SUNSET AUDIT REPORT

Department of Revenue

Division of Alcoholic Beverage Control

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
December 1982

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SUNSET AUDIT REPORT

DEPARTMENT OF REVENUE

DIVISION OF ALCOHOLIC BEVERAGE CONTROL

December 1, 1982

Legislative Division of Post Audit
State of Kansas
Topeka

FOREWORD

Liquor regulation in Kansas is designed to serve three purposes: to foster temperance, to provide an orderly market for the sale and distribution of alcoholic beverages, and to raise liquor tax revenues. This sunset performance audit showed that the regulatory program administered by the Division of Alcoholic Beverage Control to meet these objectives is one of the most restrictive in the country, primarily because of statutes and regulations that restrict liquor-related business operations.

Many aspects of regulation appear to be unnecessarily restrictive, serve to protect the industry from competition, or have little bearing on the protection of the public. These include strict residency requirements for licensees, prohibitions against advertising, restrictions on retail sales and credit practices and deliveries of alcohol, and minimum retail mark-ups of alcoholic beverage prices. Of these, retail price controls have the greatest impact on the consumer and the State. Retail liquor price controls exist in only two other states besides Kansas, and are primarily responsible for the State's liquor prices being among the highest in the nation. As a result, Kansas consumers may be paying several million dollars more each year for the liquor they buy. The auditors also determined that the State may have lost as much as $800,000 in liquor tax revenues in 1981 because higher retail prices here encouraged liquor purchases across the border. There was little evidence that retail price maintenance helps curb alcohol abuse or otherwise protect the public's interest.

The audit recommends that the Legislature review and consider eliminating restrictions in each of these areas. If retail liquor price controls are lifted, they should be phased-out gradually to help ensure greater market stability during the transition period.

The audit also identifies several areas where improvements are needed in the Division's administration of the regulatory program. The major findings relate to reciprocal agreements and inspection activities.

Regarding reciprocal agreements, the auditors found that some private clubs are able to circumvent the statutory minimum food sales requirement needed for reciprocal status. They are able to do so primarily because of the Department's lenient eligibility requirements and because of loopholes in the law that allow them to re-incorporate as a "new" club and gain a year's grace period in meeting the statutory minimum. Regarding inspections, the auditors found that routine inspections of private clubs and retail liquor stores are largely ineffective in identifying serious violations, such as sales to minors. They focus primarily on minor administrative compliance matters, and are generally conducted during the daytime, when serious violations are less likely to occur. Further, the auditors found wide variations in the number of violations cited per licensee in different areas of the State. On the whole, such problems may be indicative of a lack of

supervision and quality control over these activities. The audit makes recommendations in these and other areas to improve the regulatory program's efficiency and effectiveness and to ensure that enforcement measures are applied fairly and consistently.

At the direction of the Legislative Post Audit Committee, this audit also examined the collection and enforcement of the liquor excise tax. This issue heated up during the 1982 legislative session, when the Director of Alcoholic Beverage Control projected that liquor excise tax revenues for fiscal year 1981 should have been $11.4 million, but only $6.8 million was collected, a difference of $4.6 million.

Based on the auditors' review of the Division's method of estimating the excise taxes owed, Legislative Post Audit concluded that those estimates appear to have been overstated. Initial audits of private clubs show some taxable liquor sales are not being reported, but nowhere near the magnitude suggested by the Division's estimate. The tax auditors hired in 1982 to audit liquor excise tax collections in private clubs will need to complete a full round of audits before definitive conclusions can be reached. The audit recommends that once these audits are completed, the Department of Revenue should prepare a revised estimate and submit it to the Legislature for its consideration in judging, among other things, the cost-effectiveness of the new audit program.

All the report's recommendations, together with a brief description of the audits major findings, are presented in the summary that follows this foreword. In its response to the draft report, the Department of Revenue generally agreed with the recommendations calling for a review and revision of statutory and regulatory restrictions. It also generally agreed with all but two of the report's findings about the administration of the regulatory program--one regarding the handling of reciprocal agreements and the other regarding the assessment of inequitable penalties for violations of liquor laws and regulations. Legislative Post Audit maintains that improvements are needed in both areas.

Legislative Post Audit appreciates the courtesy and cooperation extended to the auditors by officials of the Department of Revenue. The audit supervisor was Trudy Racine, and she was assisted by team members Ellyn Rullestad and Dan Walker. Assistance was also provided by other members of the staff.

Richard E. Brown

RICHARD E. BROWN
Legislative Post Auditor

Summary of Matters for Legislative Attention

Audit Findings and Conclusions

This audit of the Department of Revenue's Division of Alcoholic Beverage Control was conducted in conjunction with the Kansas Sunset Law, which abolishes the Department on July 1, 1983, unless it is continued by an act of the Legislature. Audits have also been conducted of the Department's Division of Taxation and Division of Vehicles.

The audit focused on the regulation of retail liquor stores and private clubs. These are the liquor-related businesses that the public has the most contact with. At the direction of the Legislative Post Audit Committee, the audit also examined the liquor excise tax collection and enforcement process.

Alcohol Regulation in Kansas

The auditors concluded that there is a need for the Division to continue regulating alcoholic beverages in Kansas. Alcohol-related health and safety problems can harm Kansas citizens, and violations of State liquor laws and regulations are occurring even with regulation. The auditors could identify no less restrictive mechanism for handling regulation of liquor suppliers, wholesalers, and retailers. They also determined that the benefits of the regulatory program justify its cost, but the regulatory fee structure should be reviewed to determine whether license and permit fees should be increased. Kansas' fees have not been increased in over 30 years, are well below the average for other license states, and do not cover the cost of both the regulatory program and other community alcohol treatment programs funded from those fees.

The auditors also found that several aspects of the regulatory program do not serve to protect the public. These fell into two major categories: statutes and regulations that appear to be designed to benefit or protect the industry and not the public, and Division practices and proce-dures that have hampered the program's effectiveness.

Some statutory restrictions on business operations do not serve to protect the public. A number of regulatory restrictions on the operations of liquor-related businesses apparently serve to protect the industry from

competition, are unnecessarily restrictive, or have little bearing on the protection of the public. The major problem areas can be described briefly as follows:

—**Residency requirements for licensees.** Kansas' one-to-ten year residency requirements for liquor wholesalers, stores, and clubs are stricter than those in all other states the auditors reviewed. They are also inconsistent. For example, individuals who own private clubs must have lived in the State for five years and the county for one, but there are no residency requirements for corporate owners of private clubs. The primary effect of strict residency requirements is to protect the industry from new competition.

—**Regulation of advertising.** Kansas' restrictions on advertising of alcoholic beverages are also among the most restrictive in comparison to other states. Examples of restrictions that appear to have no direct relationship to protecting the public's interest are prohibitions against price and brand name advertising, matchbook cover advertising, the use of dummy display bottles and price tags, and references to certain holidays.

—**Private business practices.** To provide for an "orderly market," regulatory restrictions have been imposed on certain retail sales, on building specifications, on deliveries and transportation of alcohol, and on business credit and the collection of bad checks. The auditors' review of several of these regulations showed that they were designed to protect the industry rather than the public.

—**Minimum retail mark-up of alcoholic beverage prices.** Kansas is one of only three states that have a minimum retail mark-up. The auditors found little evidence that retail price maintenance helps prevent alcohol abuse. They did find, however, that it guarantees retailers a minimum profit, and thus helps to subsidize many small and inefficient retail liquor stores. Minimum mark-ups may also be costing consumers between $2.6 million and $12.0 million more for the liquor they buy in Kansas each year. Further, price controls stimulate out-of-State purchases, and potentially decreased the State's liquor tax revenues in 1981 by an estimated $800,000.

The audit concludes that the Legislature should review and consider eliminating restrictions in each of these areas.

The Division needs to improve its performance in administering several aspects of the regulatory program. The auditors also found that the Division of Alcoholic Beverage Control could improve the regulatory program's effectiveness by altering its practices and procedures for monitoring reciprocal club agreements, conducting inspections and investigations, and assessing the adequacy and consistency of enforcement activities.

Regarding reciprocal agreements, they found that some private clubs were able to operate as "reciprocal" clubs without meeting the statutory minimum food sales requirement. This "loophole" exists because the Division does not independently verify clubs' reciprocal eligibility, has lenient eligibility requirements, and does not require private clubs in hotels and motels to maintain records of food sales separately from those of public restaurants on the same premises.

The inspection and investigation process was hampered because the content and timing of routine inspections were not designed to detect serious violations of State liquor laws and regulations, and because investigative resources were not being used as efficiently as possible. Most of the items checked during routine inspections relate to minor administrative compliance matters, and most such inspections are conducted during "slack" hours and days when violations are less likely to occur. The auditors found that 88 percent of the 668 routine inspections they reviewed took place Mondays through Thursdays, 71 percent of the private club inspections occurred between 1 p.m. and 7 p.m., and 91 percent of the inspections of retail liquor stores took place before 5 p.m.

Enforcement actions are not analyzed to pinpoint areas where enforcement is lacking or inconsistent. The auditors analysis on a geographic basis of citations issued to liquor stores and private clubs revealed a wide disparity per store and per club. For example, in Shawnee County only five citations were issued against the 61 class B clubs located there for the whole of calendar year 1981, while in Wyandotte County 37 citations were issued against 89 stores. Such variations could indicate that enforcement activities are not equally vigorous in all areas of the State. The auditors also found that the penalties being assessed for different types of violations sometimes seemed inequitable, and that the Division sometimes allows penalized retailers and private club owners to choose between a fine and a suspension. Allowing licensees to participate in the penalty-setting process would seem to undermine its deterrent value.

The audit concludes that the Department of Revenue and the Division of Alcoholic Beverage Control could take actions in each of these areas to improve the regulatory program's efficiency, effectiveness, and consistency.

Collection and Enforcement of the Liquor Excise Tax

During the 1982 legislative session, the liquor excise tax was the subject of considerable discussion. According to the Director of Alcoholic Beverage Control, liquor excise tax revenues for fiscal year 1981 were projected to be $11.4 million, but only $6.8 million was collected, a difference of $4.6 million. Legislative Post Audit's examination of the liquor excise tax collection and enforcement process addressed three primary questions: Do collection procedures ensure that delinquent taxes owed on reported liquor sales are paid? Is the Division's estimate of excise

taxes owed but not paid accurate? And do audits of tax collections in private clubs show that clubs are circumventing the tax by not reporting all liquor sales?

The auditors found that most private clubs subject to enforcement action because they are late in paying liquor excise taxes on reported drink sales do eventually pay the taxes they owe. Thus, if the Division's estimate is accurate, the shortfall of tax revenues would apparently have to represent taxes due on unreported sales of alcoholic drinks. For such a shortfall to have occurred, the auditors estimated that each private club in the State would have owed taxes on an additional $39,000 in unreported drink sales in 1981. Their actual reported sales subject to the tax averaged only $58,500 that year.

The amount of liquor excise taxes owed by private clubs is based on the amount of liquor they sell in a year. The Division's method for projecting liquor excise tax revenues relies on an earlier Department of Revenue estimate of the amount of liquor consumed in private clubs in 1978. The auditors used two additional methods for projecting these tax revenues that relied on estimates of the amount of liquor purchased by private clubs for resale to consumers. These estimates came from a recent Department of Revenue survey showing retail liquor sales to private clubs for calendar year 1980, and from the auditors' survey of a sample of retailers, who reported their average sales to clubs for fiscal year 1982. When these figures were "plugged into" the rest of the formula for projecting the excise taxes owed for those two years, the results came much closer to matching actual collections than the Division's estimates. Thus, Legislative Post Audit concluded that the Division's method may be outdated and may be overstating the liquor excise tax revenues owed to the State.

The 1982 Legislature funded seven new auditor positions in the Department to audit liquor excise tax collections in private clubs. Legislative Post Audit reviewed the results of the first 21 audits completed, and conducted its own audits of 10 additional clubs. (One other club denied Legislative Post Audit access to verify its records of gross receipts for liquor and food. This case is currently under litigation.) These audits showed that nine of the 31 clubs apparently owed additional excise taxes on unreported drink sales for fiscal year 1982. One owed an estimated $30,000, and the other eight owed an estimated average of $1,072 each. The remaining 22 clubs apparently owed no additional taxes. Legislative Post Audit also found that some clubs kept inadequate accounting records and made errors in calculating the amount of taxes due.

Although these initial audits show that some taxable liquor sales are not being reported, so far the magnitude of the revenue shortfall indicated by the Department's estimate for fiscal year 1981 has not been substantiated. The Department's tax auditors will need to complete a full round of audits of all private clubs before definitive conclusions regarding liquor excise tax collections can be reached.

Audit Recommendations and Agency Response

The draft report was sent to the Department of Revenue for review. This procedure is followed in the preparation of all audit reports. It gives the agency an opportunity to point out any errors of fact, to provide additional information, and to respond to the recommendations. The full text of the Department's response can be found in Appendix C. The following is a list of the recommendations, a brief summary of the Department's responses to them, and Legislative Post Audit's replies.

Recommendations Relating to Alcoholic Beverage Regulation

Re-Establishing the Regulatory Program

The Legislature should take action to re-establish the State's alcoholic beverage control regulatory program. In its deliberations, the Legislature should consider the recommendations for improvements presented in this report.

Agency response. The Department did not comment specifically on this recommendation.

Reviewing the Regulatory Program's Fee Structure

The Legislature should review the regulatory fee structure for the State's alcoholic beverage control program to determine whether the level of fees set by statute is adequate. As part of this review, the Legislature should consider whether the program's license fees and other receipts should cover all costs of the regulatory program, including those moneys channeled to other funds to pay for community alcohol treatment programs.

Agency response. The Department concurred with the recommendation, saying the fee structure had been an area of concern for several years.

Reducing or Eliminating Residency Requirements

The Legislature should review residency requirements for liquor manufacturers, distributors, retailers, and private clubs, and should consider the following options:

a. Eliminating residency requirements altogether.

b. Eliminating all time limits on residency requirements.

c. Reducing residency requirements for all classes of licensees to a minimal level, such as one year.

Agency response. The Department agreed with the recommendation. It noted that the lengthy State residency requirement may no longer serve a significant enforcement purpose because investigations into applicants' backgrounds can be done using more recent data. The Department added that inconsistent residency requirements for individually owned and corporately owned private clubs should be rectified.

Reviewing Liquor Advertising Restrictions

The Division of Alcoholic Beverage Control and the Legislature should re-evaluate all liquor advertising regulations required in Kansas that are not required at the federal level. The review should help determine whether these regulations are necessary to protect the public and whether they should be revised or eliminated to abolish inconsistencies and to better meet the objectives of the regulatory program. As part of this review, the federal Bureau of Alcohol, Tobacco, and Firearms' advertising regulations should also be adopted by reference in Kansas.

Agency response. In its response, the Department said it had no objection to a total re-evaluation of liquor advertising restrictions in Kansas. It acknowledged that there were some inconsistencies, but said the Division was studying the State's advertising regulations and hoped to eliminate those possible inconsistencies. The Department said a "reaffirmation or revision by the Legislature" would help the Division of Alcoholic Beverage Control in carrying out legislative intent.

Eliminating Regulatory Restictions on Business Operations in the Liquor Industry

The Division of Alcoholic Beverage Control and the Legislature should review all restrictions on business operations in the liquor industry and should eliminate those regulations that appear to be designed to protect the industry, not the public. These should include regulations over insufficient funds check procedures and alcohol deliveries, but may also include regulations on numerous other practices as well.

Agency response. The Department indicated that "many of the statutes and regulations which appear to only protect the industry serve the important purpose of supporting and regulating" the three-tier liquor distribution system and maintaining an orderly liquor market. The Department did acknowledge that some requirements should be re-evaluated to determine whether they contribute significantly to an orderly market, and said it would welcome legislative guidance in this area.

Eliminating the Retail Price Maintenance Program

The Legislature should consider eliminating the State's retail price maintenance program. If retail price control is eliminated it should be phased-out gradually, and other practices such as selling below cost should be prohibited at least temporarily to help ensure greater market stability during the transition period.

Agency response. The Department did not agree or disagree with this recommendation, saying "this matter is strictly a policy decision for the Legislature."

Improving the Monitoring of Reciprocal Agreements

1. To improve its verification of private clubs' eligibility to enter into reciprocal agreements with other clubs, the Department of Revenue should consider instituting a process of matching private clubs' gross receipts and sales tax returns to the affidavits clubs file each year as proof they have met the 50 percent food sales requirement. This matching process could be limited to those clubs near the 50 percent level on food sales, and would be useful in identifying clubs that need a more extensive audit of reciprocal eligibility.

2. To tighten its eligibility requirements for reciprocal status so that some clubs are not able to circumvent them, the Department of Revenue should do the following:

   a. Discontinue the practice of granting "conditional" reciprocal status to clubs that have failed to meet the 50 percent food sales requirement in the previous calendar year.

   b. Consider denying or setting limits on the reciprocal status of private clubs that reorganize or re-incor-

porate in an apparent attempt to circumvent eligibility requirements. This effort may require changes in State law or regulation.

3. To ensure that reciprocal eligibility can be verified for private clubs in hotels and motels, the Department of Revenue should issue regulations requiring private clubs located on the same hotel and motel premises as other licensed public food service establishments to maintain a separate record of food sales.

Agency response. Although the Department did not appear to agree with the general thrust of these recommendations, it did agree that this area needs a thorough review by the Legislature because the statutory requirements for reciprocity are somewhat vague.

Regarding its stand on the recommendations, the Department made four specific points. First, the Department said it does closely monitor clubs' reciprocity based on a monthly computer print-out which calculates the ratio of liquor sales to gross sales for each club. Second, the Director of Alcoholic Beverage Control has some discretion in determining the application of statutory requirements for reciprocal agreements. Third, the Department thought the report's strict interpretation that clubs could be granted reciprocal status only upon presentation of records of actual experience put them in a "classic Catch-22 situation"--many clubs need reciprocity to meet the 50 percent food sales requirements. And fourth, the Department said the information it was now receiving from audits of private clubs' liquor and gross receipts sales put it in a better position to judge applications for reciprocity and adopt regulations clarifying the law. The Department did not address the recommendation relating to private clubs in hotels and motels.

Legislative Post Audit recognizes that private restaurant clubs need a certain period of time to build up their business and meet the food sales requirement for reciprocal status. However, at least two already established private clubs whose sales and tax records were reviewed apparently tried to circumvent the statutory minimum by re-incorporating and simply passing ownership from one partner to another or one spouse to another. One of these clubs had earlier been granted "conditional" reciprocal status by the Division, even though its food sales totaled only 38.4 percent of its gross receipts--far from the 50 percent minimum. When this club was unable to build up its food sales, it re-incorporated as a "new" club, essentially obtaining another year's grace period under current law and regulations. Legislative Post Audit maintains that until such loopholes are closed, some private clubs will continue to evade the State's minimum food sales requirement for reciprocal eligibility.

Improving the Effectiveness and Efficiency of Routine Inspections

To improve the effectiveness and efficiency of the inspections and investigations conducted as part of the alcoholic beverage control regulatory program, the Department of Revenue should do the following:

a. Consider adjusting at least some liquor control investigators' work hours so that more inspections of retail liquor stores and private clubs are conducted during the "busy" times--nights and weekends--when violations of State liquor laws and regulations may be more likely to occur.

b. Examine inspection priorities and consider reducing the frequency of, and revising the scope of, routine inspections of clubs and stores.

c. Consider eliminating criminal background investigations of new licensees and expediting examinations of licensees' financial interests. One option would be to substitute sworn statements regarding the applicant's criminal background, financial interests, and other requirements specified in K.S.A. 31-111 for investigations.

Agency response. The Department said it was reviewing priorities and work hours "with the objective of reducing the frequency and scope of routine inspections" and increasing "undercover" assignments carried out during nights and weekends. It also argued that criminal background investigations do uncover previous convictions that disqualify applicants from obtaining licenses, indicating that such checks should be retained.

Monitoring Statewide Enforcement Actions

To help identify those areas of the State where enforcement activities are lacking, inconsistent, or can be more effectively targeted, the Department of Revenue should monitor Statewide enforcement trends and analyze enforcement data by geographic area or by agent.

Agency response. The Department agreed that information about Statewide enforcement trends regarding investigations and dispositions "would be a meaningful enforcement 'tool' if automated through a computer report." It did not specifically address any plans for implementing the recommendation, however.

Ensuring the Equitability and Consistency of Enforcement Actions

To help ensure that the assessment of penalties against retailers or private clubs acts as a fair and effective deterrent, the Department of Revenue should do the following:

a. Make greater efforts to assure that the penalties assessed for violations of liquor laws and regulations bear a reasonable relationship to the seriousness of the offense.

b. Discontinue the practice of allowing licensees to participate in the penalty-setting process.

Agency response. The Department disagreed with the report's findings and recommendations in this area. It said it thought penalties "consistently bear a reasonable relationship to the seriousness of the offense," and the Director is "best qualified to make a determination as to the effect of a violation on the industry and the public." The Department also said it thought the option of a fine or suspension for clubs "with relatively violation-free records" was "an equitable exercise of administrative judgment," and added that "clubs which have a marginal financial base would be forced out of business if not given the choice between the fine or suspension when deemed equivalent by the Division. In these circumstances," the Department said, "the licensee is best suited to make an appropriate choice between equal penalties."

Legislative Post Audit maintains that the penalties assessed by the Division do not always appear to be equitable. It is generally acknowledged that sales-to-minors violations represent the most significant potential for harm to the public, but the penalties given for such offenses were generally less severe than penalties assessed for sales below minimum mark-up prices. These violations present no potential for direct harm. Legislative Post Audit would also note that, when given a choice between a fine and a suspension, licensees will always choose the one that is least harmful to them. Further, licensees who choose a suspension may also select the days they will be closed. As the audit pointed out, most of the suspensions reviewed by the auditors began on Monday and were over before the weekend. Allowing clubs or retailers that have violated State liquor laws or regulations to choose their punishment would certainly appear to lessen the deterrent value of that punishment.

Recommendations Relating To Collection and Enforcement of the Liquor Excise Tax

Improving Estimates of Liquor Excise Taxes Owed

1. To improve its estimates of liquor excise taxes due to the State, the Department of Revenue should take the following actions:

a. Obtain totals of and monitor the amount of monthly sales to private clubs by retail liquor stores.

b. As audits of private clubs are completed, compile and analyze information on the ratio of alcoholic beverage sales to the cost of liquor purchased.

c. Prepare a revised estimate of the amount of liquor excise tax shortfall in the State.

2. The Legislature should review this revised estimate and should monitor the results obtained by audits of liquor excise tax collections. The Legislature should also require the Department of Revenue to provide it with information about the additional amount of liquor excise tax revenues collected, and any increase in compliance with non-tax related matters, as a result of the new audit program. This information, which should be compiled and reported to the Legislature by the start of the 1984 legislative session, should help the Legislature and the Department determine if this auditing effort is cost-effective.

Agency response. The Department listed a number of statutory, regulatory, and procedural changes that should result in the Division receiving more accurate information upon which to base its estimates of liquor excise taxes owed. It agreed to furnish the results of the retail liquor excise tax audits to the Legislature. It did not comment further on the accuracy of the Division's estimates.

Reducing Clubs' Errors in Calculating Taxes Due

The Department of Revenue should ensure that private clubs are given clearer guidance in calculating the sales and excise taxes they must collect from their customers. This guidance could be in the form of a simple instructional manual on computing and paying these taxes.

Agency response. The Department noted that the retail liquor tax regulations include instructions regarding the calculations of sales and liquor excise taxes. It said it sent a copy of these regulations to all private club licensees on November 1, 1982.

