internal Affairs only investigates situations within the Enforcement Division, when in fact, it has investigated allegations in other divisions within the organization. Internal Affairs should report to a level higher than the divisions it investigates to ensure independence. The independence of Internal Affairs is extremely important because it handles sensitive matters, some involving criminal allegations. Without proper independence within the organization, important issues may not be handled effectively.

Research indicates that many internal affairs departments across the country report to the highest level within their organizations. A review of 45 organizational charts of state police departments found that 26 departments had their internal affairs departments clearly defined on the organizational charts. Twenty of the 26 internal affairs departments reported directly to the highest level of management, and the other 6 reported to a second level of management.

The Commission has not adequately informed the public or the industry how to file a complaint with Internal Affairs. Currently, there is no documented method to ensure that all complaints reach Internal Affairs. If complaints appear to be within the jurisdiction of Internal Affairs, they are routed to the department. Although the Commission did receive complaints from the public in fiscal year 1997, it is possible that there would have been additional complaints if the public and the industry were better informed about the complaint process. By not properly informing the public, there is a risk that issues will not be reported, investigated, or handled properly in a timely fashion.

Internal Affairs does not have an action plan to help direct its activities. The Enforcement Division plan does not contain strategies for Internal Affairs. Without a plan, it is difficult to determine if Internal Affairs is accomplishing its goals and objectives. Additionally, policies and procedures regarding Internal Affairs should be reevaluated to ensure they reflect any new organizational structure changes.

Recommendation:

- Internal Affairs should report to the highest level of management within the Commission to provide it with organizational independence. Internal Affairs should also be added to the organizational chart.

- Efforts should be made to better communicate to the public how to file a complaint with Internal Affairs. This can be accomplished through a variety of methods including listing the Internal Affairs Department in the telephone book in all of the cities that contain a field office, posting signs in field offices, adding the information to the Internet site maintained by the Commission, and/or including mailers with the notification of taxes owed.

- Develop an action plan for Internal Affairs that contains goals, objectives, and performance measures. Also, adjust policies and procedures to reflect the new placement and decision structure within the organization.

Management's Response:

The internal affairs section will report directly to the administrator on matters dealing with internal affairs issues and to the chief of enforcement on all other matters. The organizational chart will be updated to reflect this change.

In order to better inform the public on how to file an internal complaint, the agency will use its WEB site to offer instructions on how and where to file a complaint with the internal affairs department.

The section has been asked to develop an action plan that contains goals, objectives and performance measures. The employee handbook will be updated to reflect the new placement and decision structure within the agency.

Section 2:

Controls Over Some Administrative Functions at the Commission Could Be Improved

The Commission should improve controls in a variety of areas to ensure effective and efficient operations. Improvements should be made to the budgeting process to ensure certain expenditure objects are budgeted appropriately. Improvements to the performance appraisal system, training, staffing analysis, and human resources performance measures would enhance the Commission's human resources management system. Improvements in processes used in the Internal Audit Department would enhance operations.

Section 2-A:

Improve the Budgeting Process to Improve Forecasting of Certain Expenditure Objects

Management controls over budgeting should be improved. During fiscal year 1997, the Commission adjusted 11 expenditure objects more than 25 percent from their original budget estimates. There were also ten expenditure objects that exceeded 50 percent of their original budgets. These expenditure-object inaccuracies represent a trend for the Commission. These trends indicate a need to improve budget forecasting for expenditure objects such as temporary services, computer equipment, and other equipment. Table 1 shows these categories and their original budgets and actual expenditures.

Table 1

Expense Items	Fiscal Year 1995			Fiscal Year 1996			Fiscal Year 1997		
	Original Budget	Actual Expenses	(Over) or Under	Original Budget	Actual Expenses	(Over) or Under	Original Budget	Actual Expenses	(Over) or Under
Merits	$0	$0	**$0**	$180,378	$0	**$180,378**	$68,484	$0	**$68,484**
Professional Fees	$4,000	$12,750	**($8,750)**	$23,000	$35,739	**($12,739)**	$23,000	$102,232	**($79,232)**
Temporary Services	$14,350	$93,184	**($78,834)**	$0	$172,585	**($172,585)**	$15,367	$262,182	**($246,815)**
Computer Equipment	$7,000	$180,320	**($173,320)**	$8,665	$473,781	**($465,116)**	$0	$297,427	**($297,064)**
Phone Equipment	$500	$79,980	**($79,480)**	$0	$15,266	**($15,266)**	$0	$26,427	**($26,427)**
Other Equipment	$15,750	$136,032	**($120,282)**	$0	$268,825	**($268,825)**	$12,000	$185,636	**($173,636)**

The fiscal year 1998 budget has the same inherent flaws as previous budgets. For example, actual expenditures for professional fees in fiscal year 1997 totaled $102,232, but the fiscal year 1998 budgeted amount is only $23,000. (See Appendix 5 for a graph of actual expenditures to fiscal year 1998 budget.)

It appears that the Commission uses previous budgets as a basis for the budgeting process rather than past expenditures. Analysis of past expenditure trends is an important part of the budgeting process. Sound budgeting and budget monitoring begin with the establishment of realistic budgets at the beginning of the budget cycle. This is also needed to ensure that management has proper information to direct the organization. Proper budgeting will help management determine if funds are spent as expected to accomplish the goals and objectives of the Commission.

The Internal Audit Department noted budgeting issues in a February 1998 report. Recommendations from the report include suggesting that the Commission (1) analyze prior-years' operations to base the budget on historical costs, (2) ensure that budget adjustments are approved by the Budget Committee prior to making adjustments, and (3) ensure that the Budget Committee identifies the resulting demands placed on Information Resources Department prior to authorizing major information technology purchases. Additional recommendations were to obtain an opinion from Legislative Budget Board prior to submitting its fiscal year 1999 appropriations request regarding purchasing and recording computer equipment as a capital expense.

