

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL

235.3

REVIEW OF THE
MARKETING ORDER FOR WINE

JULY 1975

TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

MEMBERS

Assembly

Bob Wilson, Chairman
Eugene A. Chappie
Mike Cullen
John Francis Foran

Senate

Anthony C. Beilenson
Clare L. Berryhill
George Deukmejian
James R. Mills

ASSEMBLYMAN
CHAIRMAN
BOB WILSON
SEVENTY-SEVENTH DISTRICT
EUGENE A. CHAPPIE
THIRD DISTRICT
MIKE CULLEN
FIFTY-SEVENTH DISTRICT
JOHN FRANCIS FORAN
SIXTEENTH DISTRICT

Joint Legislative Audit Committee

GOVERNMENT CODE: SECTIONS 10500-10504

California Legislature

SENATORS
ANTHONY BEILENSON
TWENTY-SECOND DISTRICT
CLARE BERRYHILL
THIRD DISTRICT
GEORGE DEUKMEJIAN
THIRTY-SEVENTH DISTRICT
JAMES R. MILLS
FORTIETH DISTRICT

BOB WILSON
CHAIRMAN

ROOM 4126, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
(916) 445-6161

July 9, 1975

The Honorable Speaker of the Assembly
The Honorable President pro Tempore of
the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members of the Legislature:

I am today releasing the Auditor General's report on a review of the Marketing Order for Wine as administered by the Wine Advisory Board under the supervision of the Director of the Department of Food and Agriculture. The Marketing Order for Wine is one of 34 marketing orders adopted as of June 1, 1975 under the California Marketing Act of 1937.

On May 15, 1975 the Wine Advisory Board voted to withdraw their application for the renewal of the Marketing Order for Wine which is due to expire on June 30, 1975.

The Auditor General's report has cited the following data and deficiencies:

- The Department of Food and Agriculture has not conducted adequate audits of revenue and expenditures relating to the Marketing Order for Wine.
- The Department has delegated to the manager of the Wine Advisory Board the duty to audit the assessments paid by all state wineries to the department. The last such audit was performed on a single winery in April 1973. Considering that there are over 140 firms operating 321 bonded winery premises

in the state subject to the assessment, the audit of a single winery from April 1973 to date does not represent sufficient audit coverage.

- Annually, the Wine Advisory Board contracts with the Wine Institute, a nonprofit trade association of the wine industry, for a substantial portion of the board's work in the areas of research, marketing surveys, public information, publicity, education, and sanitation. In 1973-74, this contract amounted to \$2,146,848, and represented approximately 80 percent of the reported total expenditures of the board for the year.
- Since 1958, the Department of Food and Agriculture has audited the activities of the board only for the years 1964-65 and 1973-74. Both audits excluded an examination of payments made under the Wine Institute contract.
- Expenditures of the Wine Institute include trade barrier and lobbying activities. Without audit, the department is not in a position to determine whether these as well as other expenditures were for purposes authorized under the Marketing Order for Wine.
- In 1974, the Wine Institute, directly or through Viticultural Associates, whose treasurer is general counsel for the Institute, made political contributions of \$49,955. While the Institute is reported to receive income from sources other than the Wine Advisory Board, the amount of such income, if any, was not confirmed. If the political contributions made by the Institute were from funds received from the Wine Advisory Board, such contributions would not be a permissible expenditure under the marketing order. Without audit, the Department of Food and Agriculture cannot determine the source of funds which were used for the political contributions.
- Twenty-two of the twenty-five Wine Advisory Board members are also among the 68 directors of the Wine Institute. Six of the eight officers of the Wine Institute are on the Wine Advisory Board. The Wine Institute Executive Committee approved

the proposed 1973-74 budget of the Wine Advisory Board on June 1, 1973. On June 4, 1973 the board adopted the same budget.

- The Department of Food and Agriculture's rules state, "The Department requires evidence of propriety with respect to every item submitted to it for payment and will disallow any item not properly supported." Contrary to the department's rules, proper support for expenditures incurred under the Wine Institute contract has not been required by the department.

The Auditor General has recommended that the Department of Food and Agriculture:

- Conduct audits of a random sample of wineries in order to determine if assessments paid by the wineries to the department have been accurately and uniformly collected. Such audits should encompass fiscal years 1972-73, 1973-74, and 1974-75.
- Conduct a full and comprehensive audit of the Wine Institute contract awarded by the Wine Advisory Board in order to determine if Institute expenditures incurred prior to July 1, 1975 have been in compliance with the purposes of the marketing order. Such audit should encompass fiscal years 1972-73, 1973-74, and 1974-75.

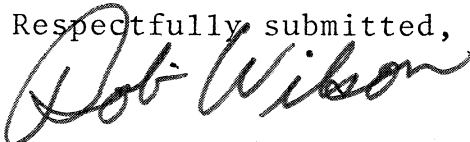
Information on voting procedures pertaining to the Marketing Order for Wine is contained on pages 14 and 15 of the report. The Auditor General has made no recommendations on this matter because it has been announced that the current Marketing Order for Wine will terminate on June 30, 1975.