Matters Remaining for Legislative Attention

The recommendations calling for the Division to be re-established, for license fees to be changed, and for statutory restrictions on liquor-

related business operations to be reduced or eliminated will all require legislative action. In general, the Department has either agreed to these recommendations or has said it would welcome legislative review and clarification of intent in these areas. Thus, the Legislature should proceed with formal consideration of recommendations calling for the following actions:

--re-establishing the regulatory program
--reviewing the regulatory program's fee structure
--reducing or eliminating residency requirements
--reviewing liquor advertising restrictions
--eliminating regulatory restrictions on business operations in the liquor industry
--eliminating the retail price maintenance program

Recommendations calling for improvements in the administration of the regulatory program will require action on the part of the Department of Revenue and the Division of Alcoholic Beverage Control. The Department generally agreed with all but two of the report's findings in these areas: one citing the need for improvements in the Division's practices and procedures for monitoring reciprocal agreements and the other reporting that penalties for violations are not always assessed in an equitable and consistent fashion. Legislative Post Audit maintains that improvements are needed in both areas to ensure greater compliance with the State's liquor laws and regulations. Therefore, the Legislature should also formally consider the recommendations addressed to the Department regarding reciprocal agreements and more equitable enforcement actions.

TABLE OF CONTENTS

CHAPTER I

INTRODUCTION

The Kansas Sunset Law abolishes the Kansas Department of Revenue on July 1, 1983, unless it is continued by an act of the Legislature. As part of the legislative review under the sunset process, the Sunset Law grants the Legislative Post Audit Committee the authority to specify programs or functions that the sunset audit should address. The Committee directed that performance audits be conducted of three divisions within the Department--the Division of Taxation, the Division of Vehicles, and the Division of Alcoholic Beverage Control. The sunset performance audit of the Division of Alcoholic Beverage Control is presented in this report.

The Sunset Law also authorizes the Comittee to make a determination of each audit's scope and the functions to be considered in each sunset audit. Because the Sunset Law focuses on the protection of the public, this audit generally focused on the regulation of retail liquor stores and private clubs--those businesses in the alcoholic beverage industry that most directly involve the public. Further, the Committee directed that this audit include a review of the liquor excise tax collection and enforcement process, a responsibility shared by the Division of Alcoholic Beverage Control and the Division of Taxation.

Sunset Audit Methods

The factors to be considered in this audit include those set out in the Sunset Law and the performance audit factors specified in the Legislative Post Audit Act. These factors, restated as questions, can be found in the box on the next page. Based on these factors, Legislative Post Audit developed a set of tests and analyses for use in this audit. These tests and analyses include the following:

--Determining the Legislature's intent in creating the regulatory program and the functions the agency should perform in accordance with that intent.

--Determining whether a need for the regulatory program exists.

--Determining and comparing the costs of regulation and the value of the regulatory activities.

--Comparing the regulatory program in Kansas with programs in other states.

--Reviewing the frequency of, and reasons for, violations and citations issued to persons and businesses regulated by the agency.

SUNSET AUDITING

The questions Legislative Post Audit asked in this performance audit are based on a combination of the factors included in the Sunset Law and the Legislative Post Audit Act. More detailed information about the tests and analyses used in this audit can be found in Appendix A.

Is There a Need for State Regulation?

1. Would the absence of regulation by the State agency or office significantly harm or endanger the public health, safety, or welfare?

Does State Regulation Protect the Public?

2. Are all facets of the regulatory process designed solely for the public's protection, and is such protection the primary effect of that regulation?

3. Is there a reasonable relationship between the State agency's exercise of the police power and the protection of the public health, safety, or welfare?

Is Regulation Worth Its Cost?

4. Does the regulation by the State agency or office directly or indirectly increase the costs of goods or services involved and, if so, by how much?

5. Is any increase in cost to the public more harmful than the harm that could result from the absence of regulation by the State agency or office?

Are Alternative Methods of Protection Available?

6. Is there another less restrictive method of regulation available that could adequately protect the public?

Is The Regulatory Program Efficient and Effective?

7. Are the responsible agencies carrying out only those activities authorized by the Legislature?

8. Is the program being efficiently and effectively implemented in accordance with the Legislature's intent?

9. Is reorganization needed to accomplish the goals of the program?

--Analyzing administrative regulations to determine if they are designed to protect the public.

--Determining if the agency conducts its regulatory programs in the most efficient and effective manner possible.

Legislative Post Audit bases all conclusions and recommendations about eliminating regulatory agencies or programs or re-establishing and improving them on the sunset and performance audit factors. If, in applying these factors, Legislative Post Audit finds no evidence that the public would be significantly harmed without regulation, or finds that regulation protects the industry, is not worth its cost, or can be administered in a less restrictive fashion, the audit will reflect those findings. This practice is in keeping with the Legislature's intent--through the sunset process--of placing the burden of proof on the agency being audited to demonstrate a continued public need for regulation.

In conducting the sunset audit of the Division of Alcoholic Beverage Control, the auditors reviewed Kansas statutes and administrative regulations under which the Division operates, and compared Kansas' regulatory program with regulatory programs in other states. They also examined records kept by the Division, including inspections, citations issued for violation of regulations, licensing files of regulated businesses, and minutes of both administrative hearings and meetings of the Alcoholic Beverage Control Board of Review. The auditors also made field visits with the Division's enforcement agents and audited the records of a sample of private clubs. Finally, surveys were sent to a random sample of 285 retail liquor store owners and 285 private club owners, and liquor distributors were interviewed by telephone, to determine their opinions about the Division's effectiveness and the various liquor laws and regulations existing in Kansas.

Organization of the Audit Report

The remainder of this chapter discusses the legislative history and intent behind the State's alcoholic beverage control statutes, and provides an overview of the operations of the Department of Revenue and the Division of Alcoholic Beverage Control. Chapter II is a sunset analysis of alcoholic beverage regulation, Chapter III discusses laws and regulations restricting liquor-related business operations that appear to be designed to protect the industry rather than the public, Chapter IV analyzes the Division's performance in carrying out the regulatory program, and Chapter V examines the collection and enforcement of the liquor excise tax.

Legislative Intent of Alcoholic Beverage Regulation

From the early days of Statehood, the regulation of alcoholic beverages in Kansas has been a controversial issue. It has been the subject

of numerous court cases and considerable legislative debate. Over the years, the Legislature has gradually eased regulation in response to the public's changing attitudes about alcohol and its perceived desire for a less restrictive system. Despite these changes, the alcoholic beverage industry continues to be one of the most highly regulated industries in the State.

Prohibition of Alcoholic Beverages

In 1880, Kansas voters approved Article 15, Section 10 of the Constitution prohibiting the manufacture and sale of intoxicating liquors except for "medical, scientific, and mechanical purposes." This was the first State constitutional ban against alcoholic beverages in the country. Subsequent problems with patent medicines led to legislation being passed in 1909 and 1911 permitting only wholesale druggists to sell alcohol to registered pharmacists for "medicinal" purposes. By the time the 18th Amendment to the U.S. Constitution imposed nationwide prohibition in 1919, it prompted little change in an already "dry" Kansas.

Repeal of Prohibition

In 1933, the 21st Amendment to the U.S. Constitution repealed the 18th Amendment and ended nationwide prohibition. This amendment gave the states absolute control over their internal markets for alcoholic beverages and exempted them from most aspects of the commerce clause of the Constitution. Congress did retain sufficient jurisdiction to enact the Federal Alcoholic Administration Act in 1935, which required permits for liquor suppliers, wholesalers, and retailers, and prohibited certain financial interests between these different businesses. In addition, the federal government also started collecting excise taxes on alcoholic beverages, prohibited certain business practices, and set standards for product size, content labeling, and advertising. The Bureau of Alcohol, Tobacco, and Firearms within the Department of Treasury was made responsible for enforcing these federal laws and regulations.

In response to the 21st Amendment, the Kansas Legislature submitted a proposed constitutional amendment to the voters in 1934 which would have empowered the Legislature to regulate and tax liquor. This amendment was defeated.

The first successful attempt to allow the sale of beverages with alcoholic content in Kansas occurred in 1937, when the Legislature excluded beer with an alcoholic content of 3.2 percent or less (also known as cereal malt beverage) from the statutory definition of an intoxicating liquor. This definition authorized the sale of "3.2 beer" throughout the State.

In 1947, the Legislature approved a proposed amendment to Article 15, Section 10 of the Constitution giving the Legislature the authority to "regulate, license, and tax the manufacture and sale of intoxicating liquors and . . . regulate the possession and transportation of intoxicating liquors.

The open saloon shall be and is hereby forever prohibited." This amendment was approved by the voters in 1948 and remains in effect today. Prohibition of the "open saloon" meant that the voters in effect approved the sale of package liquor in retail stores, but did not approve places open to the public that serve liquor by the drink.

Development of the Kansas Regulatory Program

To implement the 1948 constitutional provision, the Legislature passed the Liquor Control Act in 1949. This Act authorized package sales of liquor and established a comprehensive system of regulating, licensing, and taxing alcoholic liquor from the time of its manufacture or importation into the State until its ultimate sale by a licensed retail liquor store. To implement and enforce the Act, the Department of Alcoholic Beverage Control was created. In addition, the Alcoholic Beverage Control Board of Review was established to hear appeals of enforcement actions taken by the Director and to approve proposed regulations.

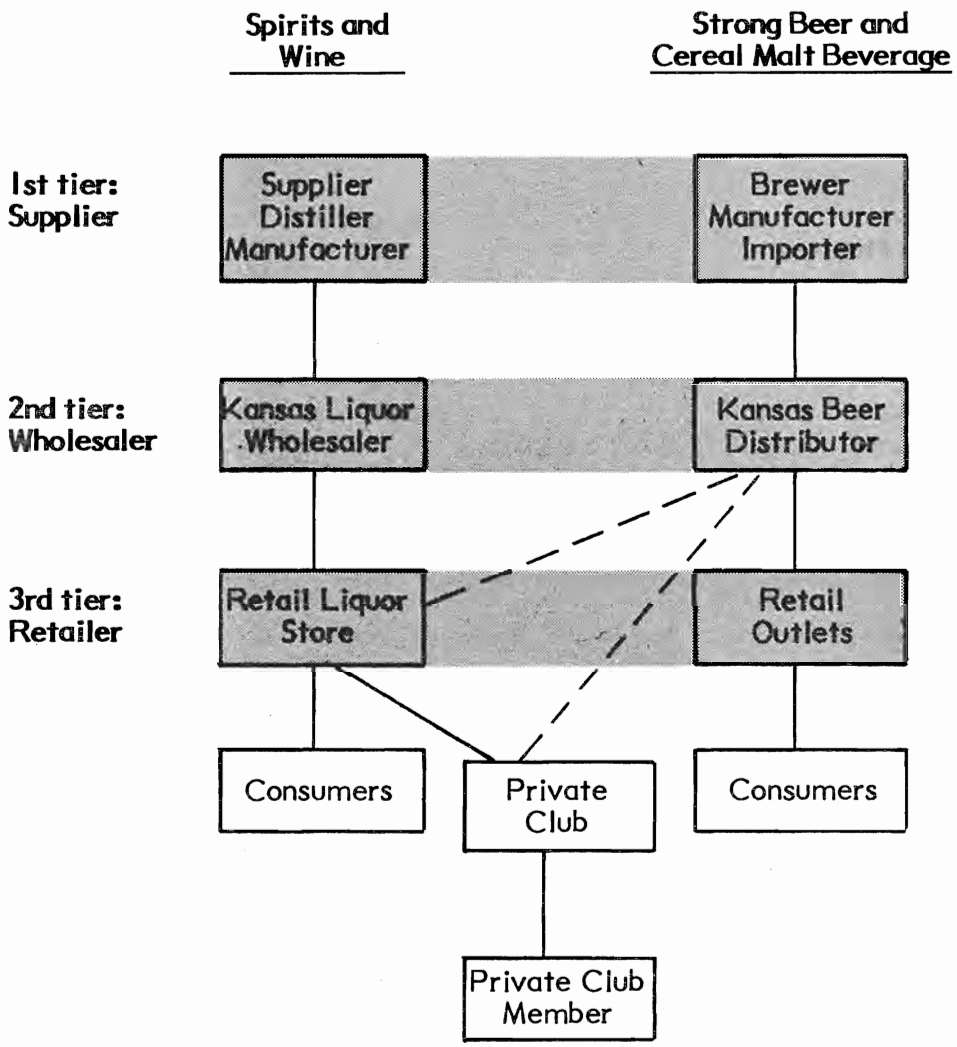
The type of regulation Kansas chose in 1949 is called the "license" system. Under this system, the State licenses and otherwise regulates private businesses that distribute and sell alcoholic beverages. In all, 32 states have chosen this system. The remaining 18 states chose the "monopoly" or "control" system, under which the state actually operates the liquor business within its borders.

Kansas' method of distributing alcoholic beverages involves a three-tier distribution system. It recognizes three independent levels of business enterprise in the distribution chain: the supplier, the wholesaler, and the retail liquor store. No person in one tier can have a financial interest in any other tier. This distribution system was established to prevent "tied houses," which are retail establishments owned or controlled by a manufacturer. Such establishments flourished prior to Prohibition, and resulted in a number of abuses because the manufacturer was entirely concerned with sales and had no interest in the community.

From 1949 to 1959, retail liquor prices were controlled through an administrative regulation authorizing suppliers to set minimum prices. This regulation was successfully challenged in the courts in 1958 and resulted in the 1959 Legislature passing the first minimum liquor price law. This law was also successfully challenged in the courts as an unlawful delegation of legislative authority. Subsequently, the 1961 Legislature passed a new minimum price law which set out guidelines for the Alcoholic Beverage Control Board of Review to set minimum wholesale and retail liquor prices.

Following the enactment of the Liquor Control Act, numerous questionable "private clubs" were created to circumvent the law by serving alcoholic liquor to club members. The Legislature responded to this law enforcement problem by enacting the Private Club Act of 1965. This Act authorized the consumption of alcoholic liquor on the premises of private

General Distribution System for Alcoholic Beverages in Kansas



The distribution system used in Kansas is known as the three-tier distribution system, and is common to many license states. This system is distinguished by a clear division of the supplier, wholesaler, and retailer. Each is required to be separate and independent of the others; the supplier must sell only to the wholesaler, and the wholesaler in turn sells only to the retailer. (Beer distributors may sell 3.2 beer to private clubs and strong beer to retail liquor stores, however.) Also, no party in one tier can have any financial interest in an establishment in a different tier.

clubs as consumption "in a place which the general public has no access," and placed a minimum membership fee and waiting period requirement on private club members. The Director of Alcoholic Beverage Control was also empowered to issue liquor licenses to class A clubs (non-profit) and class B clubs (profit-making).

In 1970, Kansans voted on an amendment to the Constitution to remove the open saloon prohibition. This proposition was rejected by a narrow margin of 346,423 votes against the amendment to 335,094 for it. Numerous attempts have been made since then within the Legislature to again submit an amendment to the voters authorizing liquor by the drink. All those attempts have failed.

During the 1970s a number of administrative changes and transfers of responsibilities occurred in the alcoholic beverage control program. As part of a major reorganization of taxation and revenue collection functions, the 1972 Legislature transferred the Department of Alcoholic Beverage Control to a division status within the Department of Revenue. In response to the constitutional approval of bingo in 1974, the Director of Alcoholic Beverage Control was also given responsibility for regulating bingo activities that take place in private clubs. To consolidate the regulation of all beverages with alcoholic content, the 1978 Legislature transferred the responsibility for licensing and supervising cereal malt beverage wholesalers from the Director of Taxation to the Director of Alcoholic Beverage Control.

In 1978, the Legislature amended the Private Club Act to redefine an open saloon. These amendments would have permitted class B restaurant clubs--which are for-profit, licensed food service establishments that make more than 50 percent of their gross receipts by selling food--to sell liquor by the drink to the general public without requiring club memberships. The Kansas Supreme Court, in State ex rel. Schneider v. Kennedy (225 Kan. 13), found these amendments to be unconstitutional because they violated the constitutional prohibition against the open saloon.

The following year the Legislature enacted Senate Bill 467, which authorized all class A and class B clubs to sell liquor by the drink to their members and bona fide guests. This bill eliminated "liquor pools," which had previously been the mechanism many private clubs used to dispense liquor. Also, the bill permitted class B clubs deriving at least 50 percent of their gross receipts from the sale of food to enter into reciprocal agreements with each other. Finally, the new law established a 10 percent gross receipts excise tax on the sale of all drinks that contain spirits, wine, and strong beer.

Another major piece of liquor-related legislation passed in 1979 was House Bill 2020, which replaced the open wholesaling system with an exclusive franchise system. Under the open wholesaling system, exclusive

distributorship arrangements between suppliers and wholesalers were prohibited. Under this system, all wholesalers could carry the same brand of liquor, and each wholesaler had to sell that brand to retailers at the same price. By contrast, the exclusive franchise system authorized agreements giving one wholesaler the exclusive right to distribute a supplier's particular brand or brands in a specific geographic area. Under the new system, then, wholesalers would not all be allowed to carry the same brand, but might be able to offer retailers a similar brand at a more competitive price. This legislation also removed the minimum price mark-up for wholesalers. The legislative intent of these changes was to institute an element of free enterprise in the alcoholic beverage market by encouraging brand competition.

Objectives of Kansas Alcoholic Beverage Regulation

The auditors determined from their review of the legislative history and intent of the State's liquor laws that the primary objective of this body of regulatory legislation was to foster temperance and to provide an orderly market for the distribution and sale of alcoholic beverages. A secondary objective of the program was to raise tax revenues.

Promoting temperance. Historically, the promotion of temperance has been the most important objective of all states' alcoholic beverage regulation. But since the end of Prohibition, the meaning of the term "temperance" has altered dramatically in response to changes in society. During the 1920s, it connoted total abstinence from alcoholic beverages, to be enforced by legal sanctions if necessary. Experience under Prohibition demonstrated the great difficulty of enforcing a complete ban, especially when large segments of the society saw nothing wrong with drinking alcoholic beverages. As liquor consumption has gradually become more acceptable to more citizens, temperance has become synonymous with moderation and the avoidance of "problem" drinking, rather than with complete abstinence.

Following Prohibition, states adopted several types of legislative provisions intended to promote temperance and thus minimize alcohol abuse and its effects on society. Some of these abuse-directed measures are relatively narrow and targeted at specific problems. Examples include minimum age requirements for buying or drinking alcoholic beverages, restrictions regarding sales to obviously intoxicated individuals, denial of licenses to persons with records of alcohol-related legal offenses, and restrictions on hours of business.

Providing for an orderly market. Although there is no clear definition in Kansas law of the phrase "orderly market"--and some states' statutes do not use that exact term--it is generally used to refer to the need for having a highly regulated distribution system. This objective is a response to various problems that occurred prior to and during Prohibition. These

problems included the development of "tied houses" in which manufacturers controlled retailers, and the development of a black market and illegal traffic in liquor by organized crime. Examples of regulations enacted to combat these problems are licensing and recordkeeping requirements, price maintenance provisions, and restrictions on financial interests and credit between different levels of the distribution chain.

Liquor-related tax revenues. Since the inception of the regulatory program in 1949, the State has taxed the alcoholic beverage industry at several levels of the distribution chain. Currently three main taxes are imposed on liquor in the State:

A gallonage tax is collected on shipments into Kansas of distilled spirits, wine, strong beer, and cereal malt beverage. This tax is collected from the suppliers of strong beer and cereal malt beverage and from wholesalers for distilled spirits and wine. The gallonage tax rates are as follows:

--distilled spirits	$2.50	per gallon
--fortified wine (more than 14 percent alcohol)	.75	per gallon
--light wine (14 percent or less alcohol)	.30	per gallon
--strong beer and cereal malt beverages	.18	per gallon

A four percent enforcement tax is collected by retail liquor stores on sales of alcoholic liquors, including strong beer, in lieu of the retailers' sales tax.

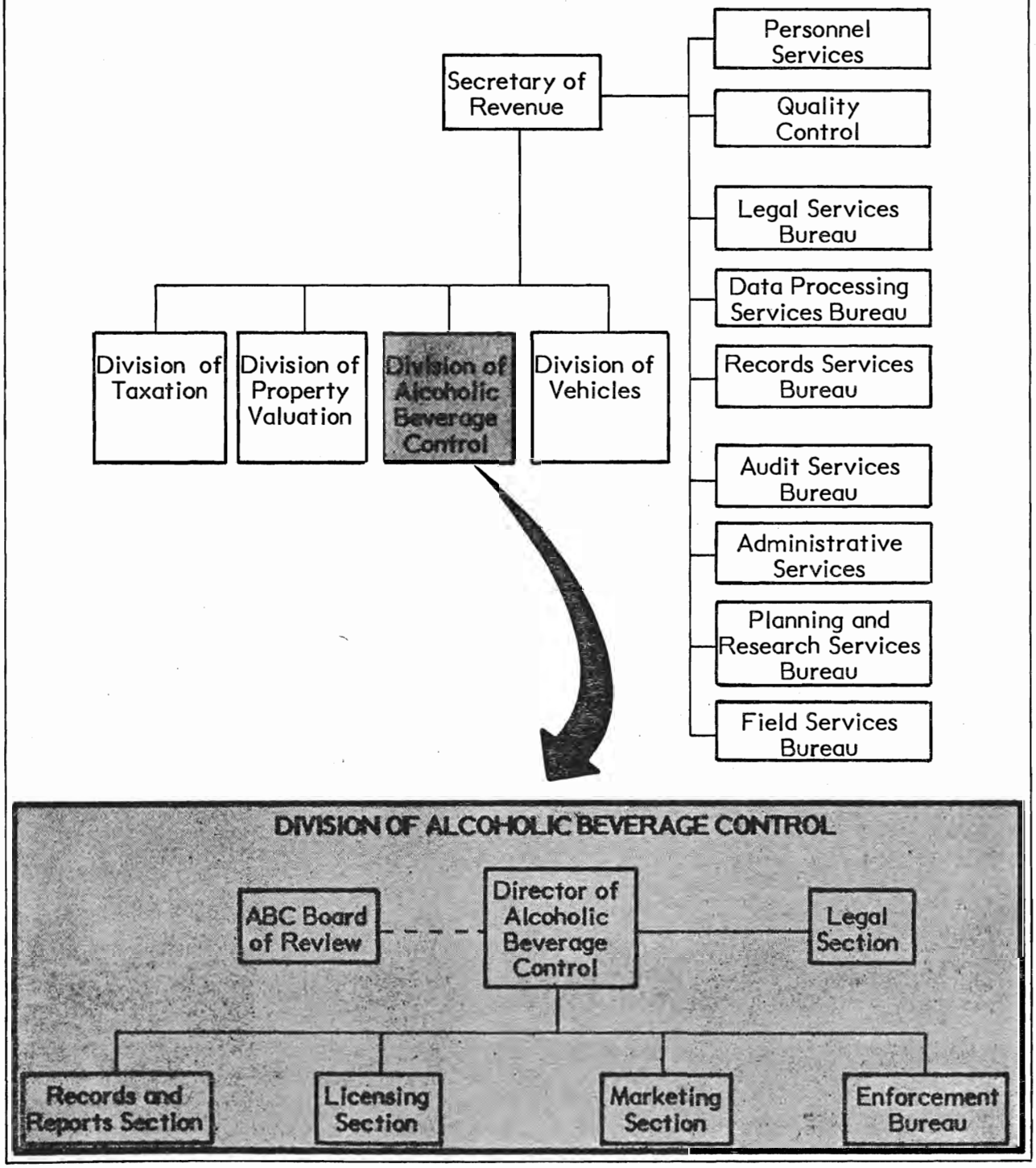
A 10 percent gross receipts tax is imposed on private club sales of alcoholic liquor, including strong beer, and on those ingredients used to make alcoholic drinks such as mix and ice.

In addition to these taxes, all sales of cereal malt beverages are subject to the regular three percent retailers' sales tax. The Division of Alcoholic Beverage Control is responsible for collecting the gallonage tax, but the other taxes are collected by the Division of Taxation.