Recommendation:

The Commission should use past expenditures as a basis to ensure all budget categories are realistically established. While trend data should not necessarily drive the budget process, it can be a useful guide. Carefully analyze areas where there have been past trends of budgeting inaccuracies to determine the cause and make the proper adjustments. Also, follow up on the budgeting issues that the Internal Audit Department identified and implement the recommendations to increase the effectiveness of the budgeting process.

Management's Response:

We concur with the recommendations and agree to better identify needs by using past expenditures as a basis for some budget categories.

Unexpended salary funds were used to purchase non-recurring capital items. The savings were realized due to the time lag in the hiring of enforcement agents and use of temporary services in the ports of entry program. All capital items including the replacement of computers are recorded as capital expenses. However, only the acquisition of new information resource technologies and other capital items with a project or unit cost in excess of $25,000 are recorded as a capital budget item.

TABC will follow-up on the budgeting issues identified by internal audit and implement the recommendations to increase the effectiveness of the budgeting process.

Section 2-B:

Improve Staffing Analysis and Planning to Improve the Human Resources Department

The Human Resources Department (Human Resources) does not have a formalized process for addressing staffing needs. It appears that some procedures for identifying staffing needs and planning to meet those needs are being performed. However, Human Resources does not plan for the seasonal need for temporary services and has not planned how to handle a potential mass retirement. Currently, the Commission has approximately 15 percent of its workforce eligible or almost eligible for retirement.

One result of the current process used to address staffing needs is the loss of full-time equivalent employees (FTEs) for the 1998-1999 biennium. During fiscal year 1996, the Commission had an average of 35 positions open throughout the year. The result was that the Commission lost 13.5 FTEs for the 1998-1999 biennium. This trend is continuing in fiscal year 1998. For the first five months of fiscal year 1998, the Commission has had an average of 35 open positions. Continued vacant positions could negatively impact agency operations. To help reduce these vacant positions, positions should be filled in a timely manner.

Proper human resources planning is essential to solve this issue. Many of the vacancies are due to the fact that peace officers in the Enforcement Division are only hired approximately twice per year due to the involved process needed to hire them. Human Resources' plans should forecast the numbers and kinds of positions that need to be filled and include mechanisms for tracking and predicting turnover and retirements. From this plan, processes used to implement the goals of Human Resources should be modified to meet the needs of the Commission.

Proactive planning, rather than planning as the need arises, will enable the Commission to recruit and select staff in a manner that optimizes the matching of qualifications of applicants with the needs of the Commission. The Commission is exposed to the potential risk of major disruption in operations arising from inefficiency and ineffectiveness of staff planning.

<u>Recommendation</u>:

The Human Resources Department should increase efforts to formalize the process used to address staffing needs. Among other things the process should provide for planning of regularly recurring seasonal needs for part-time and/or temporary services, as well as for the development of contingency plans for possible mass retirements. To ensure continuity of an effective staff planning process, pertinent policies and procedures should be formally developed.

<u>Management's Response</u>:

In cases of mass retirements and resignations, common practices, such as reallocation of personnel where shortages exist, immediate implementation of the hiring process with minimum time frames where applicable, and temporary redistribution of job tasks will be considered. The human resources department will document these common practices in a plan addressing staffing needs based on projections of the percentage of workforce eligible for retirement.

Seasonal and temporary employee needs are currently determined by each department, not by the human resources department. We agree that the human resources department should be involved in the planning process for seasonal and temporary staffing needs and will consider implementation of a policy that will accomplish this.

Section 2-C:

Ensure Employees Receive Timely Evaluations on Job-Specific Appraisal Forms

The employee appraisal process should be improved. Not all employees are evaluated in a timely fashion. Without timely evaluations, it becomes difficult for the Commission to reward good performance and correct poor performance.

- Ten of 13 headquarters personnel had not received evaluations on an annual basis. In contrast, a sample of ten field office personnel received evaluations annually. Of the ten headquarters personnel that did not receive evaluations, seven of those personnel are at the department director level or higher within the organization. All personnel, especially those performing strategic administrative roles within the organization, need annual feedback to encourage good performance, correct and discourage substandard performance, and provide a basis for an employee's training and future development.

  Although many of the personnel who did not receive annual evaluations did receive evaluations during fiscal year 1997, there were varying time periods between the most current evaluation and their previous evaluation. The Commission policy requires two 90-day evaluations for new employees and an evaluation at least once every 12 months for all other employees. Human Resources has had difficulty tracking the dates the evaluations were due because evaluation periods differ within each department.

- The instrument used to evaluate personnel should be modified. Currently, there is one evaluation form for all personnel within the Commission. This form contains the same job dimensions for peace officers, compliance officers, port-of-entry personnel and all other employees. Although the form does contain evaluation criteria, the criteria are not job-specific. Supervisors are required to fill in any job-specific information. The Commission has employees that have widely differing job requirements. Appraisal instruments should clearly lay out specific, job-related criteria on which employees will be evaluated. Without job-specific criteria, employees may not be evaluated on the crucial tasks important to performing their jobs successfully.

- Several of the division directors received evaluations in a narrative, letter format, although they were suppose to receive the evaluations on the standard form. The narrative form made it difficult to identify the criteria used to evaluate the employees. Additionally, there were no job ratings used in these evaluations. In addition to appraisal instruments having job specific criteria, it is also essential that the person being evaluated know what these criteria are before the evaluation occurs. Because the personnel who received these evaluations are high ranking, it is essential that these personnel receive appropriate evaluations.

