

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

Special Financial Audit
For Procedures Performed During Fiscal Year 2018

Report No. 18-01



OFFICE OF THE STATE AUDITOR

AUDIT LEADERSHIP:

John Dougall, State Auditor
Hollie Andrus, CPA, Audit Director
Ethan Heintzelman, CPA, Data and Technology Audit Director
Doug Seager, CPA, Financial Audit/IS Manager
Sean Clayton, Audit Senior



OFFICE OF THE
STATE AUDITOR

April 24, 2018

Members of the Utah Alcoholic Beverage Control Commission
and
Mr. Salvador D. Petilos, Executive Director
Department of Alcoholic Beverage Control

Dear Commissioners and Mr. Petilos:

We have performed various procedures on certain aspects of the Department of Alcoholic Beverage Control's (DABC's) internal control, including information technology general controls, and on financial data for July 1, 2017 through December 31, 2017. These procedures were performed in accordance with *Utah Code*, Section 32B-2-302, were agreed to by DABC management, and were approved by the Alcoholic Beverage Control Commission.

These procedures do not constitute an audit conducted in accordance with generally accepted auditing standards, the objectives of which would be the expression of an opinion on DABC's internal control. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our recommendations resulting from the procedures are found within this report.

By its nature, this report focuses on exceptions, weaknesses, and problems. This focus should not be understood to mean there are not also various strengths and accomplishments. We appreciate the courtesy and assistance extended to us by DABC's personnel during the course of the engagement, and we look forward to a continuing professional relationship. If you have any questions, please contact me.

Sincerely,

Hollie Andrus, CPA
Audit Director
handrus@utah.gov
801-808-0467

Table of Contents

Part 1—Financial Performance	1
Finding 1: Inadequate Internal Controls Over Reconciliation of AX to FINET	1
Finding 2: Liquor Markup Not in Accordance with Utah Statute	2
Finding 3: Inadequate Internal Controls Over Liquor Purchases	3
Finding 4: Inadequate Internal Controls Over Financial Statement Presentation	3
Finding 5: Inadequate Separation of Duties Over Monthly Bank Reconciliation	6
Part 2— IT General Controls	6
Finding 6: Insufficient Review of the AX User Privileges	6
Finding 7: Improper Access Privileges Granted to AX Users	6
Finding 8: Inadequate Review and Monitoring of AX User Activity	7
Department of Alcoholic Beverage Control’s Response to Findings and Recommendations	8

Part 1—Financial Performance

Finding 1: Inadequate Internal Controls Over Reconciliation of AX to FINET

The Department of Alcoholic Beverage Control (DABC) does not have adequate controls over the reconciliation of the MS Dynamics AX Application (AX) (DABC's accounting system) to FINET (the State's accounting system). As a result, multiple account balances presented in the December 31, 2017 Financial Report to the Alcoholic Beverage Control Commission (ABC Commission) did not agree to the corresponding account balances in FINET, as follows:

Report Line	Report Amount (AX)	FINET Amount	Difference Over/(Under)	Note
School Lunch and Public Safety	\$25,195,742	\$20,586,781	\$(4,608,961)	A
Accounts Receivable	\$5,518,815	\$2,197,750	\$(3,309,213)	B
Accounts Payable – Liquor Purchases	\$9,540,933	\$704,567	\$(8,836,366)	C
Accounts Payable - Other	\$18,298,404	\$22,406,979	\$4,108,575	A
Inventories	\$32,568,589	\$35,403,873	\$2,835,284	D

Notes:

- A. DABC did not perform the revenue transfer to the school lunch and public safety programs for November 2017. After our audit procedures detected the error, DABC recorded the appropriate transfer.
- B. \$2.5 million of restricted cash and \$1 million of consignment inventory was presented as part of accounts receivable in error. These accounts are DABC assets but are not accounts receivable.
- C. Payments were recorded in FINET before they were recorded in AX.
- D. A \$3,108,472 Journal Entry made on October 23, 2017 to adjust inventory was entered in FINET and AX. In November 2017, this entry was reversed in AX but not in FINET.