Following meetings to discuss this report with officials of the Agriculture and Services Agency, the department, and the board on June 24 and 27, 1975, a written response was received from the Director of the Department of Food and Agriculture. This response, which is contained on pages 16 through 25 of the report, indicated substantial concurrence with the Auditor General's recommendations by stating that on June 27, the Director moved, in the public interest, to commence a

The Honorable Members of the Legislature
of California
July 9, 1975
Page 4

complete audit of the Wine Institute. The institute refused to allow the audit to be started, and the department is pursuing the matter through administrative and legal channels. The Director further stated that arrangements are being discussed with the State Board of Equalization for an audit of winery records in order to determine whether assessments paid pursuant to the Marketing Order for Wine were accurately and uniformly collected. The response also contained additional background information and factual data pertaining to the Marketing Order for Wine.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bob Wilson". The signature is written in dark ink and is positioned above the typed name.

BOB WILSON, Chairman
Jt. Legislative Audit Committee



STATE OF CALIFORNIA

GLEN H. (JACK) MERRITT, C.P.A.
CHIEF DEPUTY AUDITOR GENERAL

Office of the
Auditor General

925 L STREET, SUITE 750
SACRAMENTO, CALIFORNIA 95814
(916) 445-0255

HARVEY M. ROSE, C.P.A.
AUDITOR GENERAL

JERRY L. BASSETT
ATTORNEY-AT-LAW
DEPUTY-CHIEF COUNSEL

PHILLIPS BAKER, C.P.A.
GERALD A. HAWES
JOHN H. McCONNELL, C.P.A.
DEPUTIES

July 7, 1975

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
Room 4126, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

Transmitted herewith is our report on a review of the Marketing Order for Wine as administered by the Wine Advisory Board under the supervision of the Director of the Department of Food and Agriculture.

Respectfully submitted,

Harvey M. Rose
Auditor General

Staff: Glen H. Merritt
Gary S. Ross
Nancy Lynn Szczepanik
Dennis Sequeira
R. Lilia Molina

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
FINDINGS	
The Department of Food and Agriculture has not conducted adequate audits of revenue and expenditures relating to the Marketing Order for Wine.	3
Recommendations	12
OTHER PERTINENT INFORMATION	14
WRITTEN RESPONSE FROM THE DIRECTOR, DEPARTMENT OF FOOD AND AGRICULTURE	16
APPENDIX A - Explanation of Marketing Orders in General and Description of the Marketing Order for Wine	26
APPENDIX B - Wine Advisory Board (WAB) Unaudited Comparative Revenue and Expenditure Statements 1969-70 to 1974-75	28

INTRODUCTION

In response to a legislative request, we have reviewed the administration by the Wine Advisory Board of the Marketing Order for Wine, as supervised by the Director of the Department of Food and Agriculture.

The Marketing Order for Wine is one of 34 marketing orders adopted as of June 1, 1975 under the California Marketing Act of 1937. Activities authorized under Article III of the Marketing Order for Wine include advertising and sales promotion, research studies and educational programs.

An explanation of marketing orders in general, and a more detailed description of the Marketing Order for Wine as administered by the Wine Advisory Board is presented in Appendix A.

Unaudited statements of revenue and expenditures for the previous five years, and the budgeted revenue and expenditures for the 1974-75 year, based on the Department of Food and Agriculture's financial statements and on expenditures reported in the Wine Advisory Board minutes, appear in Appendix B.

New Developments

The current Marketing Order for Wine terminates at midnight on June 30, 1975. On May 8, 1975, the Director of the Department of Food and Agriculture called for a public hearing on May 23, 1975 to receive testimony on the renewal of the marketing order.

A letter to the Chairman of the Wine Advisory Board dated May 7, 1975 from the Director of the Department of Food and Agriculture listed two requirements for renewal of the Marketing Order for Wine. These requirements were given as:

"First, the amount of funds collected under the marketing order which are contracted to the Wine Institute or a similar organization for services rendered cannot exceed 50% of the funds collected.

"Second, because of the unique structure of the wine industry, the assent sign-up must exceed the normal requirements in order to represent an industry consensus. In this case, the minimum sign-up requirements would be 65% by number that represents 51% of the volume, or 51% by number that represents 65% of the volume."

At a meeting of the Wine Advisory Board on May 15, 1975, the Chairman of the board stated that in addition to the renewal requirements contained in the Department of Food and Agriculture's letter a further requirement for renewal was that "trade barrier" activities could only be subcontracted to the Wine Institute for the first year of the new marketing order. At the same meeting, the Chairman of the board of the Wine Institute advised that the Wine Advisory Board should consolidate its activities with the Wine Institute and vote to withdraw their application for renewal. The motion to withdraw the application for renewal was approved by a vote of 18 in favor and 5 opposed.

