December 27, 2017

Alexis Podesta, Secretary
California Business, Consumer Services and Housing Agency
915 Capitol Mall, Suite 350-A
Sacramento, CA 95814

Dear Ms. Alexis Podesta,

In accordance with the State Leadership Accountability Act (SLAA), the Department of Alcoholic Beverage Control submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2017.

Should you have any questions please contact Randy Deems, Division Chief, Headquarters, at (916) 419-2511, randall.deems@abc.ca.gov.

BACKGROUND

Upon the repeal of Prohibition in 1933 and the return of the legal sale of alcoholic beverages in California, taxation and regulation of the manufacture, distribution, and sale of alcoholic beverages were given to the State Board of Equalization. In 1955, an amendment to the State Constitution removed the authority from the State Board of Equalization and placed it under the newly created Department of Alcoholic Beverage Control.

California Constitution, Article XX, Section 22, vests the Department of Alcoholic Beverage Control (ABC) with the exclusive right and power to license and regulate the manufacture, importation, and sale of alcoholic beverages within the State.

The ABC is currently authorized approximately 450 position and is organized in three major divisions and twenty-four district offices to meet its constitutional mandate.

The mission of the ABC is to administer the provisions of the Alcoholic Beverage Control Act in a manner that fosters and protects the health, safety, welfare, and economic well-being of the people of the State.

ONGOING MONITORING

As the head of Department of Alcoholic Beverage Control, Jacob Appelsmith, Director, is responsible for the overall establishment and maintenance of the internal control and monitoring systems.

EXECUTIVE MONITORING SPONSOR(S)

The executive monitoring sponsor responsibilities include facilitating and verifying that the Department of Alcoholic Beverage Control internal control monitoring practices are implemented and functioning as intended. The responsibilities as the executive monitoring sponsor(s) have been given to: Randy Deems, Division Chief, Headquarters.

MONITORING ACTIVITIES

ABC uses a variety of performance indicators to evaluate performance and identify emerging risks. These include:
• Workload summary reports that indicate the volume of licensing transactions and enforcement actions and illustrate the volume of pending actions at the end of each month, which help management identify performance or capacity issues.
• Annual district office reviews, which are performed by Deputy Division Chiefs, to review the various operational and performance metrics related to each district office.
• Daily transaction reports to reconcile the work performed with the revenue collected.
• Periodic scans and reviews of information security by both internal and external information security experts.
• Various annual surveys to management and staff regarding work environment, service level of centralized functions, and solicitations for program or resource improvements.
• Monthly performance reports that compare actual performance to stated goals (e.g. what percentage of license applications are processed with target time periods).
• Monthly financial reconciliations.
• Monthly executive meetings are used to identify and discuss issues including those related to internal controls.

**Addressing Vulnerabilities**

Once vulnerabilities are identified, assignments are made to the appropriate parties in order to either eliminate or mitigate the risk identified. Depending on the severity and scope of the issue, the monitoring of the actions may remain within a particular chain of command, be shared with the executive staff, or even the entire department. In some cases, ongoing monitoring reports will be produced and institutionalized as part of the ongoing operation. Examples of these processes include:

• The information technology governance process where system users identify issues and they are prioritized, put in to the queue to be addressed, and then completed in order of priority.
• The tracking of the mitigation of information security audit and management review findings.

**Communication**

ABC has created a reporting portal for its primary computer system. This portal allows authorized users to view various workload and performance reports, which allows ABC management to monitor the operation and identify existing or emerging issues.

ABC has several processes for the review and approval of changes to the department operations and controls, including: a policy and form management process which requires the affected business units and all key executive staff to sign off. This process also applies to changes in general orders, and policy manuals.

ABC has a variety of different monthly management reports regarding workload in district offices, financial management, and human resources issues. Tracking of SLAA related efforts is also shared.

**Ongoing Monitoring Compliance**

The Department of Alcoholic Beverage Control is in the process of implementing and documenting the ongoing monitoring processes as outlined in the monitoring requirements of California Government Code sections 13400-13407. These processes include reviews, evaluations, and improvements to the Department of Alcoholic Beverage Control systems of controls and monitoring.
RISK ASSESSMENT PROCESS

The following personnel were involved in the Department of Alcoholic Beverage Control risk assessment process: Executive Management, Middle Management, Front Line Management, and Staff.

Risk Identification
Risks are identified in several ways:

1. The SLAA process is used to identify the department’s most critical risks.
2. Program risks associated with ABC’s information technology applications are identified through two primary methods - the reporting of issues to the Information Technology Branch (ITB) and the interactive process facilitated by ITB management to proactively identify issues and prioritize them.
3. Periodic audits have been used to identify risks and weaknesses of information security practices.
4. ABC’s annual budget development process includes an assessment of the department’s risks and the need for resources to address them.
5. Daily and monthly financial reconciliations are used to identify mistakes and control against fraud, particularly in the area of handling revenue.
6. ABC uses a public complaint process to identify issues with both licensees and ABC’s staff interaction with the public.