- The three-member governing board does not provide the Administrator with a written annual evaluation. Currently, the only evaluation on file for the Administrator since his appointment in February 1994 is a memo written by the Assistant Administrator documenting an oral evaluation conducted by the governing board in August 1997. To ensure that the Administrator is accomplishing the goals and objectives that the three-member governing board set forth, the Administrator should be evaluated on an annual basis.

Recommendation:

- To ensure that employees are receiving timely feedback, the Commission should perform evaluations for all employees at least annually.
- The Commission should develop an evaluation system that incorporates job-specific criteria for each major group of employees. Since the work of Commission employees is so diverse, it is important that the evaluations have job-specific criteria.
- The three-member governing board should ensure that the Administrator receives an evaluation annually.

Management's Response:

The human resources department has implemented a system to monitor personnel evaluations and inform management when such evaluations have not been completed as per established policy. Policy does require that, at a minimum, annual evaluations be performed on all employees.

Commission policy requires two 90-day performance review/tracking for all new employees and quarterly performance review/tracking for enforcement personnel through the first year. Upon completion of new employee probationary period, an annual evaluation is required on all employees. Management has implemented an agency-wide annual evaluation based on anniversary date. The human resources department is utilizing the state-wide personnel/payroll system and, effective January 1998, records are being maintained to track the timely completion of performance evaluations.

We do not believe that the performance evaluation form itself needs to be modified. After several years of use, it is clear to managers and supervisors that elements in the instrument are job specific and each employee is evaluated based on that specific criteria in their job description. We will agree; however, to document the types of criteria utilized by individual job descriptions/categories in each basic element of the instrument.

The three-member commission will evaluate the administrator on an annual basis in the executive session of a scheduled commission meeting.

Section 2-D:

Improve Methods for Identifying Training Needs of Certain Commission Employees

The current system used to identify training needs for particular employees of the Commission needs improvement. Most formalized training offered in fiscal year 1997 was for peace and compliance officers. Segments of the Commission workforce, such as administrative support personnel, may need to be offered additional training. Peace officers, compliance personnel, and personnel who have licenses have easily identifiable training needs. Their training needs are dictated by the professional associations that require a certain number of specified classes or by Commission requirements. However, the remainder of the personnel's training needs are not as easily identified. Their training needs are determined by asking the employee and his or her supervisor what training is needed. Asking personnel and their supervisors to identify training needs may not produce the best results. In the past, some supervisors have not been supportive of employees participating in training classes. If not adequately trained, these personnel may not contribute to the Commission at their full potential, which could reduce the Commission's level of performance.

Training and development programs should be designed to optimize all employee productivity, enhance professional and personal development, and assist the Commission in accomplishing its goals and objectives. Management should identify weaknesses within the entity and address them through staff training and development. An entity's training and development needs should be prioritized based on a risk assessment of entity strengths and weaknesses. Jobs must be analyzed to identify the knowledge, skills, and abilities needed to perform the job tasks required. Training and development should address the knowledge, skills, and abilities identified through such job analysis.

Recommendation:

Other methods for identifying training for this segment of the Commission workforce should be instituted. Training and development needs may be identified through performance evaluations, quality assurance processes, benchmarking with other agencies, or entity goals and objectives. Training and development plans should be aligned with entity goals and strategic direction.

Management's Response:

Training has been offered to all employees based on timely topics, such as workplace violence, new notary laws, work and family issues, etc. and courses that were job related. The primary method used to identify training needed for personnel to ultimately enhance the agency's strengths, is the utilization of feedback from employees and supervisors. Surveys and employee evaluations are sources currently used to gain such feedback.

The agency will attempt to contact other state agencies to determine if there are additional ways in which to effectively identify internal training needs.

Section 2-E:

Improve Performance Measurement and Test Documentation in the Human Resources Department

Additional processes within Human Resources need improvement. Improving these processes will allow Human Resources to make better staffing decisions and more effectively measure the achievement of goals and objectives:

- Human Resources has not developed internal performance measures for the purpose of tracking departmental results; however, it has developed an action plan. The Internal Audit Department recommended that Human Resources consider using a labor hour tracking sheet to document staff hours expended on various human resources-related work (#HRD 97-1, dated September 4, 1997). Human Resources has not fully implemented this recommendation.

  Development of performance measures is necessary to monitor the achievement of the goals and objectives established as part of the strategic planning process. By not developing performance measures, Human Resources increases the risk that it will not effectively monitor its performance and achieve desired results.

- It is not easy to identify some of the positions that require testing. Positions requiring tests are not adequately documented to ensure continuity in the hiring process. The risk of not having these positions documented is that in the event of unforeseen turnover in Human Resources, there may be an inconsistency in testing applicants. Complete, documented procedures will ensure an effective process for screening and selecting staff.

<u>Recommendation</u>:

- Human Resources should develop performance measures for inclusion in its action plan. It should continue tracking data recommended by the Internal Audit Department. The *Human Resources Self-Assessment Guide* (SAO Report No. 98-025, February 1998) contains several suggested measures for use by human resources departments. This can be accessed through the State Auditor's website at <u>www.sao.state.tx.us</u>.

- Human Resources should ensure that procedures are completely documented for screening and selecting staff by documenting positions that require testing. This can be accomplished by noting that testing is required in the job postings.

Management's Response:

The labor tracking sheet proposed by the internal auditor was utilized for a short period of time and was recently revised to more accurately track human resource management performance measures identified in a report recently published by the Texas State Auditor's Office. The labor tracking sheet will be maintained and monitored by all personnel, including training staff, to specifically address performance measures relating to the department.

We will implement a procedure for documenting jobs requiring tests.