The public hearing was held as scheduled on May 23, 1975. At the conclusion, the hearing officer announced that, in view of the fact that no supporting testimony had been received from members of the industry, it probably would not be necessary to conduct a vote to determine whether to renew the order.

FINDINGS

THE DEPARTMENT OF FOOD AND AGRICULTURE HAS NOT
CONDUCTED ADEQUATE AUDITS OF REVENUE AND
EXPENDITURES RELATING TO THE MARKETING ORDER
FOR WINE.

The Food and Agricultural Code requires the Department of Food and Agriculture to receive and expend all monies on behalf of the agricultural advisory boards. In the performance of this duty relating to the Wine Advisory Board, the department has not conducted adequate audits of the revenue and expenses of the board to ensure that the board has conformed with the published rules and regulations governing agricultural marketing orders.

Audits of Revenue and Expenses Are Inadequate

Revenue

The Department of Food and Agriculture has delegated to the manager of the Wine Advisory Board the duty to audit the assessments paid by all state wineries to the department and credited to the account of the board. Such assessments are based on the amount of wine sold or removed from the premises of wineries. The last such audit was performed on a single winery in April 1973. Considering that there are over 140 firms operating 321 bonded winery premises in the state subject to the assessment, the audit of a single winery from April 1973 to date does not represent sufficient audit coverage. Assessments collected in 1973-74 totaled \$2,313,891, and during the first ten months of 1974-75 totaled \$1,857,924.

In an attempt to determine the validity of the assessments collected by the board from the wineries, we requested that the Department of Food and Agriculture authorize our office to perform audits of a random sample of winery records showing the gallonage of wine sold by or removed from the wineries. The Director declined to delegate this authority.

There are other sources of information pertaining to the wine industry but this information is either not available to us or is not regularly verified by audit. The U.S. Department of Treasury's Bureau of Alcohol, Tobacco and Firearms regularly audits winery operations; however, their reports are confidential for an individual winery and only industry totals are available from this source. In addition the State Board of Equalization maintains data on individual wineries. However, this information is obtained from data submitted to the Board of Equalization by wineries and is not regularly audited.

In summary, in our judgment, the only reliable method to determine as to whether or not assessments from the wineries have been accurately and uniformly collected is through an audit of a random sample of wineries. This has not been adequately done by the Department of Food and Agriculture, or the Wine Advisory Board.

Expenses

Each year the Wine Advisory Board contracts with the Wine Institute, a nonprofit trade association of the wine industry, for a substantial portion of the board's work in the areas of research, marketing surveys, public information, publicity, education, and sanitation. In 1973-74, this contract amounted to \$2,146,848, and represented approximately 80 percent of the reported total

expenditures of the board for the year. The 1974-75 contract is budgeted for \$2,440,900. For the first ten months of the 1974-75 year, \$1,830,675 was expended under this contract representing approximately 86 percent of the total expenditures of the board for that period.

Since 1958, the Department of Food and Agriculture has audited the activities of the board only for the years 1964-65 and 1973-74. Both audits excluded an examination of payments made under the Wine Institute contract. After the original audit of 1964-65 was completed, the department did perform a limited audit of the Wine Institute. This audit, which was done by one auditor in about one week, was basically of internal office controls and did not include verification of source documentation for major categories of expenditures.

As required by Section 58937 of the Food and Agricultural Code, every two years the Department of Finance audits the "Marketing Trust Accounts" of the Department of Food and Agriculture, including the Wine Advisory Board account. Currently they are auditing the period July 1, 1972 to June 30, 1974. They have never audited the Wine Institute contract. In 1958, the Department of Finance was critical that the Department of Food and Agriculture was not regularly auditing the Wine Institute contract. In response, the Department of Food and Agriculture formally notified the Department of Finance on December 2, 1958 that an audit of the Wine Institute was, in effect, unnecessary. Their letter stated:

"It has been administratively determined that the review of the Wine Institute's records conducted by the Manager of the Wine Advisory Board, who is working closely with the marketing economist of the department assigned to this board, provides the necessary control. Accordingly, it will not be necessary for the internal audit staff of the Bureau of Markets to review records of the Wine Institute."

Sufficient audits would determine whether, in fact, the expenditures made by the Wine Institute were for purposes authorized under the Marketing Order for Wine.

Contractor Activities Which Should Be Audited

The Department of Food and Agriculture has not performed adequate audits of the activities performed by the Wine Institute under its contract with the Wine Advisory Board. As a result, some 80 percent of the funds raised by the marketing order is expended without a detailed examination.

We obtained some information pertaining to the Wine Institute's activities by a review of those documents available to the general public in state offices, including the Secretary of State, Department of Corporations, and others. In addition, a significant number of Wine Institute Executive Committee meeting minutes were on file at the Wine Advisory Board which we were able to review. The following are examples of Wine Institute activities which indicate the need for a detailed audit of the institute's expenditures under its contract with the Wine Advisory Board.