Risk Ranking
The method of ranking risks varies across the different processes for identifying them. There is not one standard process for ranking risks. In general, risks are ranked and mitigations are prioritized based on the following:

- Financial impact
- Reputational impact
- Alignment to the department’s strategic initiatives
- Potential for increased efficiency
- Estimated likelihood and frequency of occurrence

RISKS AND CONTROLS

Risk: Operations - Internal Organizational Structure
Over the next several years the labor supply for ABC’s program management positions will be at risk of having limited experience in ABC’s licensing program and the quality and consistency of operational and policy decision making in ABC’s district offices would decline significantly.

Prior to the 1990’s both of ABC’s primary programs (licensing and compliance) were staffed by sworn peace officers. As a result, all management positions from first line supervision to executives were sworn staff. In the 1990’s a shift was made to move the licensing work to non-sworn positions and through attrition the number of ABC Agents was reduced. As this practice continued, the front line supervisors were also converted to non-sworn positions. Currently, there are only three district offices where sworn managers are supervising the non-sworn licensing staff. The supervisors over the licensing units in each of the district offices report to a supervising agent-in-charge (SAC), who manages the entire district office. Over the last ten years, the number of SACs that have licensing experience has steadily declined and it is anticipated that
in the next several years there will be very few that have hands-on licensing experience.

This organizational shift at ABC has been called "bifurcation" and is intended to decrease costs, increase the alignment of people and jobs. For example, the skill sets related to being a strong manager of a law enforcement program may be different than those which would be prioritized in the selection of a manager of a licensing program. The vision of bifurcation was to create two distinct programs, staffed efficiently, avoid using peace officers for work that does not require peace officer authority, and create a longer career path for non-sworn employees allowing for the development of licensing program expertise at all levels.

The current risk is caused by lack of ability to continue bifurcation through attrition. It is critical that ABC has second-level sworn managers in each of the existing jurisdictions.

As ABC’s SAC positions are increasingly held by managers who have never performed licensing work or supervised the licensing program, the depth of licensing expertise stops at the first level manager in district offices. As a result all licensing issues that are typically escalated beyond he front line manager are going to be addressed by a management chain who may have less experience in the program than the front line staff and supervisor. This lack of experience and expertise in the licensing program can result in poor decision making, mistakes that complicate enforcement, increased community dissatisfaction with the department, and considerable inefficiency and delays in issuance as the need for consultation and research will increase considerably.

**Control A**

ABC proposes to control for this risk by pursuing organizational changes to complete the bifurcation process. ABC will pursue opportunities to implement a reorganization that facilitates the development of a licensing program staffed with experienced program experts and managers that will effectively engage in all levels of decision making related to licensing - from overall licensing program policy to the maintenance and communication of policies and procedures to all district offices statewide. This reorganization would seek to establish an executive level position in the licensing program and provide capacity to develop and leverage program expertise to make decisions that rise above the front-line supervisory level.

**Risk: Operations - Internal Staff — Training, Knowledge, Competence**

There is a risk that the public may experience a problematic level of inconsistency in service and decision making in ABC's licensing program.

Increases in the volume and complexity of licensing workload has required an increased dedication of licensing staff to the daily transactional workload and a decrease in capacity to perform important tasks to ensure the consistency of the program across all programs. This risk is compounded by staff turnover, which decreases the capacity to mitigate the risk through on the job training by peers or front line supervisors and the decrease in the amount of district offices managed by those with licensing experience.

The current situation results in complaints from the industry and the public about inconsistency between district offices regarding the treatment of similar issues. Further, the lack of resources to create an appropriate statewide training program for the licensing program increases the likelihood of mistakes and can create delays in the issuance of licenses due to the need to escalate and research licensing issues.

**Control A**

ABC proposes to identify resources that can be used to create capacity to perform the licensing program policy and training function. The establishment of resources to perform this function will:
• Ensure that policies and procedures are kept up to date for changes in statute, case law, and the industry and that updates to policy and procedures
• Serve to provide technical assistance and in person training to licensing staff as needed and would ensure that policy decisions that are made for new situations are distributed to all licensing staff to ensure consistency
• Ensure licensing policy and program information is effectively communicated statewide to all district offices through the use of online documentation and training
• Develop expertise, training, and the capacity to provide technical assistance for non-retail licensing, which is an area of the licensing program that has high complexity and high economic impact on the licensee if there is an error on ABC’s part.

Risk: Operations - Internal - Fi$Cal Implementation, Maintenance, or Functionality

There is a risk that ABC will continue to experience delays in completing month-end closing processes and its annual financial statements and that accounting work may not be complete and accurate enough to provide effective management reports for the financial management of ABC.