Division of Alcoholic Beverage Control Operations

The Division of Alcoholic Beverage Control is responsible for administering and enforcing the laws relating to the manufacture, distribution, sale, possession, transportation, and traffic of alcoholic liquor and cereal malt beverages (3.2 beer). In addition, the Division is responsible for regulating all bingo activities conducted on the premises of private clubs. In fiscal year 1982, the Division was responsible for regulating the activities of 1,114 retail liquor stores, 1,182 private clubs, and 157 wholesalers. Only one manufacturer is based in Kansas, but it does not sell spirits directly within the State. There were 234 spirits, wine, and beer suppliers authorized to do business in Kansas, which sold more than 18,000

Organizational Chart for The Department of Revenue and its Division of Alcoholic Beverage Control



different brands and sizes of liquor, wine, strong beer, and cereal malt beverages.

The Division is one of four major operating divisions and nine service bureaus currently existing within the Department of Revenue. The Division is headed by a Director appointed by the Secretary of Revenue with the consent of the Senate. In addition, the Alcoholic Beverage Control Board of Review has certain oversight responsibilities for the program. The chart on the preceding page shows the organizational structure of the Department and the Division. Responsibilities of the organizational units within the Division of Alcoholic Beverage Control are as follows:

Records and Reports Section. This section audits all licensees' monthly reports and all shipments of liquor. It also maintains statistics for the Division, approves beer labels and territorial agreements between brewers and beer distributors, and processes license applications for cereal malt beverage wholesalers.

Licensing Section. This section processes and approves all licenses relating to the manufacture, sale, and distribution of liquor. It also issues permits for salesmen and manufacturer representatives and issues letters of approval for brewers, distillers, and importers. Finally, it is responsible for administrative actions concerning licenses and for filing all correspondence for the administrative office.

Marketing Section. This section receives monthly liquor price postings and price affirmation statements from suppliers and manufacturers, as well as monthly price postings from wholesalers. It compiles the official price schedule and approves all merchandise.

Legal Section. This section provides advice on legal matters, examines all license and permit applications, and assists in conducting investigations and hearings involving violations of laws and regulations.

Enforcement Bureau. This bureau is responsible for investigating new applicants for licenses, delivering new licenses, inspecting all licensed premises to ensure compliance with liquor laws, closing retail outlets, serving subpoenas and citations, and responding to licensee questions on liquor laws and regulations. It also inspects all bingo games conducted on private club premises.

Alcoholic Beverage Control Board of Review. This regulatory review board consists of three members appointed by the Governor. The Board is responsible for establishing retail liquor price mark-ups and approving regulations relating to liquor and private club activities. It also hears appeals of decisions made by the Director of Alcoholic Beverage Control.

Division of Alcoholic Beverage Control Resources

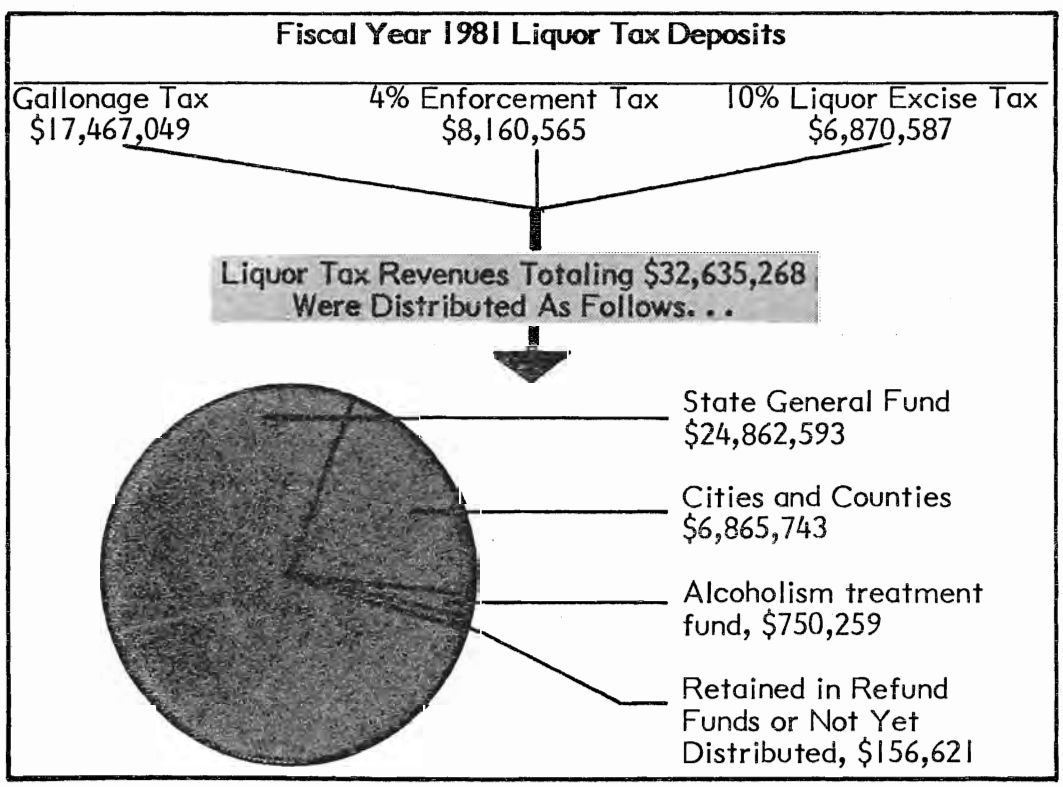
Although the Division of Alcoholic Beverage Control collects some revenue, its operations are funded entirely through appropriations from the

General Fund. The Division received a total of $1,085,035 from the Department of Revenue's appropriation for its operating expenditures in fiscal year 1981, the most current year for which information was available. Of that amount, it spent $851,057 for salaries and wages, $221,634 for contractual services, $9,680 for commodities, $2,477 for capital outlay, and $187 for other expenses.

The Division had 50 authorized positions during fiscal year 1981. As of June 1981, all of them were filled. In addition to the Director of the Division and his secretary, four positions were in the Legal Section, eight in Records and Reports, six in Licensing, two in Marketing, and 28 in the Enforcement Bureau.

Liquor Tax Revenue Collections

In fiscal year 1981, the State collected a total of $32.6 million in liquor tax revenues. Approximately $32.5 million of this amount was distributed to the State General Fund, to cities and counties for local alcohol abuse programs, parks and recreation, and general government, and to the alcoholism treatment fund of the Department of Social and Rehabilitation Services. (In all, $156,621 was retained in various refund funds or was not distributed that year because of a time lag.) As the accompanying figure shows, about three-fourths of the tax moneys distributed--or $24,862,593--was credited to the General Fund.



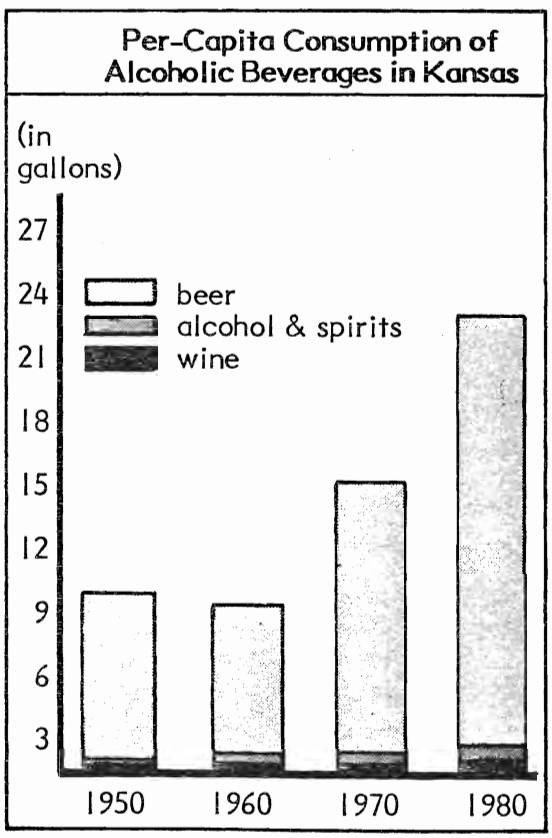
CHAPTER II

SUNSET ANALYSIS OF ALCOHOLIC BEVERAGE REGULATION

The Sunset Law has three primary purposes--to evaluate the need for certain agencies and programs, to determine if the benefits of the agency or program are worth their cost, and to determine whether the agency or program serves to protect the public or the group it regulates. Legislative Post Audit designed its review of alcoholic beverage regulation to address these concerns. Because retail liquor stores and private clubs are the businesses in the industry most directly involved with the public, the auditors' sunset review generally focused on these two groups. Their findings are reported in this chapter.

Is There A Need for Alcoholic Beverage Regulation?

To assess whether there is a need for State regulation of alcoholic beverages, Legislative Post Audit considered whether the absence of regulation would significantly harm or endanger the public health, safety, or welfare. It also considered whether there was another less restrictive method of regulation available that could adequately protect the public.



Potential Harm in the Absence of Regulation

Alcohol is generally recognized as an addictive substance that can be abused. Consequently, it appears that the potential for harm to the public could be significant. To determine the type and magnitude of alcohol-related problems in Kansas, and to determine whether such problems could cause harm serious enough to warrant State regulation, the auditors reviewed alcohol consumption statistics, information on health and safety problems caused by alcohol, and data on violations of alcohol laws and

regulations. This review provided some indication of the problems that exist even with regulation.

Consumption of alcoholic beverages. Because of the widespread use of alcohol in our society and the identifiable harm that can occur through its abusive consumption, the auditors examined data on the consumption of alcoholic beverages in Kansas. A 1977 study commissioned by the Department of Social and Rehabilitation Services' Alcohol and Drug Abuse Services on drug and alcohol use in Kansas estimated that 56 percent of the adult population in Kansas drink beer, 50 percent drink mixed drinks, and 44 percent drink table wine. In 1980, approximately 55 million gallons of alcoholic beverages were consumed in Kansas. An analysis of the per capita consumption of alcoholic beverages in Kansas over time shows that it has more than doubled since the inception of the regulatory program.

Although Kansas' per capita consumption has risen, it still is considerably lower than the national average. Industry data show that in 1980, the national per-capita consumption of distilled spirits was 1.99 gallons. Wine was 2.12 gallons, and beer was 24.3 gallons. By comparison, Kansas' per-capita consumption of distilled spirits was 1.19 gallon, wine was 0.70 of a gallon, and beer was 21.7 gallons. On a per-capita basis, then, Kansas ranked last in consumption of distilled spirits, 47th in the consumption of wine, and 39th in the consumption of strong beer and cereal malt beverages.

Consumption of Alcoholic Beverages, 1980

	Per-Capita Consumption (in gallons)		
Type of Beverage	Kansas	United States	Kansas Rank
Distilled Spirits	1.19	1.99	50
Wine	.70	2.12	47
Strong Beer and Cereal Malt Beverages	21.70	24.30	39

Alcohol-related health and safety problems. Kansas' consumption of alcoholic beverages may rank near the bottom of all states, but there is still evidence of substantial harm to citizens' health and safety from its use. To determine the extent of alcohol abuse in Kansas, the auditors reviewed estimates of the number of alcoholics and health problems caused by alcohol. Methods for estimating the number of alcoholics vary; however, one standard formula assumes a prevalence rate of 5 percent to 6 percent of the adult population nationwide. Based on Kansas' population of 1,589,000 adults (over the legal drinking age of 21) in 1980, the number of alcoholics in Kansas can be estimated at between 80,000 and 95,000.

According to records from the Department of Health and Environment, there were 105 deaths reported in Kansas in 1981 from such causes

as alcoholic dependence syndrome and cirrhosis of the liver. Health experts indicate that these figures are low, largely because, on the medical chart, alcoholism may be listed as a contributor to death but not as the primary cause of death. For example, alcoholism is known to contribute to heart disease, yet a person dying of heart failure would not be counted as a death due to alcohol. The fact that more than 16,000 Kansas citizens received treatment for alcoholism in licensed programs in 1981 is further evidence that alcohol-related health problems exist in fairly large numbers. In addition, experts acknowledge that alcohol is a major contributing factor in family violence, and a substantial cause of lost productivity at work.

According to several major studies, intoxicated motorists are estimated to have caused 25,000 of the nation's annual traffic fatalities, or at least half of the total, and liquor-related accidents are estimated to cost society $25 billion annually. An examination of motor vehicle records indicates that alcohol was a primary contributing factor in 6,401 reported motor vehicle accidents in Kansas during calendar year 1981. Of that total, 207 involved fatalities and 3,317 were injury accidents. Further, these accidents cost Kansans an estimated $48.5 million in property damage, medical expenses, insurance administration, and wage losses. Also in Kansas, 6,218 driver's licenses were suspended or modified during calendar year 1981 as a result of operating a motor vehicle while under the influence of alcohol.

Violations of alcoholic laws and regulations. Another way of assessing the potential harm to the public in the absence of regulation is to examine the number and types of violations of liquor laws and regulations by retail liquor stores and private clubs. In reviewing club violations, the auditors focused on class B, profit-making clubs. Licensees who violate State laws and regulations are cited by the Division and appear at an administrative hearing conducted by the Division for the presentation of evidence, determination of guilt, and assessment of penalties. The auditors reviewed the Division's hearing dockets and found there were substantial numbers of violations by both class B private clubs and retail liquor stores in calendar year 1981. These numbers are presented in the table on the next page.

As the table shows, the primary category of violations that could result in harm to the public's health, safety, or welfare is sales to minors. Sales to minors were the largest category of retail store violations--105, or 45 percent of the total--but were only a minor category of private club violations--20, or four percent. The other types of violations which had the potential for direct harm to the public included dispensing of drinks by drunken employees, selling to intoxicated persons, and underage dispensing. Most of the remaining violations, especially for private clubs, do not appear to result in significant harm to the public. These include such violations as excise tax delinquencies, membership, insufficient funds checks, and license and reporting requirements.

Violations By Class B Private Clubs and Retail Liquor Stores
Calendar Year 1981

Type of Violation	Number of Violations	Percent of Violations
Class B Private Clubs		
Excise Tax Delinquencies (for example, failure to pay or late payment of 10 percent gross receipts tax)	171	35%
Membership (for example, serving non-members, not checking membership cards, and no waiting period or fee)	137	28
License Requirements (for example, no city license or federal permit, failure to post license and ineligible licensee)	72	15
Personnel (for example, unauthorized personnel, drunken employee, underage dispensing, and felony conviction of employee)	37	7
Liquor Control (for example, consumption off premises and untaxed liquor)	24	5
Sales to Minors (sales to persons under 21)	20	4
Miscellaneous (for example, illegal hours of operation, giving false information, denied entry to peace officer, insufficient funds check, and sale by drink)	28	6
Total	489	100%
Retail Liquor Stores		
Sales to Minors (sales to persons under 21)	105	45%
License and Reporting Requirements (for example, delinquent enforcement tax, selling to clubs without federal permit, and lack of purchase and sales records)	44	19
Insufficient Funds Checks (for example, bad checks written to wholesalers)	44	19
Other Sales Violations (for example, sales on credit, on Sundays, or below minimum price, and illegal deliveries)	18	8
Advertising (for example, false advertising and advertising on vehicle)	13	5
Miscellaneous (for example, illegal hours, open liquor on premises, unauthorized use of premises)	9	4
Total	233	100%

In sum, it is apparent that abuse of alcohol in our society can cause harm to the public. Significant numbers of deaths in Kansas result from alcohol-related illnesses or motorists driving under the influence of alcohol. In addition, some of the violations of alcohol laws and regulations that are occurring, even with regulation, can also harm the public. Taken together, these factors led Legislative Post Audit to conclude that the absence of regulation of alcoholic beverages would significantly harm the public's health, safety, and welfare.

Are There Less Restrictive Regulatory Alternatives?

All 50 states regulate the alcoholic beverage industry, although their regulatory programs do have differences. The major difference is whether the state is a "license" state or a "control" state. The 32 license states (and the District of Columbia) allow individuals to secure licenses to conduct all phases of the wholesale or retail sale of liquor. In the 18 control states, the states themselves buy directly from suppliers and, in general, sell alcohol for off-premise consumption in state-owned and operated stores or through state agencies. No retail liquor stores exist in control states as they do in Kansas. However, all states except Iowa license private businesses to distribute and sell beer at the wholesale and retail levels.

All states also have some type of alcohol and beverage control agency. In control states, this agency is responsible for distributing or selling alcoholic beverages, and in license states, it is responsible for issuing permits and licenses. In general, these agencies issue permits to manufacturers and suppliers, collect alcohol-related taxes, and prohibit certain business practices and economic activities. These agencies also investigate complaints, hold administrative hearings concerning the violation of statutes or regulations and the issuance of licenses, and impose disciplinary sanctions on violators. In reviewing other state agencies' programs, the auditors could find no less restrictive mechanism for handling these regulatory functions.

Is Alcoholic Beverage Regulation Worth Its Cost?

To assess whether the benefits of alcoholic beverage regulation justify its cost, Legislative Post Audit considered two factors. Does the regulation by the State agency or office directly or indirectly increase the costs of goods or services involved, and, if so, by how much? Is any increase in cost to the public more harmful than the harm that could result from the absence of regulation by the State agency or office?

A review of the costs of liquor regulation to the State, the industry, and consumers revealed two basic types of costs--administrative costs and compliance costs. Administrative costs include direct costs imposed upon the regulated industry such as license fees, and State expenditures necessary to administer the regulatory program. Compliance costs are those

expenses which the regulated businesses and individuals must incur in order to comply with statutory requirements.

Administrative Costs

The primary administrative costs related to the regulation of alcoholic beverages are the regulatory fees that wholesalers, suppliers, retailers, and club owners pay to do business in the State, and the expenditures the State makes for the regulatory program. The following table lists the license and registration fees charged to licensees in fiscal year 1981, the most current data available.

Division of Alcoholic Beverage Control
Fiscal Year 1981
License and Registration Fees

Type of License or Permit	Number of Licensees	Annual License or Permit Fees	Registration Fees	
			New	Renewal
Retail Liquor Store	1,138	$ 100	$50	$ 10
Liquor Wholesaler	18	1,250	50	10
Cereal Malt Beverage Wholesaler	63	350	None	None
Strong Beer Wholesaler	84	150	50	10
Class "A" Private Club	400	250	50	10
Class "B" Private Club	735	1,000	50	10
Alcohol & Spirits Manufacturer	1	2,500	50	10
Non-Beverage User	8	10-500(a)	50	10
Distributor Salespeople and Manufacturers' Representatives	806	10		
Bonded Carrier	291	5(b)		

(a) Varies by gallons produced and class.
(b) One-time fee.

In fiscal year 1981, the Division of Alcoholic Beverage Control collected a total of $1,077,847 in license, permit, and registration fees, and an additional $111,570 in fines, price posting fees, and other miscellaneous sources. The total fee receipts of $1,189,417 represent the primary administrative costs to Kansas' alcoholic beverage industry. These charges represent less than one-half of one percent of the combined wholesale, retail, and private club sales of $372 million in fiscal year 1981. Therefore, they do not appear to significantly affect the cost of liquor to the consumer. The auditors did note, however, that the State's fee structures may need to be reviewed and revised to bring them more in line with regulatory costs and other states' regulatory fees.

Reviewing Regulatory Fee Structures for the State's Alcoholic Beverage Control Program

License fees for Kansas liquor manufacturers, wholesalers, and retailers have not increased since they were first enacted as part of the Liquor Control Act of 1949. (A bill was introduced during the 1979 Session to increase retailers' annual license fee to $1,000, but it died in conference committee.) Private club license fees were originally set in 1965 at $250 for both class A and class B clubs, although the 1975 Legislature did increase the fee for class B clubs to $1,000.

For comparative purposes, the auditors examined fees for certain licensees in other "license" states. They found that Kansas' annual license fees of $100 for retailers and $1,250 for wholesalers were significantly lower than average. For license states in 1981, the average license fee for retailers was $370, and for wholesalers of distilled spirits and wine was about $2,500.

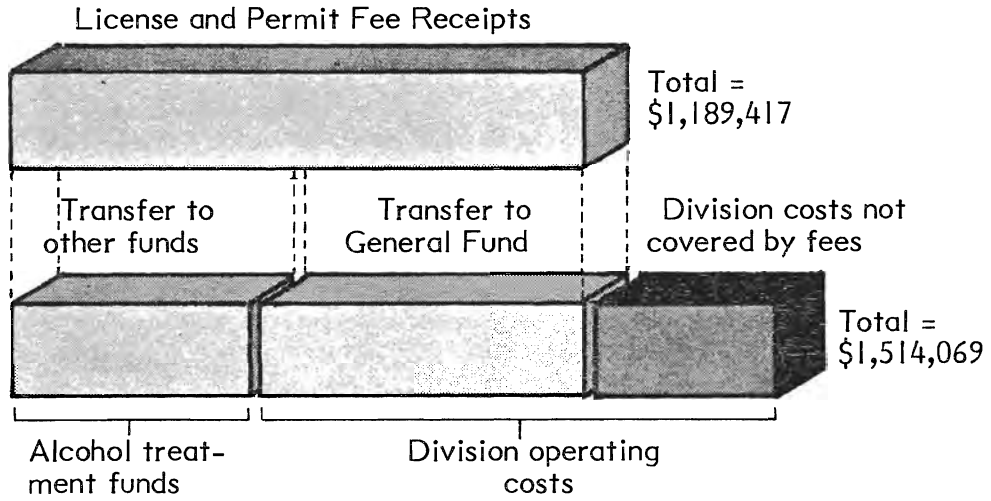
The auditors also compared the Division of Alcoholic Beverage Control's total license and permit fee receipts with its operating costs. A general fiscal policy applied to nearly every State fee-funded regulatory agency is that the cost of an agency's operations should be funded by the license fees and other receipts imposed on the regulated profession or industry. The Division of Alcoholic Beverage Control is not a fee-funded agency, but it seems reasonable that its fee structure should bear some relationship to its actual costs.

The Division is funded through an appropriation from the State General Fund; in fiscal year 1981, it received a total of $1,085,035 to finance its operations. Because all fees collected by the Division are deposited to the General Fund, it would appear on the surface that the 1981 fee receipts of $1,189,417 more than covered the amount appropriated to and spent by the Division. As illustrated by the accompanying figure, however, more than one-third of the fees collected--or $429,034--were deposited in the Community Alcoholism and Intoxication Programs Fund to cover the cost of community treatment programs for alcoholics. Only $702,295 was deposited to the General Fund. The Community Alcoholism Fund was established by the 1975 Legislature. Financial support for community programs was seen as part of the regulatory program's obligation. To provide that support, the Legislature raised class B club license fees from $250 to $1,000.

When the cost of financing community alcoholism treatment programs is added to the Division's cost of administering the alcoholic beverage control regulatory program, it is apparent that the current fee structure does not generate enough money to cover all costs.

If the Legislature intends that community alcohol treatment programs (or any other programs it designates) should be funded at least in

Comparing Fee Receipts With Regulatory Program Costs



Part of the fees collected by the Division of Alcoholic Beverage Control are transferred to fund community alcoholism treatment programs. As a result, fee receipts fall short of covering the Division's regulatory program costs by a fairly substantial amount. In fiscal year 1981, this shortfall totaled $382,740, or 35 percent of the Division's operating costs. The report recommends that the Legislature consider whether alcohol license and permit fee receipts should cover all costs of the regulatory program, including those moneys channeled to finance other funds.

part by the regulatory fees and are a legitimate cost of the regulatory program, then it should consider reviewing and increasing the fee structure to cover these costs as well. The fact that most of these fees have not increased in over 30 years, and that Kansas' fees are well below the average for license states, offers further evidence of the need to review the adequacy of the regulatory fee schedules.

Compliance Costs

Alcoholic Beverage Control statutes and regulations affect all phases of the industry operations. For example, retailers are restricted in their location and in the types of signs they may use, and all licensees are subject to numerous reporting requirements. To help determine if these regulations impose excessive compliance costs, Legislative Post Audit included a question about this topic on its survey of retail liquor store and private club licensees.