Trade Barriers -- In 1974-75, about 56 percent, or \$1,360,300, of the total expenditures budgeted for the Wine Institute in performance of its duties under the contract was for "Marketing Surveys". Marketing surveys are divided into three areas: surveys of wine marketing conditions, surveys of federal and state laws and regulations, and "activities...for the prevention, modification or removal of any trade barrier disclosed". This third area, "prevention, modification or removal of any trade barrier disclosed" is authorized under Article III of the Marketing Order for Wine.

No Wine Institute Executive Committee meeting minutes showing a detailed breakdown of the expenditures for "trade barrier" activities since 1971 were available at the board. However, the January 28, 1971 minutes which were available to us provided some description and level of expenditures for trade barrier activities in several states. Examples of trade barrier activities cited in 1971 minutes disclosed that \$25,000 was recommended to be expended by the Wine Institute in Ohio as follows:

"Ohio

On motion made, seconded and unanimously carried, Counsel was authorized to take appropriate steps to endeavor to nullify the action of the Ohio Department of Liquor Control increasing the minimum markup on wine for wholesalers from 25 to 33-1/3 percent, and to expend not to exceed the amount set forth in the Committee file for this purpose."

and that \$35,000 was recommended to be spent in South Carolina for the following activities:

"South Carolina

It was moved, seconded and unanimously carried, that an effort be made to equalize the wine tax in South Carolina, and Counsel was authorized to expend a sum not to exceed the amount set forth in the Committee file to accomplish this objective."

"Trade barrier" activities are included in the contract with the Wine Institute and authorized under the Marketing Order for Wine. However, without a full and comprehensive audit of the expenditures, the Department of Food and Agriculture is not in a position to determine whether such activities are consistent with the purpose of the Marketing Order for Wine.

Lobbying -- Information filed with the Secretary of State's Office shows that during the month of January 1975, the Wine Institute employed three lobbyists to influence legislation in California. In addition, the General Counsel for the Wine Institute is listed as an employer of lobbyists.

Section 82039 of the Government Code defines a lobbyist as:

"...any person who is employed or contracts for economic consideration, other than reimbursement for reasonable travel expenses, to communicate directly or through his agents with any elective state official, agency official or legislative official for the purpose of influencing legislation or administrative action, if a substantial or regular portion of the activities for which he receives consideration is for the purpose of influencing legislation or administrative action."

The Marketing Order for Wine allows "...presentation of facts to and negotiations with State, Federal or foreign governmental agencies on matters which affect the marketing of wine produced in this State". The contract between the Wine Advisory Board and the Wine Institute provides that the Wine Institute "shall make appearance, when necessary, before the various Federal, State, and Foreign Government(s)".

Without audit, the Department of Food and Agriculture is not in a position to determine whether such lobbying expenditures are consistent with the purpose of the Marketing Order for Wine.

Political Contributions -- The Wine Institute made contributions to candidates for California state offices during the period January 1, 1974 through December 6, 1974. The dollar value of such contributions which included

cash, wine, and freight (for the wine) totaled \$49,955.51. The payments were made either directly by the Wine Institute or through Viticultural Associates whose treasurer is general counsel for the Wine Institute. The Wine Institute is reported to have sources of income other than its agreement with the Wine Advisory Board; however, the amount of such income, if any, were not confirmed. If the political contributions made by the Wine Institute were from funds received from the Wine Advisory Board, such contributions would not be a permissible expenditure under the marketing order.

Without audit, the Department of Food and Agriculture cannot determine the source of funds which were used for the political contributions.

Relationship Between the Wine Advisory Board and the Wine Institute --

The Wine Advisory Board is a statutorily provided-for extension of the Director of Food and Agriculture, appointed by him to assist him in the administration of the Marketing Order for Wine. The Wine Institute, on the other hand, is a nonprofit corporation which operates as a wine industry trade association.

The relationship between the Wine Advisory Board and the Wine Institute is much closer than that which usually exists between a governmental entity and a contractor. This relationship reportedly has existed since the inception of the Marketing Order for Wine in 1938 and is the result of many factors. For example:

Twenty-two of the twenty-five Wine Advisory Board members are also among the 68 directors of the Wine Institute. Six of the eight officers of the Wine Institute are on the Wine Advisory Board. The other two officers are Wine

Institute employees. The present manager of the Wine Advisory Board was formerly employed by the Wine Institute.

