

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

Management Letter
For the Year Ended June 30, 2017

Report No. 17-15



OFFICE OF THE STATE AUDITOR

AUDIT LEADERSHIP:

John Dougall, State Auditor
Bertha Lui, CPA, Senior Audit Manager
Chantel Wixon, Audit Senior

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
FOR THE YEAR ENDED JUNE 30, 2017

TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| MANAGEMENT LETTER | 1 |
| FINDING AND RECOMMENDATION: | |
| Lack of Appropriate Inventory Reconciliations (Significant Deficiency to the State's Financial Statements) | 3 |



OFFICE OF THE
STATE AUDITOR

December 6, 2017

Salvador D. Petilos, Executive Director
Dept. of Alcoholic Beverage Control
1625 South 900 West
P.O. Box 30408
SLC, Utah 84130

Dear Mr. Petilos:

In planning and performing our audit of the basic financial statements of the State of Utah as of and for the year ended June 30, 2017, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the Department of Alcoholic Beverage Control's (DABC) internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of DABC's internal control. Accordingly, we do not express an opinion on the effectiveness of DABC's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or to detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency in internal control presented in the accompanying finding and recommendation to be a significant deficiency.

DABC's written response to the finding identified in our audit has not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of DABC's internal control. The finding included in this report will be included in the State of Utah's "Independent State Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*." That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering DABC's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

We appreciate the courtesy and assistance extended to us by the personnel of DABC during the course of our audit, and we look forward to a continuing professional relationship. If you have any questions, please contact me.

Sincerely,

A handwritten signature in cursive script that reads "Bertha Lui".

Bertha Lui, CPA
Senior Audit Manager
801-808-0481
blui@utah.gov

cc: Man Diep, Director of Finance
Cade Meier, Warehouse General Manager

FINDING AND RECOMMENDATION

LACK OF APPROPRIATE INVENTORY RECONCILIATIONS

The Department of Alcoholic Beverage Control (DABC) was not able to provide adequate inventory system reports to reconcile the physical inventory count records to the final inventory amounts reported on the State's general ledger (FINET). DABC implemented a new inventory system during fiscal year 2017. However, due to difficulties related to the implementation, monthly reconciliations of the inventory system to FINET were not performed during the year nor at year end as would be necessary for appropriate internal controls over financial reporting. Proper internal controls would include reconciling the following inventory system amounts: beginning inventory balances, purchases, cost of sales, transfers, and ending inventory balances – all of which should also agree to FINET on a monthly basis. By not performing the appropriate reconciliations, large adjustments were necessary at fiscal year end.

Also, DABC could not provide appropriate system reports for the bailment included in the inventory at the time of the physical counts. The bailment inventory, which is not an asset of the State, was included in the inventory records and physical counts; however, DABC was not able to provide adequate system reports for the bailment versus non-bailment inventory so as to allow proper reconciliation of inventory from physical counts to the state-owned inventory amounts reported in FINET at year end. Proper system reporting and reconciliation of inventory types are necessary to accurately reflect inventory amounts for financial reporting purposes.

Recommendation:

We recommend DABC reconcile the inventory system purchases, costs of sales, transfers, and ending balances—and ensure they agree to FINET—on a monthly basis. We also recommend that DABC implement procedures to properly account for and report bailment versus non-bailment inventory balances.

DABC's Response:

We agree that the department should reconcile each month with the State's FINET system. Conducting monthly reconciliations is a best practice that will enhance internal controls. We also agree that properly accounting for and reporting on bailment versus non-bailment inventory balances is essential to providing a clear picture with regard to the department's financial position.

The department's finance staff has been attempting to reconcile our system with FINET on a monthly basis. Nonetheless, while reconciliations are occurring, we have been unable to do so in a consistently timely manner. We hope that the steps outlined in the Corrective Action Plan will allow us to consistently reconcile the two systems in a timely manner.

As alluded to in the report, the DABC's implementation of a new ERP to replace an end of life system has been challenging. The department's focus on stabilizing the supply chain and the

commitment of resources to that effort, in addition to the introduction of changes in well-established processes and procedures because the native logic of the new ERP differed from that of the legacy system it replaced, caused delays in reporting and reconciliation of the two systems. It took time to stabilize the DABC's supply chain and it took time for DABC staff to receive training necessary to more fully understand and adjust to the system's native logic and its impact on processes.