AX and FINET should equal each other as of a financial statement report date and should properly classify DABC's assets, liabilities, revenues, and expenses. If the two accounting systems are not properly reconciled, the financial information reported to the ABC Commission and State could be inaccurate

Recommendation:

We recommend DABC ensure AX is reconciled to FINET on at least a quarterly basis and resolve any discrepancies between AX and FINET in a timely manner.

Finding 2: Liquor Markup Not in Accordance with Utah Statute

We performed a pricing analysis on approximately 25,000 liquor inventory items to identify potential markup noncompliance as of December 31, 2017. From this analysis we performed analytics to determine our population of markup deviations not in accordance with Utah Statute. Of this population we sampled 75 inventory items, and noted 9 inventory items which were sold at a markup not in accordance with *Utah Code 32B-2-304*, as follows:

Description/ Classification of Sampled Inventory Items	DABC Markup	UCA-Required Markup	Difference
Wine	- 87%	Not less than 88%	- 175%
Beer Produced by Small Brewery	110%	32%	+ 78%
	115%	32%	+ 83%
Wine Produced by Small Winery	- 25%	49%	- 74%
	88%	49%	+ 39%
	91%	49%	+ 42%
	92%	49%	+ 43%
	103%	49%	+ 54%
Inventory Sold to Military Installation	3%	Not less than 17%	- 14%

Of the 9 noncompliant markups identified above, 7 were the result of data entry errors. These 7 markups affected 37 transactions—9 of which were priced less than the statutory markup, thereby resulting in a loss to DABC of \$185.94, and 28 of which were priced more than the statutory markup, resulting in overcharges to customers totaling \$1,161.96.

All 9 errors identified above may have been prevented if DABC had effective internal controls in place to review and verify that the markup being added to alcohol inventory was accurate.

DELISTED INVENTORY ITEMS SOLD AT A LOSS

As of December 30, 2017, five alcoholic inventory items marked as “delisted” were sold at a retail price less than the purchase price – thus being sold at a loss. DABC indicated it is not their intent to sell product below cost. DABC Policy 08-07 states that delisted inventory will be discounted at a final markdown not to exceed 46% using the following formula:

$$(\text{Purchase Price} * \text{Statutory Markup}) * (1 - 0.46) = \text{Delisted Sales Price}$$

Although this formula is effective for all liquor inventory items with an original markup of more than 85% it is ineffective for those items marked up less than 85%. These five errors occurred due to an ineffective formula and lack of adequate internal controls over the delisting of an inventory item by DABC’s Purchasing Department.

Recommendation:

We recommend DABC:

- a. **Implement internal controls to ensure that alcohol inventory items are being appropriately marked up in accordance with *Utah Code 32B-2-304*.**
- b. **Implement internal controls to ensure that delisted alcohol inventory items are not being sold at a loss.**

Finding 3: Inadequate Internal Controls Over Liquor Purchases

During our review of the liquor procurement process and controls over that process, we noted DABC Purchase Order(s) or Replenish Request(s) are not reviewed by the Purchasing Agent. Current DABC liquor purchasing policy 08-02 states, “after a purchase order or replenish request is printed it will be reviewed by the purchasing agent.” Furthermore, review of that Purchase Order or Replenish Request should be documented by the Purchasing Agent, indicating his approval of the request. Failure to review and approve purchase orders and replenish requests could result in excessive liquor inventory levels and incorrect inventory costing.

Recommendation:

We recommend DABC ensure purchase orders and replenish requests are reviewed and approved by the purchasing agent in accordance with DABC policy 08-02.