As a result of this close relationship, numerous ordinary business dealings between the Wine Advisory Board and the Wine Institute, and between one or the other of these organizations and third parties, are carried out with no clear distinction that they are two separate organizations. Employees transferring from the Wine Institute to the Wine Advisory Board are treated as if they were only changing departments within a company. The Wine Advisory Board has recognized vacation and sick leave earned at the Wine Institute and computed seniority based on the date hired by the Wine Institute. Since Wine Advisory Board employees are not state employees, nor are they covered by civil service regulations, such actions are permissible. The Wine Institute routinely pays the following types of expenses for the Wine Advisory Board and then rebills the board on institute letterhead: paper, printing, freight, postage, travel, entertainment and equipment maintenance.

The Wine Institute Executive Committee approved the proposed 1973-74 budget of the Wine Advisory Board on June 1, 1973. Three days later, on June 4, 1973 the Wine Advisory Board adopted the same budget.

In view of the close relationship which exists between the Wine Advisory Board and the Wine Institute, the Department of Food and Agriculture should regularly audit the expenditures under the contract between the Wine Advisory Board and the Wine Institute.

Conformance to Rules and Regulations

As stated in the department's rules and regulations (Rule 3), effective February 12, 1973, pertaining to marketing orders, "The Department requires evidence of propriety with respect to every item submitted to it for payment and will disallow any item not properly supported."

Consistent with contractually specified billing procedures, the Wine Institute bills the Wine Advisory Board for services in 11 equal installments and the balance at year-end which includes an amount "determined by the Contractor and the board to fully compensate Contractor for all functions performed". Further, "Contractor agrees to permit the Board, the Director, or their properly designated agent to review its actual total expenditure records and audit monthly bills rendered hereunder".

The contract between the Wine Advisory Board and the Wine Institute is essentially a cost reimbursement agreement and even though the monthly bill states "For services rendered during the month", the billed amount represents one-twelfth of the total stated contract amount. Monthly billings do not represent actual monthly costs, and the adjustment between actual cost and the total of the monthly billings submitted is reconciled at year-end and reflected in the final (July) billing.

No detailed statements of actual costs for expenditures reimbursable under the contract were available at either the Wine Advisory Board or the Department of Food and Agriculture to support monthly billings or the year-end adjustment. The Department of Food and Agriculture is not adhering to its own

Rule 3 requiring proper support for expenditures incurred, nor has it exercised its rights under the contract to "review its (Wine Institute) actual total expenditure records and audit monthly bills rendered hereunder".

CONCLUSION

The Department of Food and Agriculture has conducted inadequate audits of revenue and expenditures relating to the Marketing Order for Wine.

RECOMMENDATIONS

We recommend that the Department of Food and Agriculture:

- Conduct audits of a random sample of wineries in order to determine if assessments paid by the wineries to the department have been accurately and uniformly collected. Such audits should encompass fiscal years 1972-73, 1973-74, and 1974-75.

- Conduct a full and comprehensive audit of the Wine Institute contract awarded by the Wine Advisory Board in order to determine if institute expenditures incurred prior to July 1, 1975 have been in compliance with the purposes of the marketing order. Such audit should encompass fiscal years 1972-73, 1973-74, and 1974-75.

BENEFITS

Implementation of these recommendations will determine whether the monies collected from the wineries have been accurately and uniformly collected and whether the monies paid by the Wine Advisory Board to the Wine Institute were expended for purposes authorized under the Marketing Order for Wine, as required by law.

OTHER PERTINENT INFORMATION

The procedure required for the establishment or renewal of a handler marketing order, such as wine, requires among other things a public hearing to determine industry attitudes. If the Director of the Department of Food and Agriculture determines that there is sufficient industry support and justification for a program as evidenced in the hearing, a vote of the industry will be conducted.

Under the present handler voting procedures covered by Division 21, Part 2, of the Food and Agricultural Code of California, a marketing order for wine may, with the permission of the Director of the Department of Food and Agriculture, become effective either by assent of wineries which control not less than sixty-five percent (65 percent) of the volume of a commodity, or by assent of not less than sixty-five percent (65 percent) of the number of wineries.

Under this procedure, it is possible for a marketing order for wine to be approved by the Director of the Department of Food and Agriculture even though the majority of the industry, insofar as numbers rather than volume of production, has not voted for its adoption. This is the situation in the present Marketing Order for Wine which expires June 30, 1975.

At the last vote of the industry tabulated on September 25, 1972, only 49 percent of the wineries voted in favor of the proposed action, yet, because of the voting procedures, this action became mandatory for the entire

industry. It should be noted that the 49 percent of the wineries in this instance represented 91 percent of the volume. However, the largest three wineries, which collectively produce in excess of 65 percent of the industry's volume, can control the marketing order to the extent of the vote by volume subject to the approval of the Director. The state's largest winery has sufficient volume (over 35 percent) to preclude a successful vote by volume when it so desires.

In 1967, a major amendment to the Marketing Order for Wine was proposed to decrease the assessment for dessert wine, for which an increase had just been assented to a month earlier by a majority of the industry. The final tabulation of this assent showed that only 15 percent of the number of wineries was in favor of the amendment to decrease the assessment. However, because this 15 percent represented 68 percent of the volume of the industry, the amendment to lower the assessment rate was approved.