Section 2-F:

Improve Operations of the Internal Audit Department

It appears that the controls in the Internal Audit Department (Internal Audit) exist to allow it to accomplish its goals and objectives. However, several areas for improvement were noted. Correcting these areas will make Internal Audit more effective in accomplishing its goals.

- Internal Audit does not perform yearly risk assessments, nor does it annually assess and update its existing risk assessment. The risk assessment currently being used was created in 1994. There has been no update or formal review of this risk assessment, although Internal Audit stated that it informally reviews the risk assessment. Internal Audit uses a four-year risk assessment model. *The Standards for the Professional Practice of Internal Auditing* state that risk assessment is a process that is crucial to the development of effective audit work schedules. Without consistent identification of risks, it is possible that new risks to the Commission will not be detected and properly addressed. Additionally, factors used in the risk assessment are too vague and not clearly defined. To make the risk assessment more useful, the risk factors should be clearly defined and the methodology behind the different values on the rating scale should also be adequately explained.

- Internal Audit has not implemented two recommendations from the peer review dated January 1996:

  - Internal Audit is not conducting follow-up audits. Follow-up audits should be conducted to help ensure that recommendations have been implemented and controls within the Commission have been strengthened. The current policy in the internal audit manual does not require that follow-ups by the Internal Auditor be documented in the working papers. To be in full compliance with the *Standards for the Professional Practice of Internal Auditing*, follow-up audits should be conducted.

  - Executive management should ensure that the Internal Auditor receives annual evaluations. At the time of the peer review (January 1996) the Internal Audit had not received an annual evaluation; a performance appraisal was not performed until September 1997. It is not clear if the three-member governing board had input on the evaluation. Proper and timely feedback will help to ensure that Internal Audit is performing effectively and efficiently.

- Internal Audit needs to ensure that budget hours are included in the plans submitted for the governing board's approval. Since the governing board is ultimately responsible for Internal Audit, Internal Audit should ensure that the governing board has all necessary information to make effective decisions.

Recommendation:

To improve the operations of the Internal Audit Department, the following should be implemented:

- Internal Audit should either perform a formal risk assessment each year as part of the audit planning process or provide a detailed, documented explanation as to why none of the risk factors in the environment have changed and why the four-year risk assessment is still valid. Internal Audit should also more clearly define the risk factors and the rating scale used in the risk assessment.

- Internal Audit should begin conducting follow-up audits of the work performed. These audits should be documented in the working papers. The follow-up audits can be risk-based using available resources. Executive Management should also continue to ensure that annual evaluations are performed, and that the evaluations contain input from the governing board.

- When submitting the audit plan for approval, Internal Audit should ensure that the estimated budget hours are included.

Management's Response:

Having a one-person internal audit shop affords this department the opportunity to operate a bit more informally than most internal audit departments; consequently, many decisions are made without formally documenting such. While it is true that the risk assessment model, prepared in 1994, has not been formally reviewed or updated, internal audit and management are fully aware of new risks that materialize due to policy/law changes, management philosophy changes and/or newly discovered procedural deficiencies. A good example is the situation involving the unscheduled review of the revenue processing function where an employee claimed that controls and operations were deficient. Internal audit and management made the decision to review the area although it had not been listed on that particular year's audit plan. The flexibility of being able to vary from the audit plan helps ensure that this agency addresses, on an ongoing basis, issues related to risk and/or fraud.

Internal audit will implement a formal policy on reviewing and updating its risk assessment model which will include annual evaluations of the model and the requirement that all changes to the model be documented. Internal audit will also document any justification as to why risk factors may not change from one year to the next. This formal policy will be added to the internal audit procedures manual and become effective no later than May 1, 1998.

We agree that the risk factors used in the internal audit risk assessment model could be more clearly defined and explained. Internal audit will be submitting an amended/updated version of its risk assessment model for management input by May 1, 1998 and using the new model to prepare the 1999 audit plan.

We agree that follow-up audits have not been formally documented. In the future, to better ensure that appropriate action has been taken, internal audit will document follow-ups on audit findings/recommendations.

Internal audit will inform management when an annual evaluation is due and will request that the three-member commission be given the opportunity to provide input into the process.

Beginning in fiscal year 1999, internal audit will include the budgeted hours for audit projects in the annual internal audit plan that is submitted to the three-member commission.

Section 2-G:

Improve Controls Over the Information Resources Department

The Information Resources Department (Information Resources) appears to be operating effectively and supporting the needs of the Commission. Information Resources is currently involved in developing new systems that will enhance the work of the Commission. The following are areas need improvement to continue to ensure that Information Resources will be effective:

- Improve the planning process regarding personnel needs. Information Resources has experienced a 33 percent turnover rate in its programmers in fiscal year 1997. This is an area of concern because Information Resources is currently developing a new purchasing system in-house. The total turnover rate for Information Resources is 37 percent for fiscal year 1997. Turnover is a problem currently faced by many information resources departments in the State of Texas due to the current economy and job market. However, this problem is magnified in a small information resources department, such as the one within the Commission. It is important for Information Resources to continue to plan for the turnover to ensure that it does not impact the effectiveness of the department.

One example of how turnover has affected Information Resources is that currently Information Resources is not able to produce accurate historically underutilized business (HUB) data on a monthly basis. Although various factors contribute to this problem, one factor is that experienced personnel have left and Information Resources is having problems extracting and collating data from the various databases.

- Information Resources has not formalized or implemented its testing processes regarding the Commission's business resumption (disaster recovery) plan for catastrophic disasters. Information Resources currently relies on actual disasters to test its plan. Testing is important to ensure that the plan works in the event of a disaster.