The results of the survey indicated that compliance costs were not viewed as a major problem by licensees. In fact, only four retailers (three percent of the total who responded) and one club licensee (one percent of the total) indicated that any aspect of compliance was costly. Three retailers cited the frequency with which prices had to be changed and

suggested that the monthly price posting process was too time-consuming. The other two respondents mentioned excessive paperwork requirements in general as being a problem. However, the auditors' review of paperwork and reporting requirements disclosed that most were necessary to ensure compliance with tax laws and other alcoholic beverage laws.

Does Alcoholic Beverage Regulation Protect the Public?

The primary purpose of regulation is to protect the public. Experience has shown, however, that regulatory agencies may become sympathetic to--even dominated by--the industries they regulate. These agencies may create policies and take actions that benefit the industry rather than the public. To address this concern, Legislative Post Audit made an examination to determine whether all facets of the regulatory process are designed solely to protect the public, whether such protection is the primary effect of regulation, and whether there is a reasonable relationship between the State's exercise of its police power in this regulatory activity and the protection of the public.

To help identify specific aspects of the regulatory program that do not serve to protect the public or are unnecessarily restrictive, the auditors reviewed Kansas' alcoholic beverage statutes and regulations and compared them with other states' laws and regulations and with the Model Alcoholic Beverage Control Act. This Model Act was developed by Columbia University Law School's Legislative Drafting Research Fund to provide states with a useful, uniform law for regulating alcoholic beverages.

Although many of the State's alcoholic beverage statutes and regulations appear to be designed to protect the public, a number of regulatory restrictions on the operations of liquor-related businesses apparently serve to protect the industry from competition, are unnecessarily restrictive, or have little bearing on the protection of the public. The major problem areas can be described briefly as follows:

- **Residency requirements for licensees.** The auditors found that the primary effect of strict residency requirements for manufacturers, distributors, retailers, and individual private club owners is to protect the industry from new competition.
- **Regulation of advertising.** The auditors found that many of Kansas' advertising restrictions have little or no direct relationship to protecting the public's interest.
- **Private business practices.** To provide for an "orderly market," regulatory restrictions have been imposed on certain retail sales, on building specifications, on deliveries and transportation of alcohol, and on business credit and the collection of bad checks. The auditors' review of several of these regulations showed that they were designed to protect the industry rather than the public.

—**Minimum retail mark-up of alcoholic beverage prices.** Kansas is one of only three states that have a minimum retail mark-up. The auditors found little evidence that retail price maintenance helps prevent alcohol abuse. They did find, however, that it guarantees retailers a minimum profit, helps to subsidize many small and inefficient retail liquor stores, inhibits competition, imposes higher costs on consumers, and may decrease the State's liquor tax revenues.

The auditors also found that the Division of Alcoholic Beverage Control could improve its processes and procedures for monitoring reciprocal club agreements, conducting inspections and investigations, and assessing the adequacy and consistency of enforcement activities. When problems exist in an agency's administration of a regulatory program, they can hamper its effectiveness in protecting the public's interest or in ensuring that statutory and regulatory requirements are being met. Regarding reciprocal agreements, the auditors found that some private clubs were able to operate as "reciprocal" clubs without meeting the statutory minimum food sales requirement. The inspection and investigation process was hampered because the timing and content of routine inspections were not designed to detect serious violations of State liquor laws and regulations, and because investigative resources were not being used as efficiently as possible. Finally, inspection results are not analyzed to pinpoint areas where enforcement is lacking or inconsistent, or where inspection activities can be more effectively targeted.

Findings in both areas--restrictions on business operations that serve to protect the industry, and problems with the Division's performance in carrying out its regulatory functions--are more fully explained and recommendations for improvements are presented in the chapters that follow.

Conclusion

Legislative Post Audit's review of alcoholic beverage regulation in Kansas showed that alcohol-related health and safety problems can harm Kansas citizens. Violations of State liquor laws and regulations are also occurring, even with regulation, and a number of these may also harm the public. The auditors could identify no less restrictive mechanism for handling regulation of liquor suppliers, wholesalers, and retailers, and they determined that the benefits of the regulatory program justified its cost. However, the regulatory fee structure should be reviewed to determine whether license fees and other receipts should be increased. Kansas' fees have not been increased in over 30 years, are well below the average for license states, and do not cover the cost of both the regulatory program and other alcohol treatment programs funded from those fees. Finally, the auditors found that some liquor laws and regulations apparently served to protect the industry rather

than the public, and that problems with the Division's performance in carrying out these functions can hamper the program's effectiveness.

Recommendations

1. The Legislature should take action to re-establish the State's alcoholic beverage control regulatory program. In its deliberations, the Legislature should consider the recommendations for improvements presented in this report.

2. The Legislature should review the regulatory fee structure for the State's alcoholic beverage control program to determine whether the level of fees set by statute is adequate. As part of this review, the Legislature should consider whether the program's license fees and other receipts should cover all costs of the regulatory program, including those moneys channeled to other funds to pay for community alcohol treatment programs.

CHAPTER III

RESTRICTIONS ON BUSINESS OPERATIONS

Many of the State's alcoholic beverage statutes and regulations impose restrictions on the operations of liquor suppliers, wholesalers, retailers, private clubs, and other alcohol-related businesses. In reviewing these laws and regulations and comparing them with other states' and with the Model Alcoholic Beverage Control Act, the auditors found that several appeared to protect the industry rather than the public, seemed unnecessarily restrictive, or had little bearing on the protection of the public. Problems were noted primarily in the areas of residency requirements, regulation of advertising, restrictions on certain private business practices, and minimum retail mark-up requirements for liquors and wines. This chapter describes the auditors' findings in each of these areas.

Residency Requirements for Licensees

Kansas' alcoholic beverage statutes impose strict State residency requirements on all classes of licensees--manufacturers, distributors, retailers, and private clubs. In addition, all licensees must have been U.S. citizens for at least ten years. Residency requirements were originally enacted to help ensure that out-of-State "criminal elements" or persons involved in "fly-by-night" operations did not get involved in the State's alcoholic beverage industry. Many people also believed that persons who had lived in the State and county for a number of years would be more concerned than non-resident owners about the welfare of local citizens and the abuses caused by alcohol in their communities. Finally, these requirements made it easier for the Division of Alcoholic Beverage Control to check the character qualifications of prospective licensees.

Residency requirements vary considerably for the different classes of licensees. Besides the requirement for U.S. citizenship, the in-State residency requirement for a manufacturer is five years, for a distributor is 10 years, and for retail liquor store owners is 10 years plus five years in their county. These requirements were part of the original 1949 Liquor Control Act. Private club requirements were not established until 1965, when the Private Club Act was passed. Residency requirements for individuals who own private clubs are five years in the State and one year in the county. By contrast, corporate owners of private clubs need not be residents of the State at all, as long as they employ a resident agent to handle their business affairs. This agent does not have to meet the same residency requirement as the individual club owner; he or she must be a

Licensee Residency Requirements

Type of License or Permit	Residency Requirement
Manufacturer	5 years in State
Distributor	
Alcoholic Liquor	10 years in State
Cereal Malt Beverage	5 years in State
Retailer	10 years in State 5 years in County
Private Club (Individual Owner)	5 years in State 1 year in County
Private Club License (Corporate Owner)	None

U.S. citizen and Kansas resident, but there are no time requirements on either residency. The auditors were not able to determine why residency requirements for private clubs were made much less restrictive than those for retailers and distributors, or why corporate-owned private clubs have no residency requirements for licensure.

The auditors also reviewed statutory residency requirements in nine other states and those set out in the Model Alcoholic Beverage Control Act. They found that Kansas' requirements are among the most restrictive. Two states--Minnesota and South Dakota--have no state residency requirements for licensure. Four states--Colorado, Missouri, Nebraska, and North Dakota--have state or county residency requirements but place no time specifications on them. And of the three other states with time limits on their residency requirements--Oklahoma, Texas, and Arkansas--none were as strict as in Kansas. Moreover, the Model Act has eliminated residency requirements entirely.

Although residency requirements originally may have been intended to protect the public, it appears that the primary effect of such stiff requirements is to protect the industry from new competitors. As the population has become more mobile over the years, the residency requirements have become more difficult for persons to meet. Consequently, the group of potential licensees is reduced significantly.

Given the inconsistencies in residency requirements for different types of licensees and the restrictiveness of those requirements, Legislative Post Audit concluded that these residency requirements could be reduced or eliminated. The objective of excluding "criminal elements" from the alcoholic beverage industry in Kansas can be achieved through strict licensing requirements mandating substantial disclosure of background and financial information, and providing that no person may be granted a license who has committed certain criminal offenses.

Recommendation

The Legislature should review residency requirements for liquor manufacturers, distributors, retailers, and private clubs, and should consider the following options:

a. Eliminating residency requirements altogether.

b. Eliminating all time limits on residency requirements.

c. Reducing residency requirements for all classes of licensees to a minimal level, such as one year.

Regulation of Advertising

Over the years, Kansas has developed a myriad of advertising regulations. Restrictions on advertising were generally enacted to protect the public by promoting temperance and providing for an orderly market.

Advertising of alcoholic beverages is regulated at the federal level by the Bureau of Alcohol, Tobacco, and Firearms within the Treasury Department. These regulations apply to advertising by manufacturers and wholesalers, and they prohibit advertising that is false and misleading, obscene, inconsistent with the information on the label, suggests a curative or therapeutic effect, and similar restrictions. The thrust of these regulations is to protect the public by ensuring that all statements regarding a product are true and not misleading.

Kansas has adopted many of these same restrictions, and in other cases has incorporated the federal regulations for use in Kansas. However, the State has also promulgated a number of additional statutes and regulations restricting advertising practices that are not present at the federal level. Examples of these restrictions are listed on the following page.

In comparing Kansas' regulations with other states' advertising regulations, the auditors found that Kansas restrictions are among the most restrictive. Of the license states, it appears that only Oklahoma has more restrictive rules governing advertising. In addition, the Model Act incorporates the federal advertising regulations by reference and does not add other advertising regulations, as Kansas does.

Because Kansas' regulation of advertising is more restrictive than regulations at the federal level and in most other states, the auditors examined several restrictions in greater detail.

On their face, the protection afforded consumers by a number of regulations seems questionable. These include restrictions on "dummy" display bottles, price tags, matchbook covers, and references to Mother's Day and Easter. Regulations specify not only the size and number of signs retailers can use outside their stores, but also the maximum size of "open" and "closed" signs allowed. Retailers cannot use blinking lights except during Christmas, and then they may not be used to partially or fully outline windows from either the inside or outside. Such specific and

Additional Kansas Advertising Regulations	
Advertising Restriction	**Statute or Regulation**
No reference to price No advertising by brand name	K.A.R. 14-8-2
No alcoholic liquor in store window	K.S.A. 41-714
No signs on buildings	K.A.R. 14-8-8
No hand bills or billboards	K.S.A. 41-714
No advertising of distilled spirits over radio, television, or motion picture (wine and beer allowed)	K.A.R. 14-8-11
No gifts of matches or similar advertising media	K.A.R. 14-8-11
Retail liquor store sign restrictions on number, wording, size	K.S.A. 41-714(3)
No display of liquor except at licensed premises	K.A.R. 14-8-3
Restrictions on price tags	K.A.R. 14-8-4
No "dummy" display bottles	K.A.R. 14-8-5
No advertising on vehicles (beer allowed)	K.A.R. 14-8-6
Restrictions on exterior lighting	K.A.R. 14-8-9
No reference to Mother's Day, Easter, or Holy Week	K.A.R. 14-8-10

restrictive regulations appear to have little or no relationship to protecting the public. Other regulations reviewed appeared to limit competition or to be ineffective in protecting the public. These problems are illustrated by price and brand advertising restrictions and by inconsistent advertising regulations.

Price and Brand Advertising Restrictions

State regulation prohibits advertising of alcohol prices and brand names. The rationale for these restrictions appears to be based on the assumption that keeping consumers ignorant of prices and brand names will discourage excessive consumption of alcohol. There is no demonstrated evidence of such relationships, however. Moreover, brand name advertising of liquor appears in most national magazines, so consumers subscribing to these publications already see such ads.

In actuality, Kansas' restrictions in this area tend to limit competition. Retailers may not advertise to the public about the prices of comparable brands, the availability and price of "sale" items, or the names of brands they carry.

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Department of Revenue: Dealer Licensing Regulatory Program (December 1982); Division of Alcoholic Beverage Control (December 1982)

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Recently, restrictions on price advertising also have been successfully challenged on the basis of their constitutionality in several states, including Michigan, Tennessee, and Mississippi. The possibility that price advertising restrictions may be ruled unconstitutional is suggested by a Virginia court case. The Supreme Court in the 1976 Virginia State Board of Pharmacy decision (Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748) extended the protection of the First Amendment to commercial speech. The court invalidated a regulation of the Virginia Board of Pharmacy that prohibited advertising of prescription drug prices. The court held that the First Amendment gave the druggist the right to advertise and gave the consumer the right to receive the communication. According to the authors of the Model Act, there seems to be no reason to exclude advertising of liquor prices from that holding.

Inconsistent Advertising Regulations

Some restrictions on advertising liquor seem inconsistent. For example, State regulations allow retailers to sponsor athletic teams and provide shirts or jackets printed with the name and address of their store, but they prohibit retailers from advertising in athletic schedules. The auditors also found that several advertising regulations vary according to the type of alcoholic beverage. For example, wine and beer can be advertised over the radio or television, but distilled spirits cannot. Also, 3.2 beer (cereal malt beverage) can be advertised on billboards, while distilled spirits and wine cannot.

If the objective of regulation is temperance and reduction of alcohol abuse, such inconsistencies as having different restrictions on different types of alcohol appear to be counter-productive. About 60 percent of the alcohol consumed by Kansans is in the form of beer. Further, estimates of the number of alcohol abusers in Kansas show that more regularly drink beer than all other alcoholic beverages combined. Consequently, the alcoholic beverage that contributes the most to alcohol abuse in the State is subject to the least restrictive advertising regulations.

Recommendation

The Division of Alcoholic Beverage Control and the Legislature should re-evaluate all liquor advertising regulations required in Kansas that are not required at the federal level. The review should help determine whether these regulations are necessary to protect the public and whether they should be revised or eliminated to abolish inconsistencies and to better meet the objectives of the regulatory program. As part of this review, the federal Bureau of Alcohol, Tobacco, and Firearms' advertising regulations should also be adopted by reference in Kansas.

Limitations on Alcohol-Related Business Practices

Limitations on private alcohol-related business practices can be found throughout Kansas' alcoholic beverage laws and regulations. In fact, it appears that the operations of liquor retailers and distributors and private clubs may be the most highly regulated of any businesses in the State. Areas where business practices are restricted include selling anything other than alcoholic beverages in retail liquor stores, deliveries by wholesalers, building layout, lighting, and sign specifications, credit between licensees and with consumers, recordkeeping, insufficient fund checks, and transportation of alcoholic beverages.

These restrictions are generally designed to provide for an orderly market in Kansas. Because of the large number of regulations, the auditors were unable to review all of them in detail to assess whether they actually serve to protect the public. Instead, they focused their analysis on two regulations that appeared to be designed to protect the industry rather than the public. These regulations address procedures for handling insufficient fund checks and deliveries of alcoholic beverages.

Other Examples of Business Restrictions

Although the auditors were not able to evaluate all limitations on liquor-related business practices, they did review all of these restrictions. The Division issues written interpretations of these restrictions. Some of these interpretations appeared, at least on the surface, to have little bearing on the public's protection:

--Retailers can use awnings or window shades only during the time the sun is penetrating the windows. And even then, at least one window must be left uncovered so as not to obstruct the view inside the store.

--Retailers cannot accept credit cards for the purchase of liquor, although private clubs may.

--Retailers may cool water, pop, milk, or lunches in their cooling units if the items are cooled for personal use and not for sale.

--No liquor containers may be placed under a Christmas tree or in a Christmas scene in a retail liquor store.

--When marking prices on bottles, retailers must show the consumer price and enforcement tax separately. They cannot show the total price in one figure.

Procedures for Handling Insufficient Fund Checks

By statute, wholesalers may not extend credit to retailers and retailers may not extend credit to private clubs. The intent behind these credit restrictions is to prevent "tied houses," in which one licensee obtains a substantial interest in another licensee lower in the three-tier distribution chain of suppliers, wholesalers, and retailers. Kansas is one of only seven states that require cash payments by retailers.

To further enforce this restriction on credit, regulations stipulate that retailers who receive insufficient fund checks from private clubs, or

distributors who get bad checks from retailers, must report this information to the Division of Alcoholic Beverage Control. The Division usually will hold a hearing to force the retailer or club owner who wrote the bad check to pay it. In many cases, an additional penalty is assessed by placing the retailer or club owner on a "cash basis," thus prohibiting them from making future payments for liquor by check. In 1981, there were 44 violations of the insufficient fund checks regulation by retailers and five by private clubs.

The State's Involvement in Insufficient Fund Checks: An Example

In December 1980, the Division of Alcoholic Beverage Control received a letter from a beer distributor stating that a retailer had written the company a bad check for about $180. The Division held a hearing the next month, at which the retailer stated his check had bounced because he had made an error in his bookkeeping. He said he thought he had sufficient funds to cover the check. Following the hearing, the Division's Chief Enforcement Officer revoked the retailer's check writing privileges, putting the retailer on a "cash basis" only with his distributors.

The Division's involvement in ensuring that liquor retailers or wholesalers receive restitution for insufficient fund checks appears to be an unreasonable exercise of the State's police power. The regulatory practice also appears to protect the industry rather than the public. Wholesalers who receive bad checks from retailers can, on their own initiative, require them to pay on a cash-only basis. This is a common debt management practice for most businesses. Further, if a retailer refuses to make the check good, the distributor can exercise the normal civil and criminal remedies that other businesses have when receiving bad checks. Finally, other existing laws and regulations will act to prevent licensees from gaining financial control or interest in another level of the distribution chain because of debts owed. Under State law, for instance, a retailer cannot have a beneficial interest in the manufacture, preparation, or wholesaling of alcoholic beverages, and no person holding a license in one tier of the chain can obtain a license in another tier.

Deliveries of Alcoholic Beverages

Kansas regulations restrict deliveries of alcoholic liquor to retailers in three ways:

--Retailers must order from a wholesaler by 2 p.m. on the day preceding the requested day of delivery.

--Distributors are not allowed to deliver alcoholic liquor on Saturday or Sunday.

--Each retailer must be offered no less than one day of delivery within a seven-day period, at a minimum poundage of 30 pounds.

These regulations appear to protect the industry by attempting to balance the best interests of wholesalers and retailers. By State regulation, distributors are protected from having to work on weekends, and they do not have to deliver any retailers' liquor orders received after 2 p.m. Similarly, retailers are assured a weekly, minimal-sized delivery of liquor by wholesalers, which keeps their inventory costs down.

Deliveries were originally regulated during the open wholesaling system. Wholesalers could carry the same brands under this system, but had to charge the same prices. Consequently, one of the only competitive edges they had revolved around delivery schedules and weights. In an apparent attempt to minimize this competition, the Division gradually imposed the restrictions listed above. At first, the minimum order a wholesaler was required to deliver was 100 pounds. This requirement was decreased to 30 pounds when the exclusive franchise system was instituted in 1979 to protect small rural retailers from reduced delivery schedules. The currently required delivery schedule--which guarantees every retailer in the State deliveries on at least a weekly basis--is one of the regulations that wholesalers objected to most strongly in the auditors' survey of licensees. As a result of wholesalers' concerns regarding the inefficiency of required deliveries, the Division is again planning to review this regulation.

In sum, the auditors' findings that State regulation over certain business practices appear to protect the industry seem to pinpoint the need for reviewing all restrictions on business practices and eliminating those that appear to protect the industry and are not necessarily in the public's best interest.

Recommendation

The Division of Alcoholic Beverage Control and the Legislature should review all restrictions on business operations in the liquor industry and should eliminate those regulations that appear to be designed to protect the industry, not the public. These should include regulations over insufficient funds check procedures and alcohol deliveries, but may also include regulations on numerous other practices as well.

Minimum Mark-Up of Retail Liquor Prices

The State's retail price maintenance program is the culmination of the entire marketing process for liquor and wine in Kansas. The marketing process begins with suppliers affirming that the price at which they sell their products in Kansas is the lowest price at which those products are offered anywhere in the country. The process then proceeds to the wholesale tier. Wholesalers sell their wares to retailers in an agreed-upon territory according to exclusive franchise agreements with suppliers.

Wholesalers are required to file price postings with the Division on a monthly basis and to provide price books to retailers. These price books give the retail price of each product, and include the minimum percentage mark-ups in effect as determined by the Alcoholic Beverage Control Board of Review.

Minimum mark-ups are required only at the retail level. The purpose of the minimum retail mark-up is to ensure that low prices do not unduly stimulate the sale and consumption of alcohol and to promote the orderly sale and distribution of alcoholic liquor. Retailers sell their products to private clubs and consumers for at least the minimum price established through the minimum percentage mark-up. The only exception to the minimum price law is a provision allowing retailers to offer a discount set by the Board of Review on sales of case lots or more. In addition, the minimum retail mark-up does not apply to cereal malt beverages (3.2 beer), and although the statutes provide for price maintenance on strong beer, the Board of Review has never exercised this authority.

Kansas is one of only three states that have a minimum retail mark-up on liquor and wines. The auditors reviewed the State's retail price maintenance program in considerable detail, and compared it with programs in other states. Their findings are presented in the sections that follow, preceded by a brief explanation of the retail price maintenance program's history and intent.

Legislative Intent and History of Retail Price Maintenance

After the Liquor Control Act was enacted in 1949, an administrative regulation was promulgated requiring liquor distributors to provide retail liquor stores with suggested prices. Retailers closely followed these suggested prices. In 1956, the Director of Alcoholic Beverage Control required by regulation that retailers must sell at these suggested prices. This regulation was declared invalid for lack of legislative authority by a district court in 1958.

In response to this court decision, the Legislature passed the first minimum price law. This law required suppliers to file suggested wholesale and retail prices with the Director. According to the law, these prices would become minimum prices if the Director determined that such price regulation was in the public interest. In a 1961 case, the Kansas Supreme Court declared this law unconstitutional because it improperly delegated legislative authority to private persons (suppliers) and the Director.

The 1961 Legislature restored price maintenance with legislation requiring the State to set minimum wholesale and retail prices through the Alcoholic Beverage Control Board of Review. The law further stated that the establishment of minimum prices was in the public interest and was necessary to promote the orderly sale and distribution of alcoholic liquor, to foster temperance, and to promote the public welfare.

In 1978, the Special Committee on Liquor Laws held hearings to evaluate the price maintenance program. Proponents of continued price maintenance by the State testified that these provisions eliminated illegal activities that could result from intense economic pressure, curbed ruthless commercial behavior by large competitors, prevented organized crime from entering the Kansas market, and supported an orderly market. Proponents also argued that the liquor industry was highly regulated, not unlike some utilities, and that State regulation of this product was appropriate. Opponents of minimum pricing testified that it contributed to higher consumer costs, rewarded economic inefficiencies, and was, in effect, a guaranteed profit for established wholesalers and retailers.

In response to this testimony, the Committee introduced legislation to eliminate the minimum price mark-up for wholesalers. The Committee concluded that this change was necessary because it was also recommending the implementation of an exclusive wholesale franchise system. Both proposals were enacted by the 1979 Legislature. The minimum price mark-up for retail liquor stores was retained.

Determining the Minimum Retail Price Mark-Up

Under State law (K.S.A. 41-1114 to 1116), the Alcoholic Beverage Control Board of Review is responsible for setting a minimum retail liquor mark-up that is "fair and reasonable to licensed retailers and the ultimate consumer." The law calls for the Board to consider and be guided by the following factors:

--the mean of acquisition costs of licensed retailers
--federal, State, and local taxes and license fees paid by retailers and levied or imposed in connection with their business of selling alcoholic liquor in Kansas
--the mean of selling costs of licensed retailers
--the mean of any legitimate, reasonable expense not otherwise specified incurred in the legal conduct of a licensed retailer's business
--a reasonable profit for licensed retailers

Using this information, the Board holds public hearings on the minimum mark-ups and determines if the mark-up in effect is appropriate or needs to be revised. The Board also reviews and determines the "case-lot discount." This discount is not required by law; a retailer may choose not to grant it, but if a discount is given it cannot exceed 10 percent.