CONCLUSION

We are making no recommendations on this matter because it has been announced that the current Marketing Order for Wine will terminate on June 30, 1975.

DEPARTMENT OF FOOD AND AGRICULTURE



1220 N Street
Sacramento
95814

July 3, 1975

Mr. Harvey M. Rose, Auditor General
Office of the Auditor General
925 L Street, Room 750
Sacramento, California 95814

Dear Mr. Rose

Herewith I am transmitting my comments on
your draft report of the Marketing Order for
Wine.

Sincerely

A handwritten signature in cursive script that reads "L. T. Wallace".

L. T. Wallace
Director

Enclosures

COMMENTS ON
DRAFT REPORT OF THE AUDITOR GENERAL'S REVIEW OF
THE MARKETING ORDER FOR WINE

CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE

L. T. WALLACE, DIRECTOR

July 3, 1975

COMMENTS OF THE DIRECTOR OF THE DEPARTMENT
OF FOOD AND AGRICULTURE

The Director of the Department of Food and Agriculture moved on June 27, 1975, to commence a complete audit of the Wine Institute. On June 30, 1975, a team of three auditors and legal counsel went to the offices of the General Counsel of the Wine Institute. Pursuant to the contract between the Wine Institute and Wine Advisory Board, and pursuant to the powers of the Director of the Department of Food and Agriculture, a demand was made to commence immediately an audit of the books and records of the Wine Institute in the public interest.

This request followed a telephone conversation with the General Counsel of the Wine Institute in which he agreed to allow the Director of the Department of Food and Agriculture to perform an audit without delay. However, when the formal demand was made, it was refused. Immediately thereafter the Director of the Department of Food and Agriculture moved to ensure that the books and records would be made available for an audit. An administrative subpoena has been prepared and the Attorney General's Office has been contacted for legal assistance.

Further, the Director of the Department of Food and Agriculture, through his legal counsel, has contacted an official of the State Board of Equalization to discuss arrangements for an audit of winery records in order to determine whether assessments paid to the Department of Food and Agriculture pursuant to the Marketing Order for Wine were accurately and uniformly collected.

The Director of the Department of Food and Agriculture believes that the public has a right to an audit of the use of all public monies by the Wine Institute.

BACKGROUND INFORMATION

The California Department of Food and Agriculture [CDFA], which administers the California Marketing Act, has been invited by the auditor general to comment on his draft report on the Marketing Order for Wine.

The order no longer exists. It was discontinued on June 30, 1975 following action by the department director that sought to impose controls on the use of public money collected through the order.

Here is a brief account of the events leading up to that decision.

The marketing order was adopted in 1972 and was due to expire this June 30. The question of renewal of the order came up in the early spring of 1975.

The director discussed proposed renewal with industry members of the Wine Advisory Board over a period of eight weeks. The industry representatives indicated interest in renewal.

These discussions with the industry resulted in the director setting forth new criteria more in line with most orders -- designed to raise money to promote production, research, and consumption of farm goods.

In a letter to the Wine Advisory Board May 7, 1975, the director set two new requirements:

First, the amount of funds collected under the Marketing Order which are contracted to the Wine Institute or a similar organization for services rendered cannot exceed 50 percent of the funds collected.

Second, because of the unique structure of the wine industry, the assent sign-up must exceed the normal requirements in order to represent an industry consensus. In this case, the minimum sign-up requirements would be 65 percent by number that represents 51 percent of the volume, or 51 percent by number that represents 65 percent of the volume.

Under most marketing orders, the funds collected are spent directly by the board rather than being channeled to an industry association such as the Wine Institute.

The Wine Advisory Board was working to diminish legislative and administrative restrictions imposed on the sale of California wines throughout the country.

The first requirement was prompted by the manner in which the board did business, namely through a separate entity, the Wine Institute. The director felt the spending activities of the board should be more tightly supervised by putting restrictions on its contractual arrangement with the Wine Institute.

The second requirement was prompted by the fact that three major wineries [could] dominate the outcome of marketing order elections through sheer volume.

This new requirement was designed to give smaller producers a greater voice in marketing order elections which result in their being assessed funds to pay for promotion, research, and lobbying activities.

After a public hearing May 23, 1975, the director determined that the marketing order would not be renewed in view of the unwillingness or inability of the Wine Advisory Board to comply with the director's requirements.

On March 24, 1975, the auditor general notified the department his office would begin an audit of the Wine Advisory Board the following week. On June 27, 1975, the department initiated its own, independent, audit of the Wine Advisory Board and the Wine Institute.

Three days later, an audit team was sent with legal counsel to the offices of the general counsel of the Wine Institute and was refused access to the institute's records. An administrative subpoena has been prepared and the department is now taking all necessary legal and administrative actions to complete its audit.