Finding 4: Inadequate Internal Controls Over Financial Statement Presentation

DABC 2017 ANNUAL REPORT

We reviewed the DABC 2017 Annual Report as posted on abc.utah.gov/about/annual.report.html and noted the following:

- a. The Total Operating Expenses and Net Operating Income lines on the 2017 Annual Report - Statement of Operations did not sum correctly:

Financial Statement Line – Statement of Operations	Correct Amount for the FY 2016 Column	Reported Amount for the FY 2016 Column
Total Operating Expenses	\$41,592,742	\$39,708,532
Net Operating Income	\$148,737,718	\$151,529,187

Column totals must be summed correctly for accurate financial statement presentation.

- b. We compared the fiscal year 2016 amounts as reported in the DABC 2017 Annual Report to the fiscal year 2016 amounts as reported in the DABC 2016 Annual Report and noted the following inconsistencies:

Financial Statement Line – Statement of Operations	2017 Annual Report FY 2016 Column	2016 Annual Report FY 2016 Column	Difference Over/(Under)
Retail Sales	\$404,987,894	\$404,939,933	\$47,961
Total Sales	\$405,959,345	\$405,911,384	\$47,961
Total Cost of Goods Sold	\$219,226,587	\$219,178,840	\$47,747
Gross Profit	\$186,732,758	\$186,732,544	\$214
Misc. Other Income	\$38,543	\$341,837	(\$303,294)
Total Revenue	\$190,027,380	\$190,330,460	(\$303,294)
Rentals and Leases	\$1,067,488	\$4,162,037	(\$3,094,549)
Total Operating Expenses	\$38,498,193	\$41,592,742	(\$3,094,549)

Amounts listed in the prior year column of a financial statement must be consistent with the amounts reported in the prior year statements. If these amounts differ, the reasons should be disclosed in the corresponding Notes to the Financial Statements.

- c. The Notes to Financial Statements presented in the 2017 Annual Report were not updated to reflect fiscal year 2017 financial information. Instead the notes appear to be an exact copy of the Notes to the Financial Statements presented in the 2016 Annual Report.

The Notes to the Financial Statements are intended to give the reader more detail than what is presented on the face of the financial statements. Therefore, the Notes must contain the correct data for the fiscal year being presented.

- d. The format of the financial section is confusing to the reader and should be simplified using the following considerations:

Statement of Operations:

- 1) Consider retitling statement to Income Statement or Statement of Revenues, Expenses, and Changes in Net Position since these are the terms generally used to describe this type of financial statement.
- 2) Statements should be presented as of the end of the fiscal year (June 30) as this is the end of the State’s fiscal year.
- 3) Cost of Goods Sold is not generally broken out on the Income Statement and was not broken out in the DABC 2016 Annual Report. Combining Cost of Goods makes the statement easier to read and understand.
- 4) Consider presenting only the total amount for Operating Expenses on the Income Statement and include a supplementary statement of the individual operating expenses.

Balance Sheet:

- 1) Statements should be presented as of the end of the fiscal year (June 30) as this is the end of the State’s fiscal year.

- 2) Other alcohol control states generally report the money held in funds by the state for Alcoholic Beverage Control under “Cash”. To improve transparency we recommend the DABC do report a balance for cash.
- 3) Accounts Payable-Liquor on the 2016 column of the FY2017 Annual Report - Balance Sheet shows a negative balance. This number should be re-examined as there should not be a negative balance for this account.

Because the DABC 2017 Annual Report is published on its website and provided to the Legislature, the financial information presented should be accurate and easy for the reader to interpret and understand.

MONTHLY ABC COMMISSION FINANCIAL REPORT

During our review of the December 31, 2017 ABC Commission Financial Report, we noticed that the accounts receivable amount was overstated by approximately \$3.5 million. This error occurred because DABC mistakenly includes the following items in its accounts receivable.