- The process used to review computer access needs improvement. No instances were noted where there was inappropriate access; however, the process should be improved to ensure that only appropriate personnel have access to various computer systems. Currently, Information Resources delivers reports to each manager that identify all users and user access of personnel from their particular department. However, Information Resources does not require verification of information from the managers. It relies on notification from the managers if they identify a concern. Information Resources should require all managers to formally respond to verify the agreement and access of their personnel. This should be done to help ensure that employees do not have inappropriate access to computer systems.

<u>Recommendation</u>:

- Information Resources should increase its focus on the technical personnel issue when planning for its future. This could include using non-expert staff to accomplish goals while being supported by outside vendors, analysis of incentives to ensure technical personnel retention, and consulting with other agencies (including the Department of Information Resources) to obtain ideas regarding this issue. Additionally, Information Resources should identify the problems associated with the HUB reports and develop and implement methods to correct the problem.

- Perform actual test or simulations of disasters based on risk factors such as risk of occurrence of a particular disaster or negative impact of a disaster.

- Require each manager to verify that their user lists are appropriate and return a signed confirmation to Information Resources.

<u>Management's Response</u>:

The department recognizes the problem of employee turnover and has been actively working with executive management to pursue monetary incentives for IR technical *staff that will improve retention. In addition, the department has recently added a non-technical employee from another department as part of an apprenticeship program to develop in-house technical career opportunities. The agency also plans to increase the level of awareness concerning the recruitment and retention of IR technical personnel by monitoring the successes of other state agencies.*

The department has been working to identify the source of the problem with the HUB report and will either fix the defect or develop an alternative working solution.

The department recognizes the importance of disaster recovery testing and plans to schedule a test of our plan prior to the end of the fiscal year.

The department agrees with this recommendation and has already implemented a change in procedure requiring that all department directors acknowledge, by their signature, the verification of the access control list for the systems under their control.

Issue For Further Study:

Conduct a Study to Determine How Much Additional Revenue Could Be Earned From Taxing Cigarettes Imported From Mexico

Additional revenue could be earned by taxing all cigarettes coming across the Mexican border. Collecting additional revenue would require a change to the Tax Code. Preliminary estimates indicate that if 5 of every 10 estimated smokers cross the border with a tax-free carton of cigarettes, additional annual revenue of $17 million could be earned. Alternatively, if an administrative fee of $.50 were charged on cigarettes, and 5 of every 10 estimated smokers crossed the border with a tax-free carton of cigarettes, additional annual revenue of $2 million could be earned.

Currently travelers are allowed to bring one carton of cigarettes per day per person across the border free of tax. The second and all subsequent cartons are taxed $.41 per cigarette pack, or $4.10 per carton. Over the past three years, the Commission has not collected more than $6,000 per year on the second carton of cigarettes. This indicates that the majority of the travelers crossing the border only bring one carton of cigarettes.

Data does not exist to show exactly how many travelers cross the border with a tax-free carton each year. To provide an estimate of possible revenue, several assumptions were made to predict the number of persons crossing the border with cigarettes. These assumptions were based on actual border crossing figures obtained from the U.S. port authority.

Taking into account several factors, such as the percentage of adults in Texas and the percentage of smokers in Texas, over 8 million smokers are estimated to cross the border each year. However, factors such as the exchange rate, economic conditions in Texas and Mexico, law of diminishing return, and possible changes to federal law were not included in the assumptions. The assumptions also do not consider the number of cigarettes brought across the Mexican border by non-smokers for smokers. Appendix 4 details factors that could affect the estimates.

Table 2 illustrates scenarios of annual revenue available for the State beginning with the assumption that 5 of every 10 estimated smokers will cross the Mexican border with a carton of cigarettes.

Table 2

Percentage of Smokers who Cross the Border With One Cigarette Carton	Estimated Number of Cigarette Cartons Crossing the State's Port of Entry Tax-Free (all numbers are in millions)	Tax Per Carton	Estimated Additional Revenue Based on the Percentage of Persons Crossing (all numbers are in millions)
50%	4.1	$4.10	$17.0
25%	2.1	$4.10	$ 8.5
15%	1.2	$4.10	$ 5.1
10%	0.8	$4.10	$ 3.4
5%	0.4	$4.10	$ 1.7

See Appendix 4 for methodology used to estimate number of smokers.

Chapter 154, Subsection 24 of the Tax Code currently allows the untaxed cigarette carton. This section states "a person who imports and personally transports 200 or fewer cigarettes into the state is not required to pay the tax imposed by this chapter if the person uses the cigarettes and does not sell them or offer them for sale."

Several factors exist that could make increasing the tax less beneficial than predicted. For example, an increase in total full-time equivalent employees may be necessary to fully implement this recommendation. There is also a concern that there will be an increase in the lines at the ports if all persons must pay taxes on cigarette cartons. Because of the increase in taxes, there may be a decrease in the number of persons crossing the border with cigarettes. Also, the revenue stream may exist for several years and then experience a steady decrease. Finally, certain international policies may be affected and should be considered.

Recommendation:

The Commission should perform a pilot study for three months to determine the number of persons crossing the border with a tax-free carton of cigarettes. The information collected from the pilot should be provided to all affected parties and should be used to estimate the revenue for the State. Information should be provided to 76th Legislation for consideration.

Management's Response:

Since the taxing authority for tobacco products is the Office of the Comptroller of Public Accounts, any recommendations for changes in the taxing structure should be made by and to that agency. The TABC would be pleased to cooperate with any pilot study which the Office of the Comptroller might wish to undertake regarding additional revenues which might be generated from the elimination of the personal exemption.