The Alcoholic Beverage Control Board of Review recently requested that the Department of Revenue conduct a study of the minimum retail mark-ups. The primary purpose of the study was to determine whether the mark-ups and case-lot discounts should be maintained, increased, or decreased considering retail liquor stores' costs and profits. To obtain this information, the Department sent questionnaires to 203 Kansas retailers

and obtained additional information from their 1980 tax returns. The study suggested that the minimum mark-up could be decreased on wine, increased on specialties, and instituted over strong beer, and that the case-lot discount should continue unchanged. The Board reviewed these results at its August 1982 meeting, but decided to continue the mark-ups and discount at the percentages shown below until it could review the study further.

Kansas Minimum Retail Mark-ups

Mark-up on Spirits	28.5%
Mark-up on Specialties	36.5%
Mark-up on Wines	45.5%
Discount for Case-Lot Purchase	10.0%

The other two states with retail price maintenance have much lower mark-ups than in Kansas. In Wisconsin the mark-up applied to all liquor sold in retail stores is six percent, and in New York the minimum retail mark-up is 12 percent.

Because price affirmation and price posting are not required for strong beer or cereal malt beverages, there is no uniform floor on which to base beer prices. Consequently, it would be difficult to monitor compliance with minimum beer prices. As pointed out earlier, the Board has never exercised its authority to provide for minimum retail mark-ups on strong beer. According to the auditors' survey of Kansas retail liquor stores, the average mark-up on strong beer is 23.4 percent. The Department's survey of retailers for its minimum mark-up study indicated that the average mark-up on strong beer is 18.7 percent.

The auditors' review of the guidelines used by the Board to establish minimum mark-ups showed that neither temperance nor consumer interests receive explicit recognition in the percentage mark-up computation. Further, it is not clear how minimum prices can be established that are fair and reasonable to consumers but do not unduly stimulate the consumption of alcoholic beverages. Finally, providing a 10 percent discount on the sale of case lot or more of liquor might have a counter-temperance effect. This regulation would seem to encourage people to buy liquor in larger quantities to get the 10 percent price break.

Effects of the Retail Price Maintenance System On the Industry, Consumers, and the State

The price maintenance system has an impact on many areas of the State's alcoholic beverage regulatory program. To determine the effects of minimum retail mark-ups, the auditors reviewed data available on alcohol consumption and abuse, and performed several analyses and com-

parisons involving numbers of licensed retailers, prices in other states, costs to the consumer, and out-of-State purchases. Their analyses disclosed little evidence that retail price maintenance curbs alcohol abuse. The auditors did find, however, that a minimum retail mark-up essentially guarantees retailers a minimum profit, helps subsidize many small and inefficient retail liquor stores, inhibits competition, imposes higher costs on consumers, and apparently results in lost tax revenues for the State.

Price maintenance has little impact on consumption and alcohol abuse. Because research does not support the commonly held belief that artificially high prices will lower consumption and discourage alcohol abuse, the Model Alcoholic Beverage Control Act does not include provisions for price maintenance. The authors of the Model Act concluded that, in the absence of such evidence, higher prices are an inappropriate cost for the large segment of society that consumes alcoholic beverages in moderation. They also concluded that minimum retail mark-up provisions conflict with a fundamental national policy--the promotion of competition--that the Supreme Court has proven less and less willing to subordinate to state interests in recent years.

Experience in other states that have recently discontinued price maintenance programs indicates that per-capita consumption does increase slightly. However, it is not clear that the total increase is caused by people actually drinking more. Consumption figures are arrived at by dividing retail sales by the population. Thus, current consumption figures for Kansas are already low to the extent that Kansans drink out-of-State liquor. If price controls were lifted in Kansas, consumption statistics might be expected to rise as residents who have been making out-of-State purchases return their business to Kansas. Neighboring states' consumption figures might be expected to drop correspondingly.

Based on their review in this area, the auditors questioned whether the current retail price maintenance system has been effective in promoting temperance by decreasing consumption. Consumption of alcoholic beverages in Kansas has more than doubled since the minimum retail mark-up was instituted in 1961, although there is no way to tell conclusively whether the increase would have been greater in the absence of price control. In addition, because beer and cereal malt beverages are not subject to price control--and they account for approximately 60 percent of the pure grain alcohol consumed by Kansans--the State's efforts to decrease consumption through price maintenance are directed at the source of only 40 percent of the alcohol.

Research indicates that raising the price of distilled spirits in relation to a person's disposable income does result in a decrease in liquor purchases. However, there is also evidence that beer and distilled spirits are substitutes for each other. If distilled spirits cost more than beer, beer consumption will rise. This would suggest that if temperance is the goal of

the program, it cannot be achieved due to the absence of price maintenance on beer.

Kansas has an above average number of retail liquor stores. Retail price maintenance, together with a number of other features of the regulatory system, has encouraged the operation of many retail liquor stores in Kansas. Because the minimum mark-up essentially is based on average retailer costs and a reasonable profit, it helps maintain inefficient stores. Other aspects of the regulatory system that create a non-competitive environment for retailers and contribute to maintenance of inefficient stores include the following:

--requirements that private clubs buy only from retailers
--restrictions on incorporation and multiple stores
--prohibitions on price and brand name advertising
--restrictions on credit in purchasing and selling
--restrictions on deliveries of alcohol
--residency requirements.

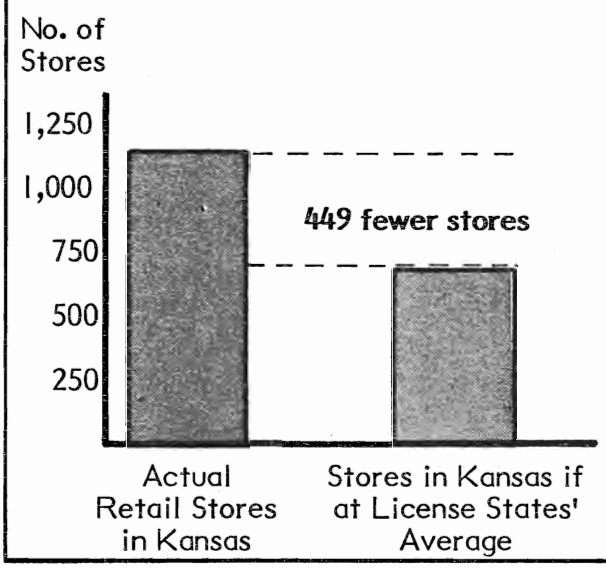
As a result of such regulatory requirements retailers can maintain low inventories, are assured the business of private clubs, and are in effect guaranteed a profit because of the high minimum mark-ups. The Department's 1982 minimum mark-up study showed that the average Kansas retailer had sales of $166,404 in 1980, and a net profit of $8,194.

Retail price maintenance and many of these other regulations may be intended to promote temperance, but the auditors found that the consequence of a high number of liquor stores may have the opposite effect. In 1980, Kansas had one retail liquor store for every 2,030 people--well above the license states' average of one for every 3,212 people. If Kansas had the average number of stores of all license states, it would have had approximately 715 liquor stores, a decrease of 36 percent.

The 1978 Special Committee on Liquor Laws concluded that there were too many retail stores in the State and that the price control system furthered economic inefficiencies. But because of reservations about large numbers of retail stores closing, the Committee did not recommend that retail price controls be eliminated. It did recommend that a "reduction in the number of retail liquor stores should be a topic of continued legislative interest in the future, since the degree of economic efficiency at that level will remain low unless and until many of the inefficient retail stores are eliminated."

Retailers in the State strongly support the price maintenance system. In the retailers' survey conducted by Legislative Post Audit, retailers were asked if they could continue to operate a business in the absence of a minimum mark-up. Altogether, 116 retailers (77 percent of those responding) indicated that they could not be successful without a minimum mark-up. The primary concern was that larger retailers would be able to cut prices drastically, driving most of the smaller retailers out of business.

Showing One Effect of Minimum Retail Mark-Ups of Liquor On the Number of Retail Stores in Kansas



In 1980, Kansas had a total of 1,164 retail liquor stores, or one store for every 2,030 people. This number is well above the license states' average of one for every 3,212 people. If Kansas had the same number of stores as the license states' average that year, it would have had only 715 liquor stores. Minimum retail mark-ups of wine and liquor, which subsidize inefficient stores, contribute to the high number of stores.

The loss of small "mom and pop" stores is especially feared, but this group is most difficult to identify. The Department of Revenue's study on minimum retail mark-ups identified the existence of three groups of retailers. The first group uses retail liquor stores as an investment or tax shelter, the second uses the store as a secondary source of income, and the third group as a primary source of support. Individuals who depend on retail stores for their total income would apparently be harmed the most if price controls were removed and all licensees choose to remain in the market. However, other groups might exit the market rapidly if price controls were removed.

Because of such concerns, the auditors also examined the experience of other states under price decontrol. In New Jersey and Connecticut, two states that recently discontinued price maintenance, few retail outlets have gone out of business. New Jersey discontinued its price maintenance program in March 1980, and lost no retailers during the first year because of price decontrol. New Jersey's liquor prices generally have not gone down, but it appears that significant price competition does exist at the retail level for comparison shoppers.

Connecticut discontinued price controls on beer and spirits in January 1982, and plans to end minimum mark-ups on wine in January 1983. It is too early to judge the total effect of the changes in Connecticut; however, so far 25 out of 1,700 retailers have gone out of business, and 50 more are temporarily closed. It is not clear how many of these closings are due to decontrol.

If retail price maintenance in Kansas is abolished, the situation may be unique because of the large number of stores in relation to the population. For this reason, the retail liquor industry in Kansas could experience more store closings than other states would. It should be noted, however, that the number of retail liquor stores in Kansas is already on a downward trend, dropping from 1,201 in 1978 to 1,138 in 1981. This decline would seem to indicate two things. First, that minimum mark-up does not protect all stores from closing, and second, that if store closings do occur following the removal of price maintenance controls, some may be attributable to factors other than the elimination of minimum mark-ups.

Experiences in New Jersey and Connecticut nonetheless suggest several measures that can contribute to market stability during a transitional period when price controls are removed:

—**A gradual, planned change.** In New Jersey, mark-ups were decreased over time; in Connecticut, they were initially removed only from certain categories.

—**Restraining new competition.** In New Jersey and Connecticut, existing stores may be sold, but new licensees have been temporarily prohibited from entering the market.

—**Prohibiting practices that provide competitive advantages to larger retailers.** These practices include cooperative purchasing, multiple licensing, group advertising, and quantity discounts from wholesalers.

—**Prohibiting retail stores from selling below wholesale cost.** Other pricing practices that might force smaller retailers out of business might also be restricted temporarily.

In addition, if minimum mark-ups are gradually phased out, such aspects of the regulatory programs as price and brand name advertising restrictions, requirements that private clubs buy only from retailers, and restrictions on incorporation and multiple stores would need to be revised or eliminated as well.

Kansas consumers pay high prices for distilled spirits. According to several economic principles, legal minimum prices (also known as price floors or price supports) are usually established to maintain the market price at a higher level than it would be if only seller supply and buyer demand determined the price. To determine the general level of Kansas' liquor prices, the auditors compared retail prices in Kansas for eight popular brands of distilled spirits with those of other license states. This "eight-brand average" is a commonly accepted indicator of prices used by the liquor industry. The data for this comparison was provided by the Distilled Spirits Council of the United States.

Comparison of Eight-Brand Average For Distilled Spirits First Quarter 1982			
	Average Price Per Fifth		
Brand	All Other License States	Surrounding States	Kansas
Seagram 7	$ 6.85	$ 6.40	$ 7.26
Old Crow	6.44	5.87	8.09
Old Granddad	10.46	8.96	10.49
Dewars Scotch	11.53	10.23	11.63
Canadian Club	9.51	8.62	9.56
Smirnoff Vodka	6.37	5.97	6.32
Bacardi Silver Rum	6.54	5.92	6.23
Beefeater Gin	10.25	9.35	10.39
Eight-Brand Average	**$ 8.49**	**$ 7.67**	**$ 8.74**

According to that information, Kansas retail prices for these eight brands during the first quarter of 1982 averaged 25 cents per bottle higher than the average price in the other license states. Kansas prices are the tenth highest of 33 reported. When compared to the average for the four surrounding states, Kansas prices averaged $1.07 per bottle higher. Even excluding Oklahoma, where prices average $2.50 per fifth less than in Kansas, the prices in Missouri, Nebraska, and Colorado average $8.09 per fifth, or 65 cents lower than Kansas. These higher prices can be attributed directly to the retail price maintenance program. Supplier prices to wholesalers are generally the same in all states because of price affirmation, and the auditors' comparison of average prices of four brands for which uniform information could be obtained indicated that Kansas' wholesale prices are also generally comparable to the surrounding states. The only difference is at the retail level.

Retail Liquor Prices in Kansas

For the first quarter of 1982, Kansas' eight-brand average retail price for liquor was $8.74 per fifth.

This amount is. . .	By this much. . .
Higher than all license states	$ .25
Higher than the surrounding states	$1.07
Higher than the surrounding states (excluding Oklahoma)	$ .65

These differences in price are the result of the minimum mark-up of liquor prices at the retail level, as required by State law and as set by the Alcoholic Beverage Control Board of Review.

Based on this comparative price data, the cost of retail price maintenance to Kansas consumers can be roughly estimated. Retail prices in Kansas are three percent higher than the national eight-brand average, and 14 percent higher than the surrounding state average. Total distilled spirits sales in Kansas are estimated at approximately $86 million for fiscal year 1982. If the same amount of distilled spirits had been sold in Kansas, but at the average price charged by all license states or by the surrounding states, Kansas liquor consumers would have paid somewhere between $2.6 million and $12.0 million less for distilled spirits in 1982. It should be noted that these figures account only for increased costs on distilled spirits. Wines and specialties are also subject to a minimum mark-up, but were not included in this estimate because of a lack of comparative data on prices for these products. Thus, the cost impact could be much greater.

Higher retail prices in Kansas stimulate out-of-State purchases, and result in lost liquor tax revenues. Higher prices in Kansas also encourage Kansans to purchase liquor outside the State, even though it is against the law to do so. To estimate the amount of out-of-State purchases, the auditors compared data from 1981 per-capita sales of liquor in all Kansas "border" counties to per capita sales of liquor in the "interior" counties. It was assumed that the drinking habits of residents in both sets of counties were equal. Border county sales of liquor were $81.45 per person, compared to $92.92 for the interior counties.

By multiplying the population of the border counties times the difference in per-capita sales between interior and border counties, the auditors estimated that Kansas lost $10.3 million in retail liquor sales to other states in 1981. (This estimate is somewhat more conservative than the Division of Alcoholic Beverage Control's estimate for 1977 of a $17 million loss in sales to other states.) Had these sales been made in Kansas, they would have been subject to the four percent enforcement tax, which would have netted the State an estimated $400,000 in additional enforcement taxes. Further, the auditors estimated that the gallonage taxes the State should have received on these sales would have amounted to more than $400,000. Potentially, then, the State lost an estimated $800,000 in liquor tax revenues in 1981 because higher retail prices here encouraged liquor purchases across the border.

Conclusion

Kansas has one of the last remaining retail price maintenance systems in the country. The State's retail liquor prices are also among the highest in the nation, apparently because of the required minimum retail mark-up. Although minimum mark-ups are intended to promote temperance and the orderly sale and distribution of liquor, there is little evidence that retail price maintenance helps prevent alcohol abuse or otherwise protect the public's health, safety, and welfare. Instead,

these price controls cause consumers to pay higher retail prices than appear to be warranted, subsidize inefficient stores by essentially guaranteeing them a minimum profit, and send some Kansans across the border to buy liquor at lower prices, thereby decreasing the State's tax revenues from liquor sales. Eliminating minimum mark-ups may have an effect on the number of stores operating in the State, but decontrol can be phased-in gradually to prevent an upheaval. For these reasons, Legislative Post Audit concluded that minimum mark-ups on the retail price of liquor should be abolished.

Recommendation

The Legislature should consider eliminating the State's retail price maintenance program. If retail price control is eliminated it should be phased-out gradually, and other practices such as selling below cost should be prohibited at least temporarily to help ensure greater market stability during the transition period.

CHAPTER IV

IMPROVING PERFORMANCE OF THE ALCOHOLIC BEVERAGE CONTROL REGULATORY PROGRAM

To evaluate the performance of the Division of Alcoholic Beverage Control in administering the regulatory program, Legislative Post Audit reviewed the Division's licensing activities, its recordkeeping, inspection and investigation procedures, and its enforcement policies and practices. Members of the industry were also surveyed to get their perceptions of performance problems in the regulatory program. This review identified two major areas where improvements were needed to make the program more effective: the monitoring of reciprocal agreements, and the adequacy and consistency of inspection and enforcement activities. This chapter discusses each problem area in detail and presents recommendations for improvements.

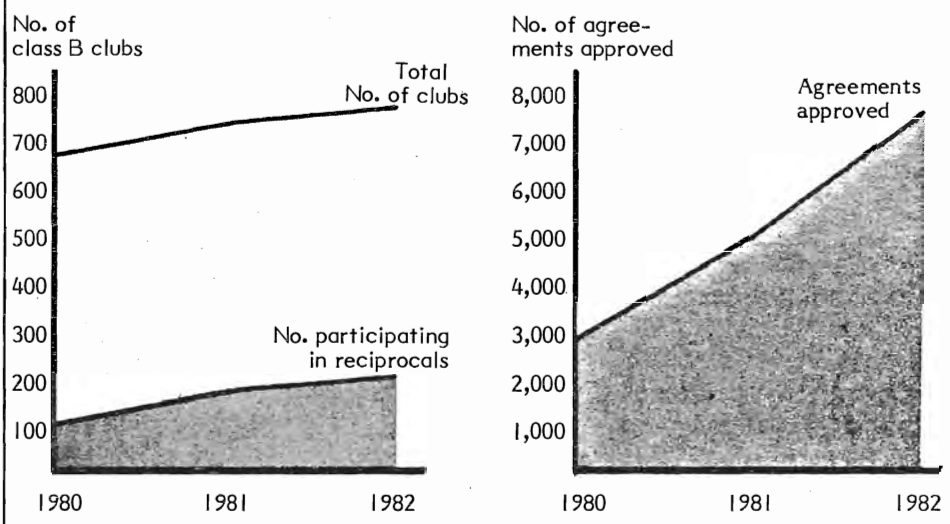
Monitoring Reciprocal Agreements

In 1978, legislation was passed which would have permitted the sale of liquor by the drink in restaurants that derived more than 50 percent of their gross receipts from food sales. When the Kansas Supreme Court ruled that this law was unconstitutional, the 1979 Legislature enacted Senate Bill 467. This bill permitted class A clubs and class B "restaurant" clubs to enter into reciprocal agreements with each other. Under such agreements, members of one private club have access to all of that club's "reciprocal" clubs, or clubs that have entered into a reciprocal agreement.

Since this law was passed, a large number of clubs have taken advantage of these agreements. By the end of fiscal year 1982, 215 class B clubs were participating in reciprocal agreements. The total number of agreements approved by the Division of Alcoholic Beverage Control was 7,562. Thus, each participating club is reciprocal with an average of 35 other clubs.

To get reciprocal status, a club must file an affidavit of gross receipts at the time it renews its license. This statement certifies that, during the previous calendar year, at least 50 percent of the club's total gross receipts were derived from the sale of food. This statement also contains the club's estimate of the percentage for the next calendar year. The Division checks the club's calculation of the food sales percentage to ensure that it is at least 50 percent, and certifies the club's eligibility to enter into reciprocal agreements. If the affidavit indicates the club is

Growth in Class B Clubs Participating in Reciprocal Agreements



Between 1980 and 1982, the number of class B clubs participating in reciprocal agreements rose at about the same pace as the increase in the total number of clubs. However, the number of agreements approved rose very rapidly, indicating that more clubs are entering into agreements with each other. By 1982, each participating club was reciprocal with an average of 35 other clubs.

deriving less than 50 percent of its sales from food, the law indicates that these clubs are not eligible for reciprocal status. Since 1979, nine clubs have had their reciprocal privileges cancelled, and only two of these have been reinstated.

The auditors' review in this area showed that the Division's processes and procedures for monitoring reciprocal club agreements allowed some clubs to circumvent the statutory minimum food sales requirement. This "loophole" exists because the Division does not independently verify clubs' reciprocal eligibility, has lenient eligibility requirements, and does not require private clubs in hotels and motels to maintain records of food sales separately from those of public restaurants on the same premises.

Lack of Independent Verification of Clubs' Reciprocal Eligibility

Although the Division's law clerk conducts a review of each club's reciprocal affidavit, the Division does not independently verify that the information provided on the affidavit is correct. Investigators from the Division's Enforcement Bureau do sometimes verify a club's eligibility for reciprocal status, but only if a complaint is lodged about that club not meeting the food requirement. If the agent cannot tell whether the food requirement is being met, the Division refers the club to the Department of Revenue's Audit Services Bureau, which audits the club's sales and tax records.

To test the effectiveness of the approval process, the auditors compared the reciprocal affidavits for 18 clubs listed by the Division as having food sales of 50 to 55 percent of total gross receipts, with the liquor excise and sales tax returns they filed with the Division of Taxation. This comparison was made for two reasons. First, to determine if the gross receipts from food and liquor sales listed on the affidavit matched the gross receipts listed on the tax returns. Second, to determine whether the food sales being reported are in fact 50 percent of the club's gross receipts.

The auditors found that tax returns for two of the 18 clubs differed substantially from what was reported on their affidavits. One club reported on the affidavit that food sales represented 53 percent of its gross receipts in 1981; its tax return showed food sales were actually 49 percent of the total. The other club reported food sales totaling 38 percent in 1980, while the tax return showed food sales to be 45 percent of the club's gross receipts. It is apparent that these clubs' reported figures not only differed from their tax returns, but also that their food sales were below the 50 percent requirement for reciprocal eligibility. One other club in the sample was also granted reciprocal status even though its food sales were below the 50 percent minimum. However, this club's affidavit and tax return matched; both showed food sales at 48 percent of the total.

The Audit Services Bureau has begun to include an examination of each club's reciprocal eligibility as part of its new liquor excise tax audits. These checks may help alleviate the problem of lack of verification. However, the process of matching tax returns to affidavits for clubs near the 50 percent requirement would still be useful in identifying clubs that need a more extensive audit of reciprocal eligibility.

Lenient Eligibility Requirements

According to the reciprocal statutes, the calculation of gross receipts is based on calendar year sales as determined by the Division Director. For clubs with existing reciprocal agreements, the base year used is the previous calendar year. However, for new clubs and for clubs that were under the 50 percent food sales requirement in the previous calendar year, the Division will accept an estimate of the next calendar year's sales in order to grant eligibility. In the case of the latter group, the Division does not have any written standard for this decision, but appears to give a club some leeway by granting it "conditional" reciprocal status if it came close to the food requirement in the previous year or intends to make changes such as remodeling or promotions to try to increase food sales. Although the statutes give the Director some discretion in applying the food sales requirement, they do not appear to authorize the granting of "conditional" reciprocal status.

In their review of the reciprocal status for 18 private clubs, the auditors noted that the Division had granted conditional status for the two clubs cited in the previous section. The Division's decision was based on

information reported on the clubs' affidavits, which for 1980 showed food sales totaling only 36 percent and 38.4 percent of their gross receipts. However, these clubs estimated that their food sales for the next calendar year would be 50.5 percent and 55 percent of their gross receipts, respectively. The auditors' review of these clubs' operations indicated they would not be considered as restaurants by most customers. They appear first and foremost to be "bars."

The club with a 36 percent reported total and a 50.5 percent estimate for the next year was granted conditional status for six months and was required to file a new affidavit showing actual food sales at the end of that period. The club did so, and its actual food sales were reported to be 53 percent of the total.