While inventory is tracked, we are aware of the need to improve the quality of system-generated reports that track bailment v. non-bailment inventory. We understand and agree that properly tracking and reporting on inventory balances is essential. We are buoyed by that fact that several of our bailment vendors have audited their inventory post implementation and found no issues. Still, DABC and DTS staff have, and continue to look for, report on, and research root causes of anomalous results and inform our vendor and/or consultants of these anomalies so they can be addressed. These efforts, as outlined in the Corrective Action Plan, should result in system reports - using the system's internal Sarbanes-Oxley and GAAP compliant logic - that will allow proper reconciliation of inventory from physical counts to state-owned inventory amounts.

Corrective Action Plan:

From the DABC's perspective, the two recommendations are intertwined with progress in one area contingent on developments in another.

It is important to note that DABC's new ERP tracks the physical inventory (quantity) and financial inventory (cost/value) separately. A unique consequence of this logic is that the transfer of ownership of physical inventory occurs when the product is purchased, rather than when received. Consequently, inventory at the warehouse and state stores, at any one time, include items that are State owned and non-state owned. The ERP relies on an inventory close process that requires a settlement process (payment of invoices) to match issues with receipts and assign the correct ownership and costs to inventory. Our consultants indicate that it is standard practice to run this process on a monthly basis.

The department's ability to consistently reconcile the two systems on a monthly basis and properly account for bailment and non-bailment inventory will require close collaboration between DABC Finance and our DTS staff since issues and discrepancies found during efforts at reconciliation requires research as to the root causes of anomalous results and communications of these anomalies with our vendor and/or consultants so they can be properly addressed.

The following Corrective Action plan outlines steps taken and to be taken in DABC's efforts to consistently reconcile ERP with FINET:

I. Finance/Accounting

- 1. Narrow gap between physical inventory and financial inventory***
 - a) Since May 2017, DABC increased the frequency of payments to drop ship vendors from semi-monthly to weekly.***

- b) *Finance staff has also worked with Purchasing staff in changing bailment payment process.*
2. *DABC Finance has established the month end closing schedule in July 2017 that lists the steps of the month end closing process. This schedule will be updated monthly.*
3. *Financial Analyst has been reconciling the AX accounts with FINET and gaining a more robust understanding of the system. Procedural steps are being documented and process is being refined. Issues or concerns found are being communicated to DTS for investigation and correction.*
4. **Oversight:** *DABC Director of Finance reviewing transactions posted and issues found.*
5. **Support:** *Steps are being taken to create redundant capabilities within DABC Finance to improve the department's ability to reconcile monthly on a consistent basis.*
 - a) *Director of Finance is working with Financial Analyst on updating accounting processes and procedures required by the new system.*
 - b) *Knowledge gained about the system as a result of greater familiarity and more robust understanding of the system is being documented for eventual training of, and transfer to, others in the division with the requisite skills.*
6. *Continue to work with DTS to develop and establish proper procedures to ensure relationships between critical reports are documented to foster better understanding and transparency with inventory movements.*
 - a) *An inventory close must occur prior to running the IVR report and before any totals are sent to FINET. The inventory close creates the final FIFO layers on posted transactions in the system.*
 - b) *After an inventory close, DABC will run and review the IVR reports (one includes inventory transactions posted to ledger and one includes transactions not posted to ledger) and the WAR. Discrepancies will be investigated and addressed properly.*
7. *The department anticipates timely reconciliation on a monthly basis before the end of June 2018.*

II. Information Technology (DTS)

1. *Continue to assist DABC Finance research root causes of issues found during closing and reconciliation process.*
2. *Continue to report issues and root causes to implementation vendor.*
3. *Continue to work with implementation vendor to prioritize and test code or program created to address issues found.*
4. *Continue to address issues found with the Inventory Value Report (IVR) which show items owned by the state (posted) and those not yet owned by the state (non-posted) in the retail network (Warehouse and stores). Non-posted items are received into the system and tracked but do not have any financial value.*
5. *Ensure continued development and proper implementation of the Warehouse Activity Report (WAR) which provides a breakdown of State-owned inventory and bailment at a site level.*

6. *DABC anticipates the above mentioned reports will be working as expected before end of June 2018.*

*Contact Persons: David Higley, Financial Analyst III, 801-977-6853, dhigley@utah.gov
Brianna Lifferth, Information Technology Project Manager, 801-977-6858,
blifferth@utah.gov*

Anticipated Correction Date: June 2018