Appendix 1:

Objectives, Scope, and Methodology

Objectives

Our audit objectives were to evaluate the management control systems within the Alcoholic Beverage Commission and to identify strengths and opportunities for improvement. We evaluated whether certain control systems are providing reasonable assurance that the Commission's goals and objectives will be accomplished. The audit evaluated control systems in place during fiscal year 1997.

Management controls are policies, procedures, and processes used to carry out an organization's objectives. They should provide reasonable assurance that:

- Goals are met.
- Assets are safeguarded and efficiently used.
- Reliable data is reported.
- Laws and regulations are complied with.

Management controls, no matter how well designed and implemented, can only provide reasonable assurance that objectives will be achieved. Breakdowns can occur because of human failure, circumvention of control by collusion, and the ability of management to override control systems.

Scope

The scope of this audit included consideration of selected management control systems involved in policy management, information management, resource management, and performance management.

Consideration of the Commission's policy management systems included a review of:

- Processes used to create and monitor Commission strategic and operating plans
- Processes used to create, monitor, and revise Commission budgets
- Processes used to evaluate and implement changes to the organization's structure
- General processes used to establish and revise the Commission's policies and procedures
- Processes used to select, train, evaluate performance, and compensate Commission employees

Consideration of the Commission's performance management systems included a review of:

- Processes used to track and use performance measures
- Processes used to evaluate programs and to ensure quality products and services

Consideration of the Commission's information management systems included a review of:

- Processes for identifying, collecting, classifying, evaluating, maintaining, and updating information
- Existing management reports
- Timeliness, accuracy, and availability of information
- Maintenance and protection of computers and computer applications

Consideration of the Commission's resource management systems included a review of:

- Processes used to control the Commission's cash
- Processes used to ensure proper management of the Commission's fleet
- Revenue and tax identification and collection processes
- General processes used to ensure proper management of inventory
- General processes used to ensure proper management of fixed assets
- General processes used to manage the Commission's plant and other assets

Methodology

The audit methodology consisted of gaining an understanding of selected control systems. In specific areas, tests were performed to determine if the control systems were operating as described. Finally, the results were evaluated against established criteria to determine the adequacy of the system and to identify opportunities for improvement.

An understanding of the control system was gained through interviews with the Administrator, management, and staff. Written questionnaires and reviews of Commission documents were also used to gain an understanding of the control systems in place. Control system testing was conducted by comparing the described and actual processes. Testing methods primarily consisted of document analysis, process and resource observation, financial analyses, and selection and testing of random samples.

The following criteria were used to evaluate the control systems:

- Statutory requirements
- Commission policies and procedures
- General and specific criteria developed by the State Auditor's Office Assessing Risk in Key Accountability Systems Project
- State Auditor's Office Project Manual System: The Methodology
- Other standards and criteria developed through secondary research sources, both prior to and during fieldwork

Fieldwork was conducted from November 1997 to January 1998. The audit was conducted in accordance with applicable professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

The following members of the State Auditor's staff performed the audit work:

- Verma Elliott, MBA (Project Manager)
- Thomas Brannom, CPA, CGFM
- Amy Dingler, M.P.Aff
- Ann Heubner, CGFM
- Carmelita Lacar, Ph.D.
- Gary Leach, CQA, MBA
- Abayomi Owolabi, MBA
- Juan Sanchez, MPA
- Worth Ferguson, CPA (Quality Control)
- Barnie Gilmore, CPA (Audit Manager)
- Craig Kinton, CPA (Audit Director)

Appendix 2:

Alcoholic Beverage Commission Profile

Mission

The mission of the Alcoholic Beverage Commission is to supervise and regulate all phases of the alcoholic Beverage industry to ensure the protection of the welfare, health, peace, temperance, and safety of the people of Texas, while facilitating fairness and balanced competition.

Background

The Alcoholic Beverage Code authorizes the Alcoholic Beverage Commission to:

- Grant, refuse, suspend, or cancel permits and licenses in all phases of the alcoholic beverage industry.
- Supervise, inspect, and regulate the manufacturing, importation, exportation, transportation, sale, storage, distribution, and possession of alcoholic beverages.
- Assess and collect fees and taxes.
- Investigate for violations of the Alcoholic Beverage Code and assist in the prosecution of violators.
- Seize illicit beverages.
- Adopt standards of quality and approve labels and size of containers for all alcoholic beverages sold in Texas.
- Pass rules to assist the Commission in all of the above.

In prior years bingo, administrative hearings for permittees, and collection and verification of mixed beverage tax were the responsibility of the Commission. However, all of these functions have since been transferred to other agencies.

Operations

The Commission's three-member governing board adopts rules necessary to carry out the responsibilities of the agency. The Governor, with the advice and consent of the Senate, appoints the members. Members hold six-year staggered terms, with the term of one member expiring every two years. The governing board meets monthly to render decisions concerning matters within its jurisdiction. The governing board also appoints the Administrator, who is the head of the agency and is responsible for employing the necessary staff to ensure that the policies established by the governing board and the laws enacted by the Legislature are implemented in an efficient and cost- effective manner.

The Alcoholic Beverage Commission is organized into three major divisions: Enforcement and Marketing Practices, License and Compliance, and Resource management.