- a. DABC erroneously included \$818,835 of store receivables as accounts receivable. Store receivables should not be recorded as accounts receivable since the stores are part of DABC and the store receivables are not collectable. This error was the result of AX automatically recording receivables for stores when there is not an actual receivable to be recorded.
- b. DABC erroneously included \$2,565,636 in restricted cash for the Parents Empowered program as accounts receivable. These monies are appropriated to DABC on an annual basis and can be spent throughout the fiscal year. Furthermore, there is an offsetting transfer of (\$1,271,750) included in the accounts receivable reported amount. However, during the fiscal year, the accounts receivable balance is overstated since this amount is not an actual receivable, but rather, is a transfer between DABC’s funds.
- c. DABC erroneously included beginning inventory given to a Package Agency (PA) (mostly type 3) when they first open as accounts receivable. Since the PA is unable to afford inventory, DABC gives them \$50,000 in consignment inventory. When the PA closes, they are required to return inventory equaling \$50,000 to DABC. If the PA does not have inventory equaling this amount, they are required to pay DABC the difference.

Recommendation:

We recommend DABC:

- **ensure the financial information presented in its annual report is accurate and presented appropriately,**
- **meet with State Finance to determine how to present its monthly Accounts Receivable and Inventories on the ABC Commission Report,**
- **ensure the financial information in its monthly ABC Commission Report is presented appropriately.**

Finding 5: Inadequate Separation of Duties Over Monthly Bank Reconciliation

We reviewed the separation of cash receipting and cash disbursing duties (including the reconciliation of the bank activity to the general ledger) at DABC's Administrative Office. One employee, a Financial Analyst I, records receipt of licensee revenue in the general ledger and performs the bank reconciliation. DABC currently does not have an independent detailed review of the bank reconciliation. Inadequate separation of duties exists when the same individual has custody of assets, records transactions in the accounting records, and/or reconciles the general ledger to the bank statement and might allow misappropriation, errors, and/or fraud to occur without detection.

Recommendation:

If cash receipting and bank reconciliation duties cannot be separated, we recommend DABC establish an independent detailed review of the bank reconciliation ensuring that the review includes agreeing the balance on the reconciliation directly to the general ledger.

Part 2— IT General Controls

Finding 6: Insufficient Review of the AX User Privileges

DABC does not have a process to regularly review the AX users for appropriate access to the application. These business process owners should periodically review these users' privileges to ensure that all application access is necessary and appropriate. Without this review, the risk of unauthorized/inappropriate application activity is increased.

Recommendation:

We recommend DABC establish a process to regularly review AX user privileges semi-annually to ensure that all application access is necessary and appropriate.

Finding 7: Improper Access Privileges Granted to AX Users

DABC has granted the "SysAdminNoDEV" role to nearly 50 AX users. This is an administrative role with no development capabilities. While this role does not grant access to the AX Application Object Tree (AOT) or the source code, it provides access to all other modules and transactions within AX. Application users should be granted the least privilege required for them to complete their particular jobs and maintain proper separation of duties. Although DABC is in the process of reviewing and limiting user access and identifying incompatible activities and

transactions, this process has not been completed. By granting users more application access than necessary, the risk of inappropriate application activity is increased.

Recommendation:

We recommend DABC grant the AX users the least privilege required for them to complete their required duties and maintain proper separation of duties.

Finding 8: Inadequate Review and Monitoring of AX User Activity

DABC does not actively monitor and review sensitive user activity within AX. While some user activity is logged by the application, these logs are not regularly reviewed for unauthorized user activity. An effective activity review control would help ensure that sensitive user activity is authorized and appropriate. Without this control, the risk of inappropriate application activity occurring without detection is increased.

Recommendation:

We recommend DABC implement a user activity review control to help ensure that sensitive user activity within AX is authorized and appropriate.

Department of Alcoholic Beverage Control's Response to Findings and Recommendations



GARY R. HERBERT
Governor

SPENCER J. COX
Lieutenant Governor

State of Utah

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

1625 South 900 West
P.O. Box 30408
Salt Lake City, Utah 84130-0408
(801) 977-6800 Telephone
(801) 977-6888 FAX
abc.utah.gov

John Dougall,
State Auditor
Office of the Utah State Auditor
315 House Building State Capitol Complex
Salt Lake City, UT 84115

Auditor Dougall:

Thank you for the opportunity to respond to the State Auditor's report - "Special Financial Audit for Procedures Performed during the Fiscal Year 2018." The department appreciates the audit team's efforts in conducting this audit.