The second club, which had a 38.4 percent reported total and a 55 percent estimate for the next year, was also conditionally approved for six months. The club stalled several times, and the Division eventually granted it extensions totaling three months. At the end of the extension, the club still had not met the eligibility requirement, nor had it filed a new affidavit. Its license was cancelled, but the club changed ownership and applied for and received reciprocal status as a "new" corporation. The club changed very little; controlling ownership simply passed from one partner to another. The auditors noted one other instance of this happening. In that case, the club was not under conditional status, but apparently because its 1980 affidavit showed it to be under the 50 percent food sales minimum and the Audit Services Bureau was going to audit the club's records, the club re-incorporated, with legal ownership passing from one spouse to another. Both clubs retained the same name, and their operations remained essentially the same. However, this change in ownership allowed them to file a new reciprocal affidavit, and be granted reciprocal eligibility on the basis of estimated food sales above the 50 percent requirement.

Circumventing the Statutory Requirement to Obtain Reciprocal Status: An Example

On its affidavit requesting reciprocal eligibility for 1981, one club reported that its actual food sales totaled 38.4 percent of its gross receipts in calendar year 1980, but estimated that its food sales for calendar year 1981 would be 55 percent.

Based on the club's estimate, the Division granted it "conditional" reciprocal status for a six-month period. The club was given until February 2, 1982, to file a new affidavit showing food sales were above the 50 percent minimum. When the Division did not receive a new affidavit, it gave the club until March 1 to file one. The club responded that it was still trying to meet the minimum requirements, and that if it did not meet them by June 1, it would voluntarily withdraw its reciprocal status and notify its members. The Division gave the club only until May 1, and said it would cancel the club's reciprocal status at that time and would not allow the club to voluntarily withdraw.

The Division did not cancel the club's license on May 1 even though it did not receive an affidavit. On June 1, the club's license was cancelled. However, by passing legal ownership from one partner to another and re-incorporating, the club was able to apply for and receive another license and reciprocal status as a "new" club. By law, the club became a new legal entity which cannot be held accountable for the original club's past performance. And by Division regulations, new clubs are granted reciprocal eligibility based on their estimate of the next calendar year's sales.

Until such loopholes are closed, some private clubs can apparently continue to circumvent the statutory minimum food sales requirement for reciprocal eligibility.

Difficulties in Verifying Motel and Hotel Club Eligibility

Many hotels and motels house one or more coffee shops, restaurants, and private clubs. Frequently, food is prepared in a central kitchen and not in the private club. For convenience, and to keep bar sales separate, food sold in the private club may be rung up on a cash register in the coffee shop or public restaurant.

The Division does not require hotels and motels to maintain a separate record of food sales for each private club and public restaurant on their premises. Because all food sales are combined for gross receipts and sales tax reporting purposes, an audit is necessary to verify reciprocal eligibility. But even through auditing procedures, it is extremely difficult to determine from a hotel's or motel's accounting records whether the amount of food actually consumed on the private club premises exceeds 50 percent of gross receipts. Compliance with the food sales requirement is further complicated by the fact that some hotels and motels have two private clubs and must meet a second 50 percent requirement.

During their review of liquor excise taxes, the auditors identified two motel and hotel clubs that appeared to have problems in this area. For one motel, the auditors were able to determine the amount of food sold in the private club by deducting public restaurant food sales from total food receipts. The remaining amount was then compared with the club's total liquor sales for the year. This comparison showed that the private club's food sales totaled only 36 percent of its gross receipts, not the required 50 percent. For the other hotel, the auditors were unable to determine the exact amount of food consumed in the private club because all food sales, both private and public, were rung up together. Liquor sales in this establishment were fairly low, so it is possible that the reciprocal requirement was being met. Nonetheless, because of this club's accounting practice of co-mingling public and private food sales receipts, there would be no way to determine conclusively whether it is eligible for reciprocal status.

Recommendations

1. To improve its verification of private clubs' eligibility to enter into reciprocal agreements with other clubs, the Department of Revenue should consider instituting a process of matching private clubs' gross receipts and sales tax returns to the affidavits clubs file each year as proof they have met the 50 percent food sales requirement. This matching process could be limited to those clubs near the 50 percent level on food sales, and would be useful in identifying clubs that need a more extensive audit of reciprocal eligibility.

2. To tighten its eligibility requirements for reciprocal status so that some clubs are not able to circumvent them, the Department of Revenue should do the following:

   a. Discontinue the practice of granting "conditional" reciprocal status to clubs that have failed to meet the 50 percent food sales requirement in the previous calendar year.

   b. Consider denying or setting limits on the reciprocal status of private clubs that reorganize or re-incorporate in an apparent attempt to circumvent eligibility requirements. This effort may require changes in State law or regulation.

3. To ensure that reciprocal eligibility can be verified for private clubs in hotels and motels, the Department of Revenue should issue regulations requiring private clubs located on the same hotel and motel premises as other licensed public food service establishments to maintain a separate record of food sales.

Assessing the Adequacy and Consistency of Inspection and Enforcement Activities

The Division's inspection and enforcement activities are designed to ensure that licensees comply with the State's alcoholic beverage laws and regulations. These activities include investigating new applicants for licenses, routinely inspecting new and existing retail liquor stores, private clubs, and distribution warehouses, and conducting "undercover" or other types of investigations of licensees. They also entail inspecting bonded carriers, supervising transfers of liquor, delivering new licenses, closing retail stores, serving citations and subpoenas, inspecting bingo games operated on private club premises, and holding hearings and assessing penalties.

The Division's Enforcement Bureau, which has a staff of 26 liquor control investigators, is primarily responsible for carrying out these activities. Individual agents are assigned to 21 specific geographical areas for retail liquor stores and private clubs. In addition, specific agents are assigned to each wholesale or distributor warehouse. Although there is some overlap because of special assignments, agents are generally responsible for all activities involving the clubs or retailers in their territory. Administrative hearings are held for stores or clubs that violate liquor laws and regulations. Citations leading to hearings can be initiated by Division investigators or by the Sales and Excise Tax Bureau, local police, and complaints. The Division's Legal Section assists in conducting these hearings, but the Director is responsible for assessing penalties.

The auditors' review of the Division's inspection and enforcement practices showed that the effectiveness of routine inspections was limited

inefficient use of investigators' time. Such problems may be indicative of a lack of supervision and quality control over these activities. The auditors also noted the need for the Division to monitor Statewide enforcement actions, and found problems with the Division's assessment of penalties for violations of State liquor laws and regulations.

Limited Effectiveness of Routine Inspections

In 1981, the Division's agents conducted 3,942 inspections of retail liquor stores and 3,322 inspections of private clubs. A minimum of one routine inspection is required for annual relicensing, but the Chief of the Enforcement Bureau has set a goal of three to four inspections of each private club and retail liquor store per year. Activity reports for 1981 show an average of three inspections per club and 3.6 per retailer. The auditors determined that the major purposes served by routine inspections are determining if a licensee is conforming to licensing and reporting requirements, acting as a deterrent to violations by periodically visiting licensed establishments, and carrying out minor administrative matters.

The auditors' review of the Division's routine inspection activities showed that the content and timing of these inspections were not designed to detect serious violations of State liquor laws and regulations.

Content of routine inspections. Two types of inspection report forms are used by the Division's liquor control investigators--one for retail stores and one for private clubs. In reviewing these forms, the auditors noted that many items--especially on the retail store inspection form--related only to minor compliance matters. The form for retail liquor stores contains 30 items in total, covering the following matters:

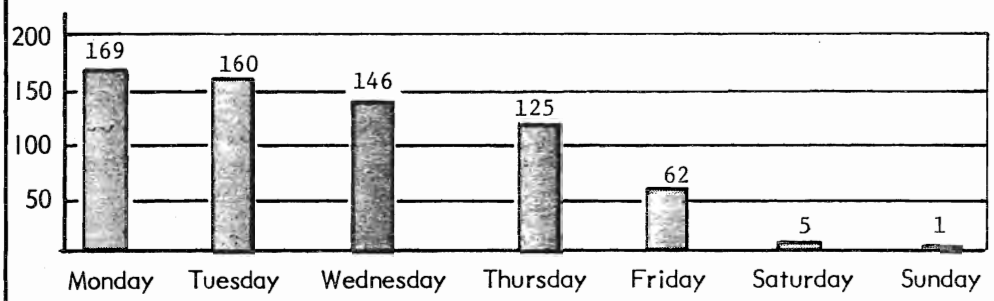
--nine items pertain to rules, regulations, or statutes such as the number of signs and location of coolers
--ten items involve checking to see that licensing or reporting requirements have been met (for instance, licenses must be posted and records must be kept on the premises)
--five items involve administrative matters such as verifying the store's telephone number and checking to make sure the licensee has received copies of informational material
--six items pertain to observing certain suspect activities, such as having open containers on the premises or selling on credit

It is apparent that most of the items checked during a routine inspection would not result in the discovery of major violations. The first 24 items relate to minor compliance matters that may need to be checked only once a year. However, these items are checked during every inspection, and retailers are inspected an average of 3.6 times a year. If such items were checked less frequently, investigators could devote more of their time to special investigations into more serious types of violations.

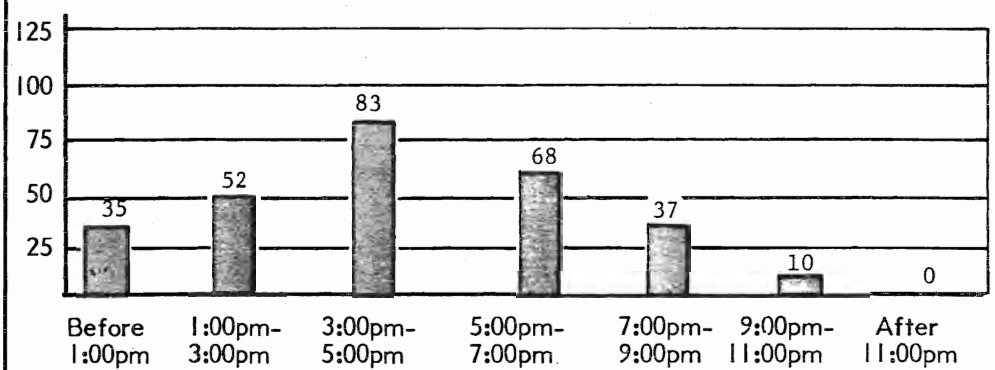
Regarding the last six items checked, observations of such activities during a routine inspection are generally insufficient to warrant a citation.

Reviewing the Timing of Routine Inspections of Retail Liquor Stores and Private Clubs

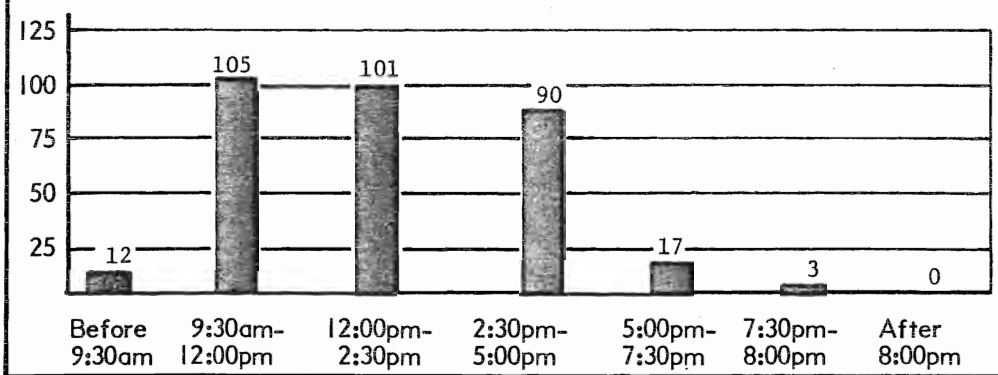
The auditors found that most routine inspections were conducted during "slack" hours and days. For example, 88 percent of the 668 inspections reviewed took place on Mondays through Thursday.



They also found that 71 percent of the 321 routine inspections of private clubs took place between the hours of 1 p.m. and 7 p.m



Finally, 91 percent of the 347 routine inspections of retail liquor stores occurred between 9:30 a.m. and 5:00 p.m.



At best, the liquor control investigator might pick up a clue that would precipitate a subsequent investigation. Although the private club inspection form does not contain as many items of a questionable nature, the same observations apply.

Timing of routine inspections. The auditors examined 668 inspection reports turned in by the field agents for the first three months of 1982. Reports for the county representing the major responsibility for each agent were examined to determine when inspections were done--both what day and what time of day. The results were as follows:

--about 88 percent of all retail store and private club inspections took place on Mondays through Thursdays
--71 percent of the club inspections took place between the hours of 1 p.m. and 7:00 p.m.
--91 percent of the retail inspections took place between 9:30 a.m. and 5:00 p.m.

Given the time of day and the day of the week that inspections are routinely conducted, Legislative Post Audit questioned their usefulness in acting as a deterrent or detecting violations. Even if wrongdoing were suspected, it is doubtful that problems would be uncovered during "slack" hours and days.

The auditors could not assess the deterrent quality of routine inspections. However, they did review a sample of 90 of the 752 administrative hearings against retailers and clubs held in 1980 and 1981 as a result of routine inspections. This review was designed to assess their effectiveness in detecting the more serious violations, such as sales to minors. Only nine of the 90 hearings, or 10 percent of the total sample, were initiated because of citations issued by the Division's investigators during routine inspections. Of these nine, four involved failure to obtain a federal tax stamp, and all were subsequently dismissed. If the Division wants to maximize the usefulness of routine inspections and enhance the potential pay-off in terms of detecting violations, work hours may need to be adjusted so that more inspections are conducted during the "busy" times--nights and weekends--when violations are more likely to occur.

Inefficient Use of Investigative Resources

Enforcement Bureau agents spend approximately half their time conducting investigations. During fiscal year 1981, these investigations included the following:

Criminal Background Investigations of New Licensees and Managers of Private Clubs	4,174
Investigations of Clubs and Taverns	1,210
Investigations and Surveillance of Licensees	1,148
Border Patrol Investigations	123
Bootlegger Visitations	117
Sales to Minors Investigations	105
Membership Violations or Sales to Non-Members	101
Total Investigations	6,978

Investigations are conducted for two primary purposes; to detect and obtain evidence of citable violations, and to determine if applicants and other individuals meet licensing requirements. Since the licensing process is subject to time limits, those investigations receive priority. As the number of applications increase, the amount of time available for investigations that are specifically targeted to detect and obtain evidence of citable violations decreases. In areas where new applications are high, this activity can occupy a major portion of the agent's time.

Criminal background investigations are conducted to determine if various categories of licensees, managers, and officers of private clubs have committed legal offenses, have not met residency requirements, or have other financial and business interests that would disqualify them from holding these positions. The impact of these requirements for private clubs is particularly great because they pertain to any officer, manager, director, or stockholder holding more than five percent of the corporation's stock, for clubs that are owned by corporations. These criminal background investigations accounted for 4,174, or 60 percent, of all investigations conducted by the Enforcement Bureau in 1981. The remaining 2,804 investigations were generally conducted undercover.

Despite the high number of criminal background investigations, these activities seldom result in the discovery of circumstances leading to the denial of a license application. One application for a sales representative's permit was denied in 1981, and an additional 18 convictions were found that resulted in the applicant either withdrawing the application, resigning as a corporate officer, receiving a citation, or having the conviction expunged from his records. In all, criminal background investigations that produced significant findings accounted for fewer than one-half of one percent of all such investigations. Thus, the amount of effort devoted to licensing investigations appears to be a questionable use of resources, especially since the workload imposed by them decreases the time available for activities that could more directly protect the public, such as investigations of sales to minors and bootlegging activities. Such investigations are required by law (K.S.A. 41-311), and to reduce or eliminate them would require statutory changes.

The Division has attempted to decrease the amount of agent time required for such investigations by installing a teletype machine to access centralized information resources and speed up the criminal background check. If residency requirements were eliminated, such a change would further decrease the time required for licensing investigations. While financial interests may still need to be examined as a preventative measure, the Division should also look for ways of expediting this process.

Need to Monitor Statewide Enforcement Actions

The Division regularly obtains information about Statewide liquor control enforcement activities, such as inspection reports for retail and private club licensees, agents' monthly activity reports, hearings held, and

the resulting penalties. Most of this information is tallied and reported in the Department of Revenue's annual report. However, the Division does not analyze this information on a geographical basis or by agent.

Analyzing enforcement activities on a geographic basis. To determine if such analyses could help the Division pinpoint areas where enforcement is lacking, inconsistent, or can be more effectively targeted, the auditors analyzed information on the number of citations against class B clubs and retail liquor stores issued during 1981. A citation may include one or more violations, and a hearing may involve one or more citations. They then sorted this information according to geographic areas of the State. There are a total of 21 single or multi-county areas designated in the State.

The auditors' review of this information showed that there were a total of 196 citations issued against retail stores in calendar year 1981, or an average of .17 citations per store. There were also 231 citations issued against 770 class B private clubs, or an average of .3 citations per club. (Results for each area are presented in Appendix B.) However, this review revealed that the number of citations per class B club and retail liquor store varied considerably in different areas of the State.

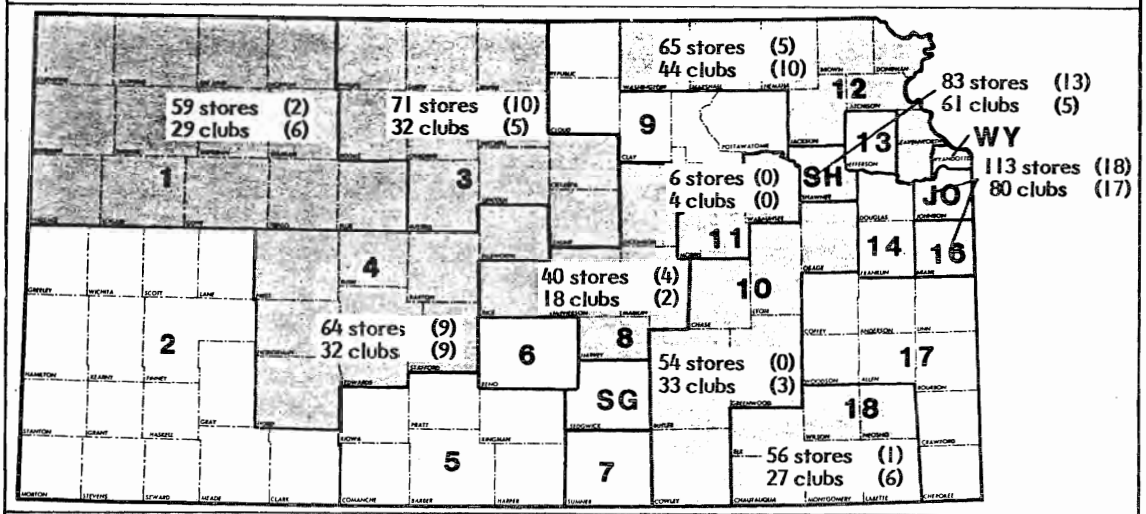
Citations issued in 10 of the 21 geographic areas fell below the Statewide average for both retail liquor stores and private clubs. As the map on the next page shows, most of these areas comprise rural counties, although they do include such cities as Salina, McPherson, Atchison, Emporia, and Hays. Two of the State's four large urban areas--Shawnee and Johnson/Miami Counties--also fell into this category.

The table below presents violations for these four areas. As the table shows, the number of citations per club was especially low in Shawnee County. In calendar year 1981, only five citations were issued against 61 class B clubs that year.

	Retail Liquor Stores			Private Class B Clubs		
County	No. of Stores	No. of Citations	Citations/ Store	No. of Clubs	No. of Citations	Citations/ Club
Sedgwick	170	49	.29	162	62	.38
Shawnee	83	13	.16	61	5	.08
Wyandotte	89	37	.42	88	34	.39
Johnson + Miami	113	18	.16	80	17	.21
Statewide	1,127	196	.17	770	231	.30

Several factors may account for variations in the number of citations issued. For instance, rural licensees with little competition may have less incentive to commit certain violations. Also, the enforcement activities

Geographic Areas of the State Falling Below Statewide Averages for Citations Issued Against Retail Liquor Stores and Class B Clubs



In calendar year 1981, 231 citations were issued against class B clubs and 196 against retail liquor stores for violating State liquor laws and regulations. The shading on this map highlights the 10 geographic areas where citations issued against both groups fell below Statewide averages. The numbers in parentheses represent the total number of citable violations noted for the stores and clubs in that area. As these numbers show, some stores and clubs received no citations or very few citations over the 12-month period. For example, the 54 retail liquor stores in Area 10 had no citations, the 59 stores in Area 1 had only two citations, and the 61 clubs in Shawnee County received only 5 citations. Low incidences of citable violations could indicate that enforcement activities are not equally vigorous in all areas of the State.

noted include citations of violations initially detected by local authorities, and their degree of involvement in liquor control enforcement varies. It is doubtful, however, that citable violations are totally absent in any area of the State, especially over a 12-month period. Nevertheless, there were two areas in which no class B private club was cited during 1981 and three in which no retail liquor store was cited. For example, no citations were issued against the 54 retail liquor stores in Area 10. Only two violations were cited at the 59 stores in Area 1, and one at the 56 stores in Area 18.

Wide variations in the number of violations cited per licensee could also indicate that enforcement activities are not equally vigorous in all areas of the State. Some investigators might be more lenient than others, or some areas might be inspected less often than others. For example, the auditors found that six of 22 private clubs in one county were not inspected at all during fiscal year 1982. In another county one club was not inspected from August 1980 through June 1982, although the five other clubs and 10 retailers in that county were apparently inspected regularly. If the types of violations cited in each area were to be monitored on a regular basis, variations may also be detected that would enable enforcement activities to be more effectively targeted.

One reason the Division does not analyze this data is that, except for price information and tax records processed on the Department of Rev-

enue's computer, all other records of the Division are maintained manually. Currently, there is no centralized information processing in the Division because each section or bureau keeps track of what it needs to perform its own function. Related entries are made in the licensee's file by each separate unit's staff. As a result, gaps in information exist that make it difficult to obtain a broad view of Division activities, and it is not possible to easily aggregate information in new or different ways, such as by area or by type of violation. While it is possible to perform such analyses manually, as the auditors did, the Division would probably benefit in the long run by maintaining this information on the computer and conducting such analyses on a periodic basis.

Assessment of Enforcement Penalties

In calendar year 1981, a total of 801 violations of liquor laws and regulations were identified that led to citations being issued and administrative hearings being scheduled. By reviewing the nature of these violations in administrative hearing docket books or licensee files, the auditors found that 560 violations, or 70 percent of the total, involved private clubs. Retail liquor store violations were the second highest group, with 233 violations or 27 percent of the total. The remaining licensees accounted for only a small fraction of total violations. The accompanying table shows this distribution by type of license.

Liquor Violations By Type of License
Calendar Year 1981

Type of License	Number of Violations	Percent of Total
Private Clubs	560	69.9
Retail Liquor Stores	233	29.1
Liquor and Beer Distributor	4	.5
Salesmen	1	.1
Beer Manufacturer	0	--
Distiller and Importer	3	.4
Total	801	100.0%

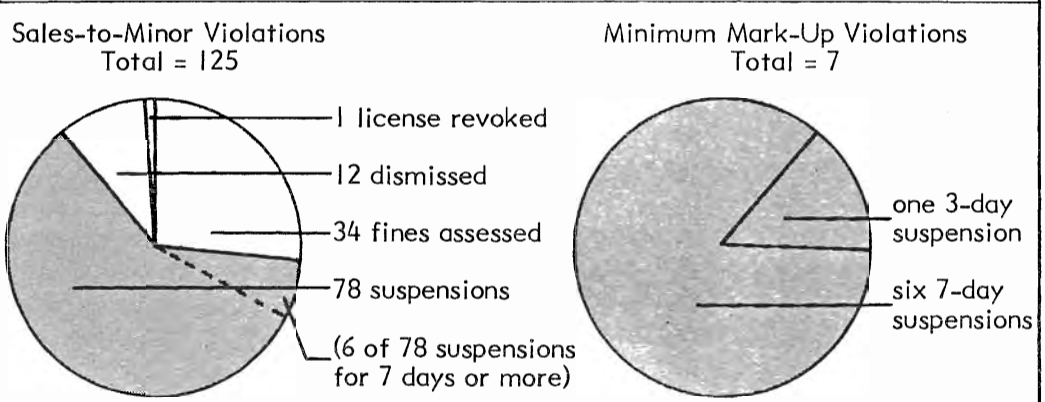
For the 229 non-tax-related private club cases decided in 1981, 93 resulted in suspensions totaling 545 days, 68 resulted in fines totaling $37,750, 82 were dismissed, one license was revoked, and 15 resulted in other penalties. (The number of penalties noted here may exceed the actual number of hearings because some hearings involve two penalties, such as a fine and a suspension.) For the 191 retail liquor store cases decided in 1981, 69 cases resulted in suspensions for a total of 300 days, 49 resulted in fines totaling $20,000, 43 were dismissed, 29 resulted in cash-basis only basis rulings, three licenses were revoked, and six had other miscellaneous results, such as being placed under advisement, having their license cancelled or expired, and being suspended indefinitely.