At the auditor general's request, the following specific comments are intended to correct inaccuracies in the auditor general's draft report.

If in the judgment of the Office of the Auditor General, all inaccuracies in the draft report have been corrected.

FACTUAL DATA

The following comments correct or clarify statements made by the Auditor General in the report. (For reference purposes, the headings below correspond to those in the Auditor General's report.)

1. Introduction

a. The statement (page 1) of authorized marketing order activities should include a reference that trade barrier activity is also permitted under Section 58889 of the California Marketing Act. Such a statement at the outset is essential for a meaningful understanding of the remainder of the report.

b.

* * * 1/

c. The hearing officer, at the May 23, 1975, hearing, stated that he did ". . . not believe we (CDFA) would make the findings necessary to issue it (the Marketing Order) for a vote."

2. Findings

The Auditor General concludes that inadequate audits were made "of revenues and expenditures relating to the Marketing Order for Wine"

(Page [3]).

The Director recognizes the need to audit marketing order activities for administrative control purposes. Consistent with this view, the Director will continue to audit marketing order activities. It should be emphasized that CDFAs have access to, obtain, and utilize a wide range of information in carrying out its marketing order administrative responsibilities, with audits being only one source of information.

1/ Comments deleted refer to items shown in draft report but not included in this report.

3. Audits of Revenue and Expenses are Inadequate

a. The assessment revenue (page[3]) attributed to ten months of 1974-75 represents assessments on transactions occurring only during the first nine months of 1974-75.

* * * 1/

b. The report (page[4]) deals only with that portion of the WAB expenses attributable to its annual contract with Wine Institute. These funds represented about 80 percent of WAB's total expenses for the 1973-74 fiscal year. The report's statement that WAB's actual expenses for the first ten months of 1974-75 represent "approximately 86 percent of the total expenditures of the Board for that period" is misleading because it implies that the contract expenses for 1974-75 will be a higher percentage of the total in 1974-75 than they were in the previous year. In fact, this higher percentage results from the timing of Wine Advisory Board payments. For example, for the first ten months of the 1973-74 fiscal year, contract expenses were 85.2 percent of the total, but amounted to 80.4 percent for the entire year.

4. Contractor Activities which should be Audited

Exercise of State control over alcoholic beverages has created a maze of State and local laws and regulations which constitute extensive barriers to the sale and distribution of wine. Wine is an alcoholic beverage whose general sale and distribution in the United States was prohibited during 1919 to 1933. This prohibition was then repealed by the 21st Amendment to the U.S. Constitution. The repeal amendment, as interpreted by the courts, gives State and local governments broad

1/ See comment 1/ on page 22. (-6-)

control over the manner in which wine may be sold or distributed, and thus permits them to impose laws and regulations affecting wine and other alcoholic beverages that would not be lawful for other commodities.

The threat of additional laws and regulations is ever present. This was recognized by the California Legislature in providing specific authority in the California Marketing Act of 1937 to permit the establishment of marketing orders on wine, and for provisions in marketing orders for ". . .the prevention, modification, or removal of trade barriers which obstruct (restrict) the free flow of any commodity to market" (Sections 58889 and 58604 of the California Marketing Act of 1937).

5.

* * * 1/

6. Conformance to Rules and Regulations

The purpose of the Wine Institute audit presently being initiated by the Department of Food and Agriculture is to ensure that Rule 3 (effective February 12, 1973) of the Department's rules and regulations pertaining to marketing orders is being fully complied with.

7. Other Pertinent Information

a.

* * * 1/

1/ See comment 1/ on page 22.

b. The major amendment to the Marketing Order for Wine in 1967 (page 15) was to decrease the rate of assessment. There were no objections to the decrease. Failure on the part of a winery to file an assent does not necessarily mean opposition to the Marketing Order.

There are a number of ways to terminate a marketing order if sufficient opposition exists. These are set forth in Article 15, beginning with Section 59081, of the California Marketing Act.

Publications describing the purpose, nature, and operations of marketing orders are available from the California Department of Food and Agriculture.

EXPLANATION OF MARKETING ORDERS
IN GENERAL AND DESCRIPTION OF
THE MARKETING ORDER FOR WINE

A marketing order is a program for the agricultural industry designed to carry out some activity pertaining to an agricultural commodity. Within the State of California, marketing orders and similar programs operate under the rules and regulations of the Director of the Department of Food and Agriculture as authorized in the provisions of the California Marketing Act, the Agricultural Producers Marketing Act, the California Beef Council Law, and the Dairy Council of California Law.

These programs are designed to enable farmers, with the aid of the policing powers of the state, to join together to establish orderly marketing of their commodity. Growers and/or handlers of a commodity may elect to engage in one or more of the following activities: volume control, quality control, mandatory inspection, advertising and sales promotion, research, prohibition of unfair trade practices, pest and disease control, and education. Acceptance of a program by a majority of the industry electorate (as defined in the act), makes it binding on the entire industry. Financing the cost of the program is carried out by means of assessments on the industry as approved by the Director of the Department of Food and Agriculture.