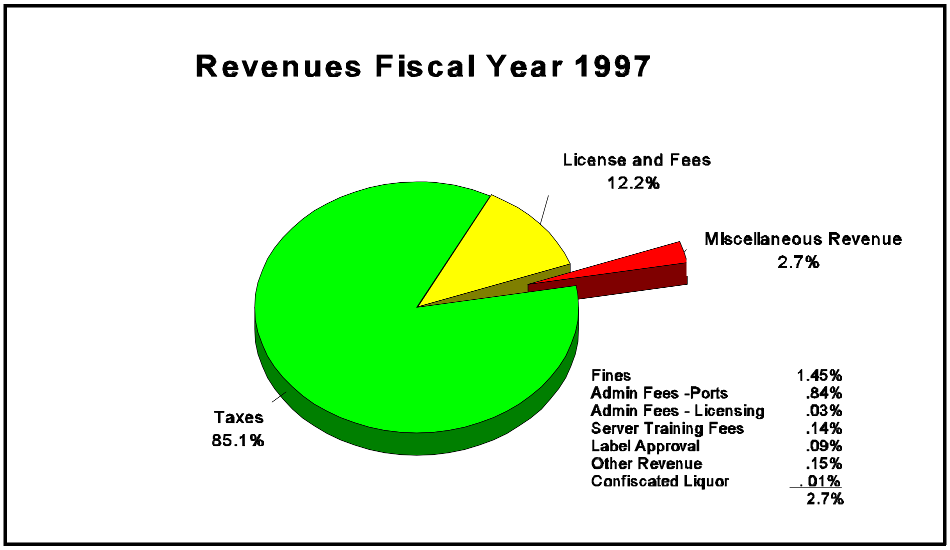
The Enforcement Division is the Commission's largest and most visible operating unit and is responsible for the criminal and administrative enforcement of the State's alcoholic beverage laws. The Licensing Department processes applications for all phases of the alcoholic beverage industry involving the manufacture, sale, purchase, transportation, storage, and distribution of alcoholic beverages. The Compliance Department conducts inspections, fee analyses and regulatory assignments to ensure adherence with the Alcoholic Beverage Code. The Resource Management Division includes four departments; Fiscal Services, Information Resources, General Services, and Human Resources.

Appendix 3:

Financial Information

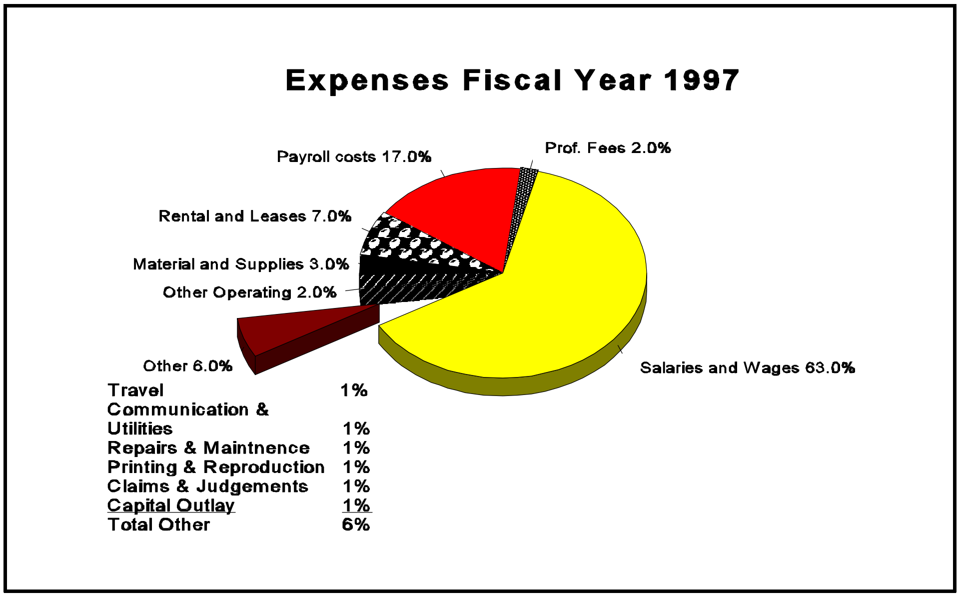
The Alcoholic Beverage Commission had revenues totaling $172 million in fiscal year 1997. The largest source of revenue was from taxes (85.1 percent). Licenses and fees were the second largest revenue producer (12.2 percent). Expenditures totaled $25 million in fiscal year 1997. Salaries and wages accounted for the largest portion of total expenditures (63 percent).

Figure 1



Source: Alcoholic Beverage Commission's Annual Financial Report

Figure 2



Source: Alcoholic Beverage Commission's Annual Financial Report

Appendix 4:

Cigarette Tax Revenue Assumptions

This appendix presents a brief summary of how the number of smokers crossing the border was estimated. It also presents factors that could affect the potential revenue realized by the state if all cigarette cartons crossing the Mexican border are taxed. The revenue estimates indicate a need for a study to determine, based on actual observation, the number of travelers that cross the border with a tax-free carton of cigarettes.

Table 3

Estimation for Smokers Crossing the Border and Potential Revenue		
Assumptions for determining how many smokers will cross the border annually with one carton of cigarettes.		
Row	**Assumption**	**Result**
1	Total persons annually crossing the border from Mexico to Texas excluding trucks	48,089,328
2	Percentage of Texans who are 18 years older according to the U.S. Census Bureau	71.5%
3	Estimated number of adults who cross the border from Mexico to Texas annually (Row 1 multiplied by Row 2)	34,379,061
4	Percentage of Texans who are smokers according to *Morbidity and Mortality Weekly Report*	23.7%
5	Number of adult smokers estimated to cross the border from Mexico to Texas annually (Row 3 multiplied by Row 4)	8,250,975
6	Number of adult smokers estimated to cross the border from Mexico assuming that 5 of every 10 smokers will cross the border annually with one carton of cigarettes (Row 5 divided by 2)	4,125,488

Based on the assumptions in Table 3, Table 4 shows the estimated annual revenue for assessing a tax on all cigarettes imported from Mexico.