Finding 1

We agree that the department should reconcile AX with the State's FINET system on a monthly basis. The department fully recognizes that the recommendation to reconcile monthly vital to the internal controls and accuracy of financial reports.

We acknowledge that DABC's efforts at reconciling AX to FINET on a monthly basis have not been conducted in a consistently timely manner. DABC has been working diligently to resolve discrepancies in a timelier manner, and are continuing to incorporate in formal procedures, lessons learned to guide our efforts in this area.

Further, DABC hired time limited staff to relieve workload, and has a contract in place for a consultant to provide DABC Finance staff with additional training and knowledge on more technical aspects of AX.

Finding 2

The DABC is committed to ensuring that retail prices are correct. We appreciate the diligent work conducted by the auditors in identifying seven (7) items that were priced incorrectly.

Retail pricing is data entry intensive, especially in light of the dynamic environment in which it takes place. In a given month, the DABC must accurately price new items, discontinued items, items going on and off special price allowances, and special orders, while ensuring that these items are properly categorized to ensure that the proper mark ups are applied. In addition, the change in markup introduced

by for HB 442 required the DABC to change the price on over 25,000 items by July 1, 2017.

Our research indicates that these items were incorrectly priced because of data entry errors. To ensure price accuracy, DABC's Department of Technology Services staff have created the following:

- a) a computer audit that flags items that have an incorrect markup percentage;
- b) a new price change module that applies the correct formula to help us ensure pricing is correct when entering new items and price changes; and
- c) a new item creation program within the internal facing Vendor Portal (currently in test) that significantly reduces the possible entry points available to create a new item, and requires review and approval by a different purchasing agent from the one who set up the item prior to the product being recorded in AX. The department anticipates program go live by April 29th.

We also note that the majority of the seven mis-priced items were special orders. The department has identified those who placed the orders and are in the process of refunding their overpayment.

Finding 3

DABC will review and update all liquor purchasing policies.

Finding 4

DABC will ensure adequate explanatory notes for changes made to prior year financial statements are included in the future. In addition, DABC Finance is working with State Finance to more properly categorize items currently in accounts receivable.

Finding 5

We agree and have taken steps to improve internal controls over cash receipts and monthly bank reconciliation.

Finding 6

We agree with the finding and recommendation. We will establish a process by June 1, 2018 for use by all Business Process Owners in reviewing each user's security permissions on a semi-annual basis.

Finding 7

We agree with the finding and recommendation. As the auditors note, the DABC is currently in the process of addressing this issue. The DABC in collaboration with DTS will continue to take a methodical approach to security implementation.

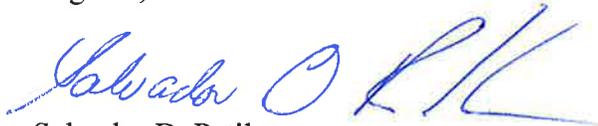
Security configuration and development efforts which we anticipate will be completed by October 1, 2018 include:

- a) The creation of new roles, including transaction-level duties and privileges, using copies of out-of-the-box security roles which are then customized to meet the agency's needs with Create, Read, Update, or Delete capabilities.
- b) The development of new roles, duties, or privileges may be required in cases of custom development. For any action related to custom development functionality, there will not exist an out-of-the-box security role for use as a baseline.
- c) A tool within the System administration module in AX called, "Security entry point permissions," will also be used as we continue to review each user individually after a role has been assigned to them - in order to ensure detail by user pertains to any separation of duties requirements that exist.

Finding 8

We agree with the finding and recommendation. DABC, with input from DTS, has a contract in place with a consultant to assist in the development of a user activity review control that will not compromise system performance.

Regards,



Salvador D. Petilos
Dept. of Alcoholic Beverage Control