To examine how equitably and consistently certain violations are penalized, the auditors reviewed the penalties given to retail stores and private clubs cited for only one violation. This review identified two problem areas: the penalties assessed for different offenses sometimes seemed inequitable, and the Division allows some retailers and club owners to choose the type of penalty they will receive.

Inequitable penalties for different offenses. Comparisons of penalties for different offenses are difficult because of differences in violation circumstances, the perceived severity of the cases, and licensees' historical compliance records. In at least one case, the auditors identified a disparity in the relative penalties applied for violations of sales-to-minors and for violations of minimum price mark-ups.

Generally, sales-to-minors violations are regarded as potentially the most harmful to the public. Restrictions on sales to minors are based on the commonly held belief that individuals below the legal age are incapable of exercising sufficient self-control when they drink alcohol to assure their safety and the safety of others in the community. Of the 125 sales-to-minors violations committed by retail liquor stores in 1980 and 1981, 78 resulted in suspensions, 34 resulted in fines, 12 were dismissed, and one license was revoked. The average number of days the stores were suspended was four days, and the average fine was $495.

Comparing Penalties Assessed for Sales-to-Minors Violations And Minimum Retail Mark-Up Violations



The penalties assessed against retailers for two types of violations from 1980 and 1981--sales to minors and minimum retail mark-ups--did not always seem related to the severity of the offense. All seven minimum mark-up violations resulted in suspensions, six of which were for seven days. Such violations present no potential for direct harm. By contrast, only 78 of the 125 violations of sales to minors, which are generally considered to have the greatest potential for harm to the public, resulted in suspensions. And only six of those 78 suspensions were for seven days or more.

Sales below the minimum retail price mark-up generally are not perceived as resulting in harm to the public. However, for the seven violations of this law in 1980 and 1981, six resulted in seven-day license suspensions for retailers and one in a three-day suspension. By contrast, only six of the 78 retailers suspended for selling to minors received a suspension of seven days or greater. Thus, the penalties given for sales below minimum mark-up were generally more severe than penalties assessed for sales to minors.

Some licensees participate in choosing their penalties. The auditors' review of hearing transcripts and their observations of actual hearings showed that retailers and private club owners occasionally were given a choice between a suspension and a fine. The Legislature has allowed fines to be assessed as an alternative to suspension to give the Director more discretion in making the punishment fit the violation. However, at times it appears the Director has delegated his discretion to the licensee.

A choice between a fine and suspension may appear to be equally punishing, but licensees can actually choose which they prefer. Licensees who are suspended may also select the days they will be closed; thus, it is possible for them to coordinate their punishment with a planned vacation or needed redecorating. Allowing a punishment to become convenient would appear to remove much of its value. Not surprisingly, most of the suspensions reviewed by the auditors began on Monday, presumably a day of low sales volume, and generally were over before the weekend. Only those lasting five or more days extended to Friday, primarily because of the requirement that the days suspended must be consecutive.

Recommendations

1. To improve the effectiveness and efficiency of the inspections and investigations conducted as part of the alcoholic beverage control regulatory program, the Department of Revenue should do the following:

   a. Consider adjusting at least some liquor control investigators' work hours so that more inspections of retail liquor stores and private clubs are conducted during the "busy" times--nights and weekends--when violations of State liquor laws and regulations may be more likely to occur.

   b. Examine inspection priorities and consider reducing the frequency of, and revising the scope of, routine inspections of clubs and stores.

   c. Consider eliminating criminal background investigations of new licensees and expediting examinations

of licensees' financial interests. One option would be to substitute sworn statements regarding the applicant's criminal background, financial interests, and other requirements specified in K.S.A. 31-111 for investigations.

2. To help identify those areas of the State where enforcement activities are lacking, inconsistent, or can be more effectively targeted, the Department of Revenue should monitor Statewide enforcement trends and analyze enforcement data by geographic area or by agent.

3. To help ensure that the assessment of penalties against retailers or private clubs acts as a fair and effective deterrent, the Department of Revenue should do the following:

   a. Make greater efforts to assure that the penalties assessed for violations of liquor laws and regulations bear a reasonable relationship to the seriousness of the offense.

   b. Discontinue the practice of allowing licensees to participate in the penalty-setting process.

CHAPTER V

COLLECTION AND ENFORCEMENT OF THE LIQUOR EXCISE TAX

In discussing the scope of the Division of Alcoholic Beverage Control sunset audit, members of the Legislative Post Audit Committee expressed concerns about the collection and enforcement of the liquor excise tax imposed on private club drinks. Although the responsibility for these functions is shared with the Department of Revenue's Division of Taxation, the Committee directed Legislative Post Audit to include a review of liquor excise tax matters in the audit of the Division of Alcoholic Beverage Control.

Legislative History and Intent of the Liquor Excise Tax

Senate Bill 467, enacted by the 1979 Legislature, authorized all class A clubs and class B clubs to sell liquor by the drink to their members and guests. This bill eliminated liquor pools, which had been the mechanism used by many private clubs to dispense liquor to their members. As part of this change, a liquor excise tax was levied at the rate of 10 percent of the price of all drinks sold to private club members. Both alcoholic liquor and the mix that goes into the drink is taxed. There is no sales tax on items subject to the liquor excise tax, but private clubs do charge sales tax on all other sales including cereal malt beverage (3.2 beer) and food. The liquor excise tax is collected by the Division of Taxation's Sales and Excise Tax Bureau, but collection is enforced by the Division of Alcoholic Beverage Control, which holds hearings on excise tax delinquencies.

During the 1982 Legislative Session, the liquor excise tax was the subject of considerable discussion. According to the Director of Alcoholic Beverage Control, liquor excise tax revenues for fiscal year 1981 were projected to be $11.4 million, but only $6.8 million was collected. If this estimate is accurate, the apparent shortfall of $4.6 million would represent a serious problem of non-payment. For such a shortfall to occur, many of the State's private clubs apparently would have to be deliberately circumventing their proper excise tax assessments by underreporting liquor sales or reporting alcoholic beverage sales as food.

Primarily as a result of this apparent shortfall in revenues, several alternatives--including collecting the tax at the retail level--were considered by the 1982 Legislature. Instead of changing the collection procedures, House substitute for Senate Bill 888 was passed, which strengthened the current system by authorizing the Secretary of Revenue to require private club owners to post a bond with the Director of

Taxation. Delinquent excise tax payments that are uncollectable can now generally be recovered from this bond money. The 1982 Legislature also increased the Department of Revenue's appropriation by an additional $280,000 to hire seven new auditors and one law clerk. The Division of Alcoholic Beverage Control had requested that 23 additional auditors be hired, based on the number of clubs existing in Kansas. The seven auditors have been added to the staff of the Department of Revenue's Audit Services Bureau, but have been assigned to audit the liquor excise tax. The law clerk is in the Division of Alcoholic Beverage Control.

Legislative Post Audit's examination of the Division's liquor excise tax collection and enforcement process addressed three primary questions:

1. Do collection procedures for delinquent excise tax payments ensure that the tax owed by private clubs on reported liquor sales is actually paid?
2. Is the Division's estimate of liquor excise tax revenues owed but not paid by private clubs accurate?
3. To what extent do audits of liquor excise tax collections in private clubs demonstrate that private clubs are significantly underreporting liquor sales, and that excise taxes owed on those sales are not being paid?

The auditors' findings in each of these areas are discussed in the sections that follow.

Do Collection Procedures Ensure That Delinquent Liquor Excise Taxes Are Paid?

Upon receiving notification from the Sales and Excise Tax Bureau that a private club owner is three or more months delinquent in paying the liquor excise tax, the Division of Alcoholic Beverage Control schedules an administrative hearing on the monthly date set aside for sales and excise tax violations. In calendar year 1981, more than 188 private clubs were cited by the Division for delinquent excise tax payments in excess of three months. These accounted for 22 percent of all violations cited by the Division.

The hearing process generally results in payment of the taxes due on or before the hearing date, in which case the citations are dismissed. In those instances where clubs still do not pay the tax due, Division officials indicated that the penalty prescribed is generally a three-day suspension (temporary closure of premises, followed by an indefinite suspension until the tax is paid. This action inevitably produces payment, except for those few clubs that surrender their licenses for cancellation. Based on the auditors' review of this collection procedure, Legislative Post Audit concluded that, although a major enforcement effort is required, most private clubs subject to enforcement action because they are late in paying liquor excise taxes do eventually pay the taxes owed.

Is the Division's Estimate of Liquor Excise Tax Revenues Owed By Private Clubs Accurate?

The State collected more than $6.8 million in liquor excise taxes in fiscal year 1981. However, in April 1982, the Division estimated that approximately $11.4 million in taxes was owed for the year, or a difference of $4.6 million. As noted in the previous section, it appears that most excise taxes are eventually collected on reported liquor sales. Consequently, the estimated shortfall apparently represented taxes due on unreported sales of alcoholic drinks.

The auditors determined that for a $4.6 million shortfall to have occurred in fiscal year 1981, the 1,173 private clubs in existence at the time of the estimate would have to have underreported an average of more than $39,000 apiece in taxable liquor sales for the year. Actual reported sales subject to the 10 percent excise tax averaged only $58,500 per club that year. Thus, if the Department's estimates are accurate, every private club in the State would have to have sold an average of 66 percent more liquor than it reported selling.

Because the Division's estimate for fiscal year 1981 was so much higher than actual collections, the auditors reviewed this estimate and the 1978 study on which it was based. In addition, using a different method of determining liquor purchases and sales, the auditors prepared their own estimates and compared them with the Department's estimates and actual tax collections.

Reviewing the Division's Estimating Procedure

Estimating liquor excise taxes owed is a three-step process. First, the amount of alcoholic beverages bought by private clubs for resale must be determined. Second, receipts from the actual or potential sale of alcoholic drinks using the purchased liquor must be estimated. Third, the tax owed is computed to be 10 percent of the drink sales.

The Division of Alcoholic Beverage Control's method of estimating liquor excise tax revenues is based primarily on a study of liquor consumption in private clubs conducted by the Department of Revenue in 1978, in anticipation of the new excise tax. The study estimated that, of approximately $142 million in total retail liquor sales reported in 1977, about $20 million (or 14 percent of total sales) was ultimately consumed in private clubs. The $20 million estimate was based on two factors: the actual 1977 liquor purchases by liquor pool clubs of $12.7 million, and a Department estimate that bottle consumption in private clubs was $6.8 million to $7.8 million.

The Department also assumed that receipts from the sale of alcoholic drinks would be approximately four times the cost of the liquor (this is a

generally accepted estimate for determining sales). Using this estimating procedure, the Department estimated that drink receipts for fiscal year 1980--the first year of the tax--would be approximately $80 million, and that liquor excise tax revenues would be $8.2 million to $8.6 million. Actual excise tax collections that year totaled about $5.0 million, or at least $3.2 million less than projected.

In making its estimate of excise taxes owed for fiscal year 1981, the Division of Alcoholic Beverage Control essentially used the Department's estimating procedure and assumptions. The Division assumed that 14 percent of the total 1981 retail liquor sales was ultimately purchased by and consumed in private clubs.

The auditors noted two potential problems with the Division's reliance on this method. First, the 14 percent figure includes a factor for bottle consumption in private clubs. Yet liquor pools were eliminated in 1979 when private clubs were allowed to sell liquor by the drink to their members and guests, and it is doubtful that many club patrons continued to carry bottles into private clubs after that. Second, bottle consumption may not have been a significant factor even in the Department of Revenue's initial estimate. The Department had included bottle consumption in private clubs in that original projection for fiscal year 1980, and its estimate of excise taxes owed was at least $3.2 million higher than actual collections that year. If the Department had not included bottle consumption in its initial projections of liquor purchased by and consumed in private clubs, its estimate of taxes due would have been about $5.1 million; $5.0 million was actually collected.

Developing Additional Methods for Projecting Liquor Purchased and Sold by Private Clubs

Because actual excise tax collections for fiscal years 1980 and 1981 were significantly below estimated revenues, and because the Department's method of estimating liquor purchases included a factor for bottle consumption, the auditors looked for other ways of estimating the amount of liquor bought by private clubs. The resulting figures were used to estimate the amount of tax due on the sale of drinks made with that liquor.

One method used by the auditors was to estimate current liquor sales by retailers to private clubs. Questions were included in the auditors' random survey of retailers about these sales. The responses received were determined to be representative of the State's retailers. The 83 retailers responding who reported sales to private clubs provided an average sales estimate of $29,000 in fiscal year 1982. Projecting this amount to the 650 to 680 retailers who have authority to make sales to private clubs, the auditors estimated that private club purchases of alcoholic liquor would have totaled approximately $18.8 million to $19.7 million. If alcoholic beverage purchase costs are multiplied by four to arrive at a sales

estimate, that estimate would be $75 million to $79 million for 1982, and liquor excise tax collections would be 10 percent of that amount, or $7.5 million to $7.9 million. Actual liquor excise tax collections for 1982 were $7.7 million.

Because the Division does not make revenue projections for every year, this 1982 figure could not be compared with a Division estimate. In an attempt to assess the accuracy of this estimating procedure for other periods of time, the auditors applied it to the results recently obtained by the Department of Revenue's retail minimum mark-up study.

The Department's survey showed an estimate of approximately $15 million in retail liquor sales to private clubs in calendar year 1980. Multiplying this figure times four would result in sales of approximately $60 million, and $6 million in excise taxes. Actual figures for fiscal year 1980 tax collections were approximately $5.0 million and for fiscal year 1981 were $6.8 million. If one assumes that half of each of these two fiscal years approximates total revenues for calendar year 1980, actual collections in 1980 were $5.9 million, or just under the $6 million estimate. Thus, the results of the auditors' method for both years compared favorably with actual receipts.

For their second method of determining the amount of liquor purchased by private clubs for resale, the auditors had the advantage of one month's actual sales figures reported by retailers. Under regulations promulgated to facilitate liquor excise tax auditing, retail liquor stores were required beginning in July 1982 to report all of their liquor sales to private clubs to the Division. The auditors obtained a figure for actual reported sales during July 1982 by totaling all stores' individual reports. Based on this figure and on past collection trends, they estimated that private clubs' gross receipts would be approximately $80 million in fiscal year 1983, and that $8.0 million would be owed in excise taxes.

The Division made no estimate of taxes owed for 1983, so the auditors could not compare their estimate with any other projection. It is interesting to note, however, that their projection is several million dollars less than the Division's estimate of excise taxes owed two years ago. Yet consumption figures overall have risen during that time, not fallen. Thus, if the auditors' estimate proves accurate, it could indicate that the Division's earlier estimate was inaccurate.

In sum, the auditors' estimates using either estimating procedure do not seem to support the contention that liquor sales have been significantly underreported in Kansas. On the contrary, it appears that the Division of Alcoholic Beverage Control's projections of the amount of excise taxes owed may have been too high.

What Do Audits of Liquor Excise Tax Collections Show?

The 1982 Legislature funded seven new auditor positions in the Department of Revenue to audit liquor excise tax collections in private clubs. Rules and regulations needed to implement this auditing function have been written and are being processed, and audit procedures have been developed. The auditors have been hired and are conducting initial audits.

Reviewing the Results of Department Audits

By reviewing and comparing a private club's accounting records of the amount of liquor bought, the number of drinks sold, the receipts from these sales, and other relevant data, the Department's auditors can determine whether the amount of reported liquor sales seems reasonable or suspicious.

A common assumption used in estimating excise tax collections is that drink sales will total approximately four times the cost of the liquor used. But given some clubs' practices of providing two or more drinks for the price of one, serving free wine with meals, and the like--practices that are not subject to the 10 percent tax--the Department's auditors allow drink sales totaling three times the cost of the liquor purchased to be considered as reasonable. If the ratio of sales receipts to costs goes any higher than that, however, the auditors generally assume that some sales have not been reported. They may either assess the club an amount that would bring its ratio to 3-to-1, or they may compute potential sales on the basis of the amount of liquor purchased, subtract the club's reported sales figure from this amount, and assess the club the difference.

Legislative Post Audit reviewed the results of the first 21 audits completed by the Department's auditors. During this first round of audits, records for up to three previous years were reviewed if they were available. Sixteen of the 21 audits resulted in no additional assessment; in other words, the club's reported sales apparently seemed reasonable in comparison to the amount of liquor bought and used. The other five audits resulted in assessments totaling $31,000. One club accounted for approximately $30,000 of this amount, and four for the remaining $1,000.

Conducting Additional Audits of Private Clubs

Legislative Post Audit conducted its own audits of 11 additional private clubs to test the correctness of the gross alcoholic drink sales receipts reported for fiscal year 1982, and of the liquor excise tax revenues received by the State. It was also hoped that any possible problem areas the Department's auditors may face in conducting such audits would surface. While Legislative Post Audit did not audit related taxes, or recommend tax adjustments, it did follow procedures similar to those used by the Audit Services Bureau in its liquor excise tax audits.

Different types of clubs were chosen for examination: one was a class A fraternal club, four were non-reciprocal class B private clubs, two were reciprocal class B clubs not located in hotels, and three were reciprocal class B clubs located in hotels. Two of the clubs were located in more rural areas of the State, while the remaining eight were located in the major metropolitan areas.

Legislative Post Audit's review disclosed the following results:

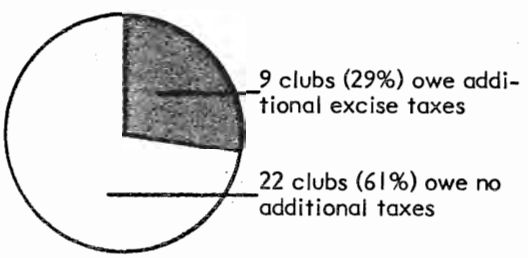
--The reported amount of liquor bought as a percent of the liquor sold ranged from 25 percent to 51 percent. In other words, drink sales were reported to be anywhere from four times to only twice the cost of the liquor.

--Four clubs appeared to owe additional liquor excise taxes because of unreported actual or potential drink sales. One club owed an estimated $3,404-$5,300, another owed an estimated $1,588-$2,084, and the other two clubs owed an estimated $500 or less each.

--Six clubs apparently owed no additional liquor excise taxes because of unreported sales.

--One club denied Legislative Post Audit access to verify its records of gross receipts for liquor and food. These records were needed to complete the auditors' analysis. They did note, however, that the amount of liquor purchased by this club during fiscal year 1982 exceeded 55 percent of the liquor receipts it reported to the State. Thus, it appeared that the additional amount of liquor excise tax owed may be substantial. Legislative Post Audit had received specific direction from the Legislative Post Audit Committee to audit the records of private clubs for its analysis. The club's denial has been reported to the Division of Alcoholic Beverage Control, and Legislative Post Audit has requested that the Attorney General prosecute the club under K.S.A. 46-1115 for failing to furnish information for an audit.

Reviewing the Results of Audits of Private Clubs' Liquor Excise Tax Collections



The combined result of the 21 excise tax audits completed by the Department and the 10 conducted by Legislative Post Audit show that nine of 31 clubs apparently owe additional excise taxes on unreported drink sales. One of the nine owed $30,000, and the other eight owe an estimated average of $1,072 each. The remaining 22 clubs apparently owe no additional taxes. These results are not conclusive, but so far there is no indication that the problem of underreported sales is of the magnitude suggested by the Division's fiscal year 1981 estimate. Based on that estimate, all private clubs operating in Kansas would have to have sold an average of 66 percent more drinks than they reported.

Because the audits completed by the Department's auditors and Legislative Post Audit are not rep-

resentative of all private clubs in the State, it is not yet possible to project the actual shortfall in excise tax revenues. Nonetheless, the audits conducted to date do provide some evidence that additional excise tax moneys are owed the State and that some clubs are apparently underreporting liquor sales. There is no evidence so far, however, that the degree of underreporting is at the magnitude indicated by the Department's estimate of excise tax revenue shortfalls. Based on the Department's estimate, all 1,173 clubs operating in Kansas at the time the estimate was made would have to have underreported their liquor sales by an average of $39,000 each. As the first round of audits is completed, the Department and the Division will get a more complete picture of the liquor excise tax revenues not being paid. If there is not as great a difference as the Department has projected, as Legislative Post Audit's estimates and the results of the audits conducted to date seem to indicate, the Department should review and revise its method of estimating excise taxes owed so it can more accurately project revenues owed to the State from this tax.

Further, these audits may also aid the Department and the Division in discovering such non-tax related problems as reciprocal violations, membership violations, payments for liquor delivery, and the like, which would then be reported to the Division of Alcoholic Beverage Control for investigation and possible citation. Finally, a complete cycle of audits of private clubs should give the Department sufficient documentation to judge whether the additional amount of excise tax revenues collected, as well as any increase in compliance with non-tax related matters, justify the cost of the new audit program.

Inadequate club accounting records. One frequent problem encountered by Legislative Post Audit during these audits was the absence of records needed to conduct a valid audit. Most clubs keep required records, such as liquor purchase receipts, but they also commonly use business practices that make it difficult to determine the actual amount of their sales. Such practices include providing two or more drinks for the price of one, free wine with meals, or other complimentary beverages. In addition, the size of a shot glass or the amount of liquor in a drink when a free-pour system is used can substantially affect the percentage of a drink price that is liquor. Further, many clubs do not keep track of their drink prices on a historical basis. Such factors complicate current audits, but some of them should be resolved over time as a result of rules and regulations that have been developed to address these problems. It is apparent, however, that these requirements could substantially increase the recordkeeping efforts for many private clubs.

Errors in calculating taxes due. Another problem encountered by Legislative Post Audit was that club owners made numerous errors in calculating the liquor excise taxes they owed. In most instances, such errors appeared to be caused by inadequate or inaccurate information rather than an intentional effort to avoid paying taxes. In some cases, the

mistakes were costly to the club, while other mistakes cost the State money. In the ten-club sample, the auditors found the following types of mistakes:

--gross sales of liquor were incorrectly computed

--some clubs did not pay the three percent sales tax on membership income or, alternately, paid the 10 percent excise tax on memberships

--both sales and excise taxes were paid on some liquor sales

It appears that the frequency of errors could be greatly reduced if private club owners were given clearer guidance, such as a simple instructional manual on computing and paying sales and excise taxes on private club sales.

Conclusion

Based on the auditors' review of the Department of Revenue's method of estimating excise taxes owed, and on their own estimates of taxes owed, Legislative Post Audit concluded that the Department's estimates appear to have been overstated. Initial audits of private clubs show that some taxable liquor sales are not being reported, but so far the revenue shortfall indicated by the Department's estimate has not been substantiated. The Department's tax auditors will need to complete a full round of audits of all private clubs before definitive conclusions regarding liquor excise tax collections can be reached.

Recommendations

1. To improve its estimates of liquor excise taxes due to the State, the Department of Revenue should take the following actions:

   a. Obtain totals of and monitor the amount of monthly sales to private clubs by retail liquor stores.

   b. As audits of private clubs are completed, compile and analyze information on the ratio of alcoholic beverage sales to the cost of liquor purchased.

   c. Prepare a revised estimate of the amount of liquor excise tax shortfall in the State.