Table 4

Percentage of Adult Smokers Estimated to Cross the Border	Smokers Crossing Border (all numbers are in millions)	Tax	Additional Revenue (all numbers are in millions)
50%	4.1	$4.10	$17.0
40%	3.3	$4.10	$13.5
30%	2.5	$4.10	$10.1
25%	2.1	$4.10	$ 8.5
15%	1.2	$4.10	$ 5.1
10%	0.8	$4.10	$ 3.4
5%	0.4	$4.10	$ 1.7

Based on the assumptions in Table 3, Table 5 shows the estimated annual revenue for assessing an administrative fee of $.50 on all cigarettes imported from Mexico.

Table 5

Percentage of Adult Smokers Estimated to Cross the Border	Smokers Crossing Border (all numbers are in millions)	Fee	Additional Revenue (all numbers are in millions)
50%	4.1	$.50	$2.1
40%	3.3	$.50	$1.7
30%	2.5	$.50	$1.2
25%	2.1	$.50	$1.0
15%	1.2	$.50	$06
10%	0.8	$.50	$0.4
5%	0.4	$.50	$0.2

Factors Affecting Taxing all Cigarettes Imported Across the Border

The following are some benefits to the State and factors that support taxing all imported cigarettes:

- Possible increased revenue for the State will be generated from imported cigarette cartons taxed at border crossings.
- Possible increased tax revenue for the State if smokers discontinue purchases in Mexico and purchase cigarettes in Texas.

- The Federal Government is considering raising the federal tax on cigarettes. This could make importing cigarettes more attractive.

The following are some factors that could make increasing the tax less beneficial than predicted.

- Additional full-time equivalent employees may be needed to implement the change.

- Lines at the ports could increase causing time delays for travelers.

- Because of the tax, there may be a decrease in the number of people who cross the border with cigarettes.

- The increased revenue collected at the Mexican border from the tax on cigarette cartons may decrease as time progresses.
- International policies may be affected.

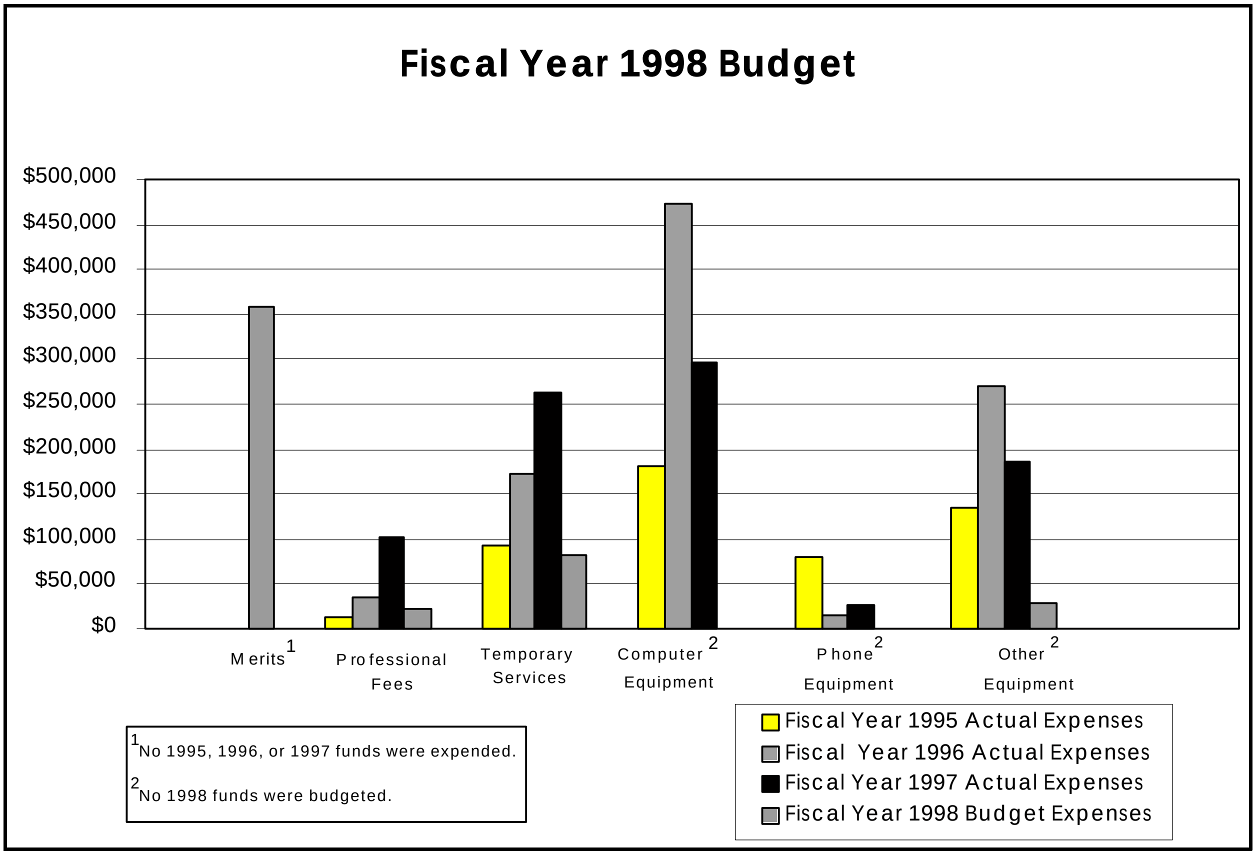
- Factors, such as the exchange rate, were not included in the assumptions used to estimate the potential revenue and may cause a change in the revenue estimates.

Appendix 5:

Fiscal Year 1998 Budget

Figure 3 depicts the actual expenses for the past three years relative to the budgeted projections for fiscal year 1998. This shows that the budgeted amounts are not in line with past expenditures.

Figure 3



Source: Alcoholic Beverage Commission's Budgets

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