Increased level of detail in budget and accounting processes under the Fi$Cal system (moving from appropriation level to line item) has significantly increased workload in budget and accounting for the development and administration of the ABC budget and preparation of accounting reports. Further, Fi$Cal-driven changes to the procurement and revolving fund processes have significantly increased the workload involved in performing these tasks. Over the last three years since ABC migrated to Fi$Cal, accounting staff have been significantly behind in completing required financial reporting. As a result, ABC has had to accept the fact that individual transactions or account level data may be incorrect or not properly accounted for to facilitate proper management reporting, and instead focus on closing the books at the highest level. ABC’s experienced significant turnover (the loss of its three most senior staff, including both supervisors) during the 2017-18 fiscal year.

If ABC accounting staff continues to lack the capacity to perform accurate work at the lower level of detail and does not have the capacity to fully utilize the functionality of fiscal - such as internal budgeting, ABC faces the following potential consequences:

• Inability to produce timely and accurate financial management reports
• Increased risk of over-expenditure due to limited ability to project expenditures and control internal budgets
• Inaccurate accounting and reporting of the ABC fund
• Continued turnover of critical staff
• Increased risk of insufficient controls against fraud

Control A

ABC will continue to redirect resources to perform internal budgeting and expenditure projection outside of Fi$Cal using various parallel processes and data sources in combination with Fi$Cal reports. ABC will continue to strive to catch up on its month-end closings so staff can begin to look at ways to improve the accuracy of the accounting information through comprehensive monthly reconciliations and the reorganization of ABC’s internal budgeting and expenditure classification processes, which span the procurement, accounting, and budget functions. ABC will continue to pursue opportunities to identify additional resources to fully implement this control.

Risk: Operations - Internal - Staff — Key Person Dependence, Workforce Planning

There is a risk that the loss of key employees could create significant operational risks to ABC.
Within the next five years, the Department risks losing 25 percent of its Agents through peace officer retirement. In addition, 75 percent of its Deputy Division Chiefs and 50 percent of Supervising Agents in Charge are eligible to retire within the next five years, creating a significant loss of institutional knowledge. Although this is a common problem among state departments, it is more acute at ABC because the vast majority of the management staff are eligible for peace officer retirement at the age of 50.

Further, there are a few key positions where critical expertise is concentrated in just one position, including ABC’s General Counsel and the department’s Fiscal Officer. These key person dependencies occur partly as a result of the size of the organization and the difficulty in securing resources to provide effective backup and support for these functions.

As noted elsewhere in this report, ABC’s expertise in handling the more complex and sensitive licensing issues resides in the senior management of the field divisions. Of these positions, over 50 percent are within five years of retirement age. As these leaders retire, ABC will see a significant drop in institutional knowledge, especially as it relates to the Licensing program. This loss of knowledge could lead to significantly greater challenge in establishing a formal licensing program (updating policies and procedures, creating training, etc.) to drive statewide consistency. Further, if ABC’s leadership team is considerably less experienced, the industry and the public is more likely to observe inconsistency in the implementation of ABC’s programs from one jurisdiction to another.

In the key positions of General Counsel and the Fiscal Officer, ABC is at risk of losing expertise that would be very difficult to replace and for which there could be significant consequences. The General Counsel is the Director’s sole legal advisor on administrative cases that the department brings against licensees. This role drives the incumbent to have a very thorough knowledge of all aspects of the ABC Act because they are called upon to provide technical assistance and advice in all areas of the Act. In the case of the Fiscal Officer, the incumbent spends the vast majority of their time doing associate level staff work because ABC does not have staff capacity at that level. In addition to this workload the incumbent also applies a very thorough and extensive knowledge of accounting to assist ABC in developing ways to operate effectively within the new FI$Cal system. There is a significant chance that ABC will not be able to find an equally qualified candidate should the incumbent leave. If ABC does not find a comparable replacement, there is a significant risk that ABC would quickly move backward in its efforts to become current and improve the accounting and budgeting processes at ABC.

Control A
ABC will work to develop an effective succession plan for its key leadership positions. This program may include components such as leadership training, mentoring, and rotational assignments in order to increase the breadth and depth of experience for future leaders.

Control B
To address the more acute key staff dependencies will attempt to implement the following controls:

- Increase the exposure of other staff to the functions performed by these key staff through rotational opportunities, increased resources for the function, or providing temporary assignments to other staff that allow them to be more familiar with the work performed.
- Improve the documentation of processes and decision making of the incumbents so that the value of their expertise can be institutionalized and assist in any future transition to new staff in these roles.
CONCLUSION

The Department of Alcoholic Beverage Control strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising controls to prevent those risks from happening. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

Jacob Appelsmith, Director

CC: California Legislature [Senate (2), Assembly (1)]
  California State Auditor
  California State Library
  California State Controller
  Director of California Department of Finance
  Secretary of California Government Operations Agency