2. The Legislature should review this revised estimate and should monitor the results obtained by audits of liquor excise tax collections. The Legislature should also re-

quire the Department of Revenue to provide it with information about the additional amount of liquor excise tax revenues collected, and any increase in compliance with non-tax related matters, as a result of the new audit program. This information, which should be compiled and reported to the Legislature by the start of the 1984 legislative session, should help the Legislature and the Department determine if this auditing effort is cost-effective.

3. The Department of Revenue should ensure that private clubs are given clearer guidance in calculating the sales and excise taxes they must collect from their customers. This guidance could be in the form of a simple instructional manual on computing and paying these taxes.

APPENDIX A

TESTS AND ANALYSES USED TO MAKE A DETERMINATION OF THE SUNSET PERFORMANCE FACTORS

Sunset Factor 1

Whether the absence of regulation by the State agency or office would significantly harm or endanger the public health, safety, or welfare.

Test and Analyses

--Determine the number of persons or entities directly regulated by the agency and any significant changes in this number over time.

--Determine the number of complaints filed over time against those individuals or entities which are regulated.

--Relate the number of complaints to the population of the State, users of the service, and number of licensees to determine the magnitude of any problems.

--Determine if the users of services lack the knowledge necessary to evaluate the qualification of those offering services.

--Determine if a high degree of independent judgment is required of practitioners; and how much skill and experience is required in making these judgments.

--Determine the harm to the public which might occur if complaints filed with the agency were not resolved.

--Determine the "value" to the public of the agency's enforcement and licensing functions.

--Determine the harm to the public prior to State regulation or in states without regulation.

Sunset Factor 2

Whether all facets of the regulatory process are designed solely for the purpose of the protection of the public and have such protection as a primary effect.

Tests and Analyses

--Determine the composition of all advisory boards to ensure general public representation.

--Document what the agency has done to encourage public input into the regulatory process.

--Determine if controls are sufficient to prevent unauthorized individuals or entities from operating in the State.

--Review regulation procedures, tests, and qualifications to determine if they are relevant and valid criteria for evaluating applicants desiring to provide services covered by regulation.

--Determine the frequency of and reasons for complaints made by the public against those entities or individuals regulated by the agency. A high level of complaints might indicate that unqualified individuals are allowed to become licensed or certified to provide the regulated services.

--Review enforcement procedures utilized by the agency to determine if there is a follow-up and resolution of complaints.

--Determine the types of disciplinary action taken against those individuals and companies whom complaints have been filed against.

--Determine the extent to which the agency has recommended statutory changes to the Legislature which would benefit the public as opposed to the persons regulated.

--Determine if the agency has taken all actions necessary to protect the public.

Sunset Factor 3

Whether there is a reasonable relationship between the exercise of the police power of the State by the State agency or office and the protection of the public health, safety, or welfare.

Tests and Analyses

--Based on audit findings concerning harm that would result without regulation and alternative methods of regulation, determine whether the regulation is reasonable or unnecessarily restrictive.

--Determine the reason for refusals of applications for licensing; determine if the refusals are based on valid criteria.

--Review complaints made by those regulated which might indicate that the standards or criteria used in the regulatory process are invalid or unjustified.

--Determine if there are any artificial barriers to entry such as:

a) excessive fees
b) unreasonable age, education, or residency requirements
c) unnecessary apprenticeships

Sunset Factor 4

Whether the regulation by the State agency or office has the effect of directly or indirectly increasing the cost of any goods or services involved, and, if so, to what degree.

Tests and Analyses

--Determine the costs to those regulated (i.e., license fees, testing fees, taxes, etc.).

--Determine the indirect costs to those regulated (i.e., training requirements, meetings, tests, paperwork-records, etc.).

--Compare the total costs of regulation to the total dollar volume of business done and/or the total cost of doing business by those regulated to determine if the cost of regulation is significant enough to increase the price charged for goods or services.

--Determine the degree to which the regulation restricts the supply of practitioners, thereby increasing the costs of goods or services.

--Determine if a less restrictive method of regulation would decrease the costs of goods and services.

--Determine if the agency restricts competition by prohibiting or restricting advertising.

Sunset Factor 5

Whether the increase in cost is more harmful to the public than the harm which could result from the absence of regulation by the State agency or office.

Tests and Analyses

--Compare the "value" of complaints resolved by the agency and the "value" of other regulatory activities with any costs due to regulation to determine whether the protection provided by regulation is greater than or equal to the cost of regulation. Consideration should be given to non-quantitative factors such as:

a. the deterrent effect of regulation
b. the effect of regulation on the competency of practitioners

Sunset Factor 6

Whether there is another less restrictive method of regulation available which could adequately protect the public.

Tests and Analyses

--Compare the regulatory activity in Kansas with that of other states.

--Determine if there is another agency or body which is already providing regulatory services or can adequately provide the same regulatory services.

--Determine if the following laws or standards could adequately protect the public without the agency:

a. unfair and deceptive trade practice laws
b. civil remedies such as injunctions and cease and desist orders
c. criminal laws such as prohibitions against false pretense, deceptive advertising, and cheating
d. standards such as construction codes or product safety standards

Performance Audit Factor 1

Whether any State agency is carrying out only those activities or programs authorized by the Legislature.

Tests and Analyses

--Determine the intent of the Legislature in creating the agency and the functions to be performed by the agency in accordance with that intent.

--Review statutes, regulations, legislative committee minutes, legislative studies, Attorney General opinions, and court decisions relevant to the agencies.

--Analyze the information to determine:

a. what circumstance or need led to the creation of the agency.
b. what functions the agency was originally created to perform.
c. how and why the agency's functions have changed over time due to statutory changes, legal opinions, etc.

--Compare current agency programs and activities to those authorized by the Legislature.

--Note any discrepancies between the activities performed by the agency and the activities authorized by the Legislature, and determine what changes need to be made to bring all programs and activities into compliance with Legislative intent.

Performance Audit Factor 2

Whether the programs and activities of a State agency, or a particular program of activity, are being efficiently and effectively operated.

Tests and Analyses

--Evaluate the agency's expenditures for regulation.

--Compare the agency's expenditures by activity over several years to determine if costs have increased for the various aspects of regulatory activity.

--Compare agency regulatory expenditures to those in other states with similar programs.

--Review application and complaint files to determine:

a. if applications are being processed on a timely basis
b. if complaints are processed and resolved within a reasonable time span

--Review agency operations for:

a. duplication of efforts or activities
b. wasteful practices (for example, underutilized equipment or personnel)

APPENDIX B

CITATIONS ISSUED AGAINST
RETAIL LIQUOR STORES AND PRIVATE CLASS B CLUBS
CALENDAR YEAR 1981

Retail Liquor Store Citations

Area	Number of Retail Stores(a)	Number of Citations	Citations Per Store
1	59	2	.03
2	51	6	.12
3	71	10	.14
4	64	9	.14
5	22	3	.14
Sedgwick	170	49	.29
6	28	4	.14
7	9	0	--
8	40	4	.10
9	69	12	.17
10	54	0	--
11	6	0	--
Shawnee	83	13	.16
12	65	5	.08
13	5	2	.40
14	26	12	.46
Wyandotte	89	37	.42
Johnson + 16	113	18	.16
17	47	9	.19
18	56	1	.02
Statewide Total or Average	1,127	196	.17

(a) As of November 30, 1981.

Private Class B Club Citations

Area	Number of Class B Clubs(a)	Number of Citations	Citations Per Club
1	29	6	.21
2	25	8	.32
3	32	5	.16
4	32	9	.28
Sedgwick	162	62	.38
5	11	1	.09
6	18	10	.56
7	4	5	1.25
8	18	2	.11
9	44	18	.41
10	33	3	.09
11	4	0	--
Shawnee	61	5	.08
12	44	10	.23
13	2	0	--
14	35	27	77
Wyandotte	88	34	.39
Johnson + 16	80	17	.21
17	21	3	.14
18	27	6	.22
Statewide Total or Average	770	231	.30

(a) As of February 15, 1982.

APPENDIX C

Agency Response

Kansas

DEPARTMENT OF REVENUE

State Office Building
Topeka, KS 66625

November 24, 1982

Dr. Richard E. Brown
Legislative Post Auditor
Legislative Division of Post Audit
301 Mills Building
Topeka, Kansas 66612

RE: Sunset Audit of the Department of Revenue - Division of Alcoholic Beverage Control

Dear Dr. Brown:

As requested by Legislative Division of Post Audit, the Department of Revenue hereby submits its response to the above-referenced Post Audit draft report. This response shall follow the sequence of the audit report and concentrate on the recommendations presented in the report.

Post Audit Recommendations

Page 23.

"1. The legislature should take action to reestablish the state's alcoholic beverage control regulatory program. In its deliberations, the legislature should consider the recommendations for improvements presented in this report.

2. The legislature should review the regulatory fee structure for the state's alcoholic beverage control program to determine whether the level of fees set by statute is adequate. As part of this review, the legislature should consider whether the program's license fees and other receipts should cover all costs of the regulatory program, including those monies channeled to other funds to pay for community alcohol treatment programs."

Agency Response

The Kansas regulatory fee structure has been an area of concern for the ABC Division for several years. Most fees presently charged for licensing and renewals were originally set in 1949, and may not be adequate to cover the administrative costs incurred by the Division today.

Representatives of the Division of Alcoholic Beverage Control testified in support of an increase in fees when the legislature considered the matter in 1979. No legislative action in this problem area was forthcoming.

The Department and the Division concur with Legislative Post Audit's recommendation that the legislature should review the regulatory fee structure for the State's alcoholic beverage control program to determine whether the level of fees set by statute is adequate.

Post Audit Recommendation

Page 26 - 27. "The legislature should review residency requirements for liquor manufacturers, distributors, retailers and private clubs, and should consider the following options:

a. Eliminating residency requirements altogether.
b. Eliminating all time limits on residency requirements.
c. Reducing residency requirements for all classes of licensees to a minimal level--such as one year."

Agency Response

Kansas liquor license residency requirements have been a subject of discussion and concern among the public and legislature alike for many years. A review of licensee qualifications revealed that the legislature intended that each licensee have an impeccable background. Clearly, the stringent residency requirements imposed upon an applicant insured that a personal history would be available for investigation by the Division. Experience has shown that an appropriate evaluation of an applicant can be made by investigators utilizing considerably more recent data. Thus, the lengthy state residence required by statute may serve no significant enforcement purpose. Moreover, inconsistent and ineffectual requirements such as mandating a five-year residence in the state and one year in the county for an individual private club license applicant and no residency requirement whatsoever for a corporate private club license applicant should be rectified.

While the legislature has considered this issue in some fashion during recent sessions, notably in 1980 and 1982, the Department and the Division concur with the Legislative Post Audit's recommendation that this area is once again in need of legislative review and possible revision.

Post Audit Recommendation

Page 29. "The Division of Alcoholic Beverage Control and the Legislature should reevaluate all liquor advertising regulations required in Kansas that are not required at the federal level. The review should help determine whether these regulations are necessary to protect the public and whether they should be revised or eliminated to abolish inconsistencies and to better meet the objectives of the regulatory program. As part of this review, the Federal Bureau of Alcohol, Tobacco and Firearms' advertising regulations should also be adopted by reference in Kansas."

Agency Response

The statutory framework in which the Division of Alcoholic Beverage Control operates must be viewed and evaluated from an historical perspective. As the Post Audit Report points out, Kansas has a long tradition of promoting temperance by strict regulatory control. A key provision of this approach has been a ban on most forms of advertising. Through the years, statutory and regulatory changes have been made which reflect a less restrictive view, but often these changes have created inconsistency regarding the State's approach to liquor advertising. It should be noted that the Joint Committee on Rules and Regulations completed a five (5) year review of the Division's rules and regulations in July, 1982, and their concerns have been addressed.

Presently, Kansas advertising regulations are under study by the Division, which hopefully will eliminate these possible inconsistencies. Considering recent court decisions and the clash of perspective which is evidenced by the present statutory and regulatory framework, the ABC Division has no objections to the Post Auditor's recommendation that the entire area of advertising of liquor in the State be reevaluated. A reaffirmation or revision by the legislature would assist the ABC Division in carrying out legislative intent.

Post Audit Recommendation

> Page 32. "The Division of Alcoholic Beverage Control and the Legislature should review all restrictions on business operations in the liquor industry and should eliminate those regulations that appear to be designated to protect the industry, not the public. These should include regulations over insufficient funds check procedures and alcohol deliveries, but may also include regulations on numerous other practices as well."

Agency Response

The Post Audit draft report recognized that the underlying structure of liquor regulation in Kansas is based on the three-tier system. This system controls transactions in alcohol by clearly separating the supplier, distributor, and retailer and closely monitoring any interaction between these tiers. Many of the statutes and regulations which appear to only protect the industry serve the important purpose of supporting and regulating this three-tier structure. Any discussion of a specific regulation alleged to solely "protect the industry" must begin by an evaluation of its effect in maintaining the delicate balance which presently exists in this complex system of State control. The consumer and the citizen of Kansas are benefited by the State's maintenance of an orderly liquor market, even if that benefit is not obvious in a cursory review.

However, some regulations and statutory requirements should be reevaluated to determine whether or not they contribute significantly to the State's maintenance of an orderly market. The Division would welcome any legislative guidance in this area.

Post Audit Recommendation

> Page 42. "The Legislature should consider eliminating the State's retail price maintenance program. If retail price control is eliminated it should be phased out gradually, and other practices such as selling below cost should be prohibited at least temporarily to help ensure greater market stability during the transition period."

Agency Response

As the Post Audit draft report indicates, this matter is strictly a policy decision for the Legislature.

Post Audit Recommendations

Pages 47 - 48.

"1. To improve its verification of private clubs' eligibility to enter into reciprocal agreements with other clubs, the Department of Revenue should consider instituting a process of matching private clubs' gross receipts and sales tax returns to the affidavits clubs file each year as proof they have the 50 percent food sales requirement. This matching process could be limited to those clubs near the 50 percent level on food sales, and would be useful in identifying clubs that need a more extensive audit of reciprocal eligibility.

2. To tighten its eligibility requirements for reciprocal status so that some clubs are not able to circumvent them, the Department of Revenue should do the following:

   a. Discontinue the practice of granting "conditional" reciprocal status to clubs that have failed to meet the 50 percent food sales requirement in the previous calendar year.

   b. Consider denying or setting limits on the reciprocal status of private clubs that reorganize or reincorporate in an apparent attempt to circumvent eligibility requirements. This effort may require changes in State law or regulation.

3. To ensure that reciprocal eligibility can be verified for private clubs in hotels and motels, the Department of Revenue should issue regulations requiring private clubs located on the same hotel and motel premises as other licensed public food service establishments to maintain a separate record of food sales."

Agency Response

With respect to the first recommendation, it should be noted that the Department of Revenue currently has a computer report produced monthly which calculates the ratio of liquor sales to gross sales for each private club. Any club having liquor sales in excess of 50 percent of its gross sales for any one month is closely monitored.

The second recommendation presumes that the Division has no flexibility in granting reciprocal status to restaurant-clubs. When the legislature authorized reciprocal arrangements between certain private clubs, its apparent intent was to grant bonafide restaurants the ability to provide their customers the opportunity to have alcoholic liquor with their meals. It is also apparent from a reading of the relevant statutes that the Director of Alcoholic Beverage Control has not been given specific guidelines in determining eligibility for reciprocal status and has, in fact, been given some discretion in determining the application of the statutory reuirements.

It is also important to realize that, under the strict interpretation of the law urged by the Post Auditor's report, reciprocal status could only be granted upon presentation of records of actual experience. In the event a year of operation did not qualify the club in question, such club could never qualify. In other words, reciprocity is needed by many clubs to meet the 50 percent food sales requirement; and without an opportunity to achieve that figure by operating under reciprocal agreements, clubs would be caught in a classic Catch-22 situation.

Prior to July of 1982, lack of manpower and auditing capability prevented an effective evaluation of the veracity of gross receipts affidavits submitted by clubs in order to meet reciprocity requirements. As a result of the recent addition of private clubs auditors in the Department of Revenue, the Department and the Division are gaining new information with regard to the actual status of gross receipts received by clubs claiming the reciprocal privilege. As a result of receiving the information now being obtained, the Division is not only in a better position to pass judgment on an application for reciprocity, but will also be better able to adopt regulations clarifying the law in this area.

Because the statutory requirements for reciprocity are somewhat vague and because, as the Post Audit report pointed out, a strict interpretation of these statutes would force private clubs to reincorporate in order to become entitled to a new period in which to establish qualifying food sales, the Department and the Division feel that this area needs a thorough review by the legislature as well in order to clarify legislative intent.

> ***Legislative Post Audit response.*** *Legislative Post Audit recognizes that private clubs need a certain period of time to build up their business and meet the food sales requirement for reciprocal status. However, at least two already established private clubs whose sales and tax records were reviewed apparently tried to circumvent the statutory minimum by re-incorporating and simply passing ownership from one partner to another or one spouse to another. One of these clubs had earlier been granted "conditional" reciprocal status by the Division, even though its food sales totaled only 38.4 percent of its gross receipts--far from the 50 percent minimum. When this club could not bring its food sales up, it re-incorporated as a "new" club. Legislative Post Audit maintains that until such loopholes are closed, some private clubs will continue to evade the State's food sales requirement for reciprocal eligibility.*

Post Audit Recommendations

Pages 57 - 58.

"1. To improve the effectiveness and efficiency of the inspections and investigations conducted as part of the alcoholic beverage control regulatory program, the Department of Revenue should do the following:

   a. Consider adjusting at least some liquor control investigators' work hours so that more inspections of retail liquor stores and private clubs are conducted during the "busy" times--nights and weekends--when violations of State liquor laws and regulations may be more likely to occur.

   b. Examine inspection priorities and consider reducing the frequency of, and revising the scope of, routine inspections of clubs and stores.

   c. Consider eliminating criminal background investigations of new licensees and expediting examinations of licensee's financial interests. One option would be to substitute sworn statements regarding the applicant's criminal background, financial interests, and other requirements specified in K.S.A. 31-111 for investigations.

2. To help identify those areas of the State where enforcement activities are lacking, inconsistent, or can be more effectively targeted, the Department of Revenue should monitor statewide enforcement trends and analyze enforcement data by geographic area or by agent.

3. To help insure that the assessment of penalties against retailers or private clubs acts as a fair and effective deterrent, the Department of Revenue should do the following:

   a. Make greater efforts to assure that the penalties assessed for violations of liquor laws and regulations bear a reasonable relationship to the seriousness of the offense.

   b. Discontinue the practice of allowing licensees to participate in the penalty-setting process.

Agency Response

It is not accurate to imply that clubs and liquor stores are not being investigated during busy hours. Most undercover assignments are made during "busy" times--nights and weekends--when violations of state liquor laws and regulations may be more likely to occur. In line with the Post Auditor's draft report, the Division is reviewing priorities and work hours with the objective of reducing the frequency and scope of routine inspections, presently averaging three or more inspections a year for each licensee, and possibly increasing undercover operations to insure compliance with the law.

The Division has reviewed the agents' reports with respect to the significance of running routine interviews and criminal background checks on licensees. The Post Audit report (on Page 52) states: "Despite the high number of criminal background investigations, these activities seldom result in the discovery of circumstances leading to the denial of a license application. Only one application was denied in 1981, and that was for a sales representative's permit..." This statement is not accurate.

Division records indicate that during 1982, eighteen (18) convictions were discovered which resulted in either applicants withdrawing their application, resigning as corporate officers, or having the conviction expunged or annulled, or resulting in a citation.

Also, during the year 1982, the Division found seventeen (17) similar disqualifying convictions which were surfaced as a result of criminal background investigations in 1981, forty-three (43) licenses or permits were either denied, withdrawn or revoked.

Legislative Post Audit response. *The draft report has been revised to reflect the occurrence of undercover investigations and the additional 18 convictions discovered during criminal background investigations of applicants during 1981 (not 1982, as indicated in the Department's letter.)*

This office has consistently worked on improving the retail and club inspection procedures, revising inspection forms as necessary to obtain necessary information and insure a degree of uniformity and compliance for all concerned.

With respect to the need of a statewide enforcement trend analysis, the Department and the Division agree that the volume of investigations being made is nearly impossible to analyze manually. Such information with respect to investigations and dispositions would be a meaningful enforcement "tool" if automated through a computer report.

The Division of Alcoholic Beverage Control and the Department of Revenue are convinced that penalties assessed for violations of liquor laws and regulations consistently bear a reasonable relationship to the seriousness of the offense.

The Director assigns a penalty to a licensee based on the circumstances surrounding the violation. Every case is evaluated on its own merits. Accordingly, the Director, having both extensive experience as well as access to the details of the occurrence, is best qualified to make a determination as to the effect of a violation on the industry and the public.

The Department and the Division disagree with the Post Auditor's recommendation that the option of fine or suspension no longer be provided to a licensee in violation. The Division feels that the option, when offered to licensees with relatively violation-free records, is an equitable exercise of administrative judgment.

Often clubs which have a marginal financial base would be forced out of business if not given the choice between the fine or suspension when deemed equivalent by the Division. In these circumstances, the licensee is best suited to make an appropriate choice between equal penalties. Clearly, flexibility must continue to be available to the Director to evaluate each case on its merits. Further, such options are not always provided but are given when the circumstances warrant.

Post Audit Recommendation

Pages 67 - 68.

"1. To improve its estimates of liquor excise taxes due to the State, the Department of Revenue should take the following actions:

   a. Obtain totals of and monitor the amount of monthly sales to private clubs by retail liquor stores.

   b. As audits of private clubs are completed, compile and analyze information on the ratio of alcoholic beverage sales to the cost of liquor purchased.

   c. Prepare a revised estimate of the amount of liquor excise tax shortfall in the State.

2. The Legislature should review this revised estimate and should monitor the results obtained by audits of liquor excise tax collections. The Legislature should also require the Department of Revenue to provide it with information about the additional amount of liquor excise tax revenues collected, and any increase in compliance with nontax related matters, as a result of the new audit program. This information, which should be compiled and reported to the Legislature by the start of the 1984 legislative session, should help the Legislature and the Department determine if this auditing effort is cost-effective.

3. The Department of Revenue should ensure that private clubs are given clearer guidance in calculating the sales and excise taxes they must collect from their customers. This guidance could be in the form of a simple instructional manual on computing and paying these taxes."

Agency Response

Effective July 1, 1982, all retail liquor stores holding a federal wholesaler's basic permit are required to submit to the Division of Alcoholic Beverage Control a monthly summary recap of all sales to private clubs. This summary must be submitted to the Division by the fifteenth day of the month following such club sales. With the employment of seven (7) auditors pursuant to the 1982 legislative's appropriation, retail liquor excise tax audits are now being conducted. The results of these audits are being accumulated and such data will be furnished to the legislature.

On October 25, 1982, new retail liquor excise tax regulations were promulgated to assist private clubs in complying with the requirements of K.S.A. 1981 Supp. 74-41a03. Included in these regulations were instructions regarding the calculation of sales and liquor excise taxes. Further, on November 22, 1982, various members of the private club industry met with representatives of this Department in an effort to resolve questions about recordkeeping requirements and possible alternatives in computing the applicable retail liquor excise tax due--i.e. complimentary drinks, overage, spillage, theft, and two or more drinks for the price of one.

The Department will continue to work in this area to achieve overall appropriate retail liquor excise tax collections to the State. It should be pointed out that on July 9, 1979, an informational notice was sent to all private club licensees concerning the provisions of Senate Bill 467, which implemented the retail liquor excise tax. Also, on November 1, 1982, an informational letter, a copy of the retail liquor excise tax regulations, and a printed sign indicating that the retail liquor excise tax is included in the price of a drink, was sent to all private club licensees.

Respectfully submitted,

Michael Lennen
Secretary of Revenue

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