Marketing order programs were originally established due to the conditions facing the California farmers during the depression of the 1930s. During this period, farmers experienced conditions such as seasonal surpluses, lack of

quality standards, and unfair trade practices. These conditions resulted in the California Agricultural Prorate Act of 1933, from which evolved the California Marketing Act of 1937 which is the basis of the present Marketing Order for Wine.

The Wine Advisory Board receives its funding from all wineries in the state under the mandatory assessment program of the Department of Food and Agriculture. Assessments are paid monthly based on the amount of wine prepared for market which was sold or removed from a winery's premises. Each winery files a report with the Department of Food and Agriculture stating the amount of wine they prepared for market during the previous month's operations in each of the four classifications: grape table (still), grape dessert, grape table (sparkling), and fruit berry and other agricultural wine. Based on this report, each winery pays according to the following assessment rate:

- Grape dessert wine	\$0.010/gallon*
- Grape table wine (still and sparkling)	0.010/gallon
- Fruit or agricultural wine	0.005/gallon

*Currently assessed at \$0.010 even though the allowable maximum rate is \$0.015.

WINE ADVISORY BOARD (WAB) UNAUDITED COMPARATIVE
REVENUE AND EXPENDITURE STATEMENTS 1969-70 TO 1974-75

	Actual					Budgeted 1974-75
	1969-70	1970-71	1971-72	1972-73	1973-74	
REVENUE						
Current Assessments	\$2,144,683	\$2,335,060	\$2,357,354	\$2,277,617	\$2,313,888	\$2,450,000
Delinquent Assessments	2,154	9,653	1,927	1,421	3	-0-
Total	<u>2,146,837</u>	<u>2,344,713</u>	<u>2,359,281</u>	<u>2,279,038</u>	<u>2,313,891</u>	<u>2,450,000</u>
Interest Income	95,630	105,236	102,555	82,883	76,976	50,000
Miscellaneous Income	-0-	-0-	-0-	-0-	40,220	-0-
TOTAL REVENUE	<u>\$2,242,467</u>	<u>\$2,449,949</u>	<u>\$2,461,836</u>	<u>\$2,361,921</u>	<u>\$2,431,087</u>	<u>\$2,500,000</u>
EXPENDITURES						
<u>Direct WAB Expenses</u>						
Salaries	\$ 140,769	\$ 152,536	\$ 155,546	\$ 165,061	\$ 95,267	\$ 108,900
Administration	158,552	201,288	194,412	78,769	31,738	64,200
Research	169,523	194,600	713,935	297,339	326,717	304,600
Advertising & Promotion	50,297	55,250	72,420	74,538	47,049	20,000
Total	<u>519,141</u>	<u>603,674</u>	<u>636,313</u>	<u>615,707</u>	<u>500,771</u>	<u>497,700</u>
Department of Food and Agriculture Charges	<u>15,047</u>	<u>12,206</u>	<u>16,932</u>	<u>21,707</u>	<u>22,023</u>	<u>27,000</u>
<u>Wine Institute Contract</u>						
Public Information			748,784	1,090,377	832,037	853,200
Marketing Survey			949,855	1,063,560	1,099,806	1,360,300
Research			130,490	131,597	66,098	64,000
Sanitation & Safety			12,578	26,465	34,514	36,000
Administration			108,679	108,712	114,393	127,000
Total	<u>\$1,410,140</u>	<u>\$1,594,620</u>	<u>\$1,950,386</u>	<u>\$2,420,711</u>	<u>\$2,146,848</u>	<u>\$2,440,900</u>
TOTAL EXPENDITURES	<u>\$1,944,328</u>	<u>\$2,210,500</u>	<u>\$2,603,631*</u>	<u>\$3,058,125*</u>	<u>\$2,669,642*</u>	<u>\$2,965,600*</u>

*Excess of expenditures over revenues is financed from surplus.

NOTE: See notes on page 19.

Notes to Financial Statements on Page 18

These statements, based on the Department of Food and Agriculture's financial statements and expenditures reported in the Wine Advisory Board minutes, are provided here for information only, as these statements are not prepared in accordance with generally accepted accounting principles applied on a basis consistent with prior years.

Our review disclosed that accounting methods used relating to the revenues and expenditures were not applied uniformly within years or between years, nor were they in conformity with generally accepted accounting procedures.

For example, miscellaneous income reported on the 1973-74 statement is primarily revenue received from the sale of "wine related items" which began prior to 1969-70. All of the miscellaneous income from these sales in the other years and a portion of the miscellaneous income from these sales in 1973-74 was recorded as a reimbursement to the Administration Expense. The purchase of the merchandise sold as "wine related items" was recorded as an Administration Expense.