AUDIT SUMMARY

Our audit of the Department of Alcoholic Beverage Control for the year ended June 30, 1999, found:

- the financial statements are presented fairly, in all material respects;

- two internal control matters that we consider reportable conditions; however, we do not consider any of these to be material weaknesses; and

- no instances of noncompliance that are required to be reported.

The Board needs to review its methodology and processes for software acquisitions. Our report describes several issues that arose during the implementation of ABC's new Product Distribution System (PDS). Many of these issues appear to have originated with inadequate planning and development of the systems requirements. Additionally, during the contract awarding process, staff did not identify significant issues such as training and licensing, which should have affected the terms of the final contract. While ABC complied with the legal requirements for procurement, the process failed to identify and react to significant long-term system management issues. In addition to addressing the specific PDS implementation issues, management should use this acquisition to re-examine its software acquisition methodology and processes.

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September 29, 1999

The Honorable James S. Gilmore, III
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Richard J. Holland
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have audited the accounts and records of the **Department of Alcoholic Beverage Control** (the Department) as of and for the year ended June 30, 1999, and submit our complete reports on financial statements and compliance and internal controls.

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the balance sheet of the Department of Alcoholic Beverage Control as of June 30, 1999, and the related statements of revenues, expenses, and retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Alcoholic Beverage Control as of June 30, 1999, and the results of its operations and cash flows for the year then ended, in conformity with generally accepted accounting principles.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit of the financial statements of the Department of Alcoholic Beverage Control as of and for the year ended June 30, 1999, we considered internal controls over financial reporting and tested compliance with certain provisions of laws, regulations, and contracts in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Governmental Auditing Standards.

Compliance

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the section entitled "Internal Control Findings and Recommendations."

We believe none of these reportable conditions are material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

The Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting is intended solely for the information and use of the Governor, General Assembly of Virginia, and management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

EXIT CONFERENCE

We discussed this report with management on October 1, 1999.

AUDITOR OF PUBLIC ACCOUNTS

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INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Review System Development and Acquisition Methodology

The Board needs to review its methodology and processes for software acquisitions. We have described below several issues that arose during the implementation of ABC's new Product Distribution System (PDS). Many of these issues appear to have originated with inadequate planning and development of the systems requirements. Additionally, during the contract awarding process, staff did not identify significant issues such as training and licensing, which should have affected the terms of the final contract. While ABC complied with the legal requirements for procurement, the process failed to identify and react to significant long-term system management issues. In addition to addressing the specific issues below, management should use this acquisition to re-examine its software acquisition methodology and processes.

Product Distribution System Implementation

ABC should resolve several system implementation and operational issues with its Product Distribution System (PDS). This system accumulates store inventory and sales information, and uses this data to calculate and record financial and forecasting information. In August 1998, ABC implemented PDS to replace the Inventory Management and Control System (IMAC). The original contracts for PDS involve multiple vendors and total approximately $8.2 million. Of this amount, $5.6 million is for system development and implementation, and $2.6 million is for a five-year service contract.

ABC made the final contract payment and accepted the system in June 1999. At that time, ABC still had operational issues to resolve with the vendor, but determined the issues were not significant enough to withhold final contract payment. We identified the following operational and system implementation issues with PDS that ABC needs to address. Management has already acted to address some of the issues and we have included this information below.

- ABC staff do not have a thorough understanding of how PDS processes information and cannot adequately explain the flow of data between other systems. The lack of understanding results from the vendor providing inadequate documentation and the staff receiving inadequate training. The primary vendor had to create system documentation when the sub-vendor would not release their proprietary system documentation. Therefore, the system documentation does not thoroughly document the system's technical design. To address these issues, ABC hired a consultant in August 1999 to explain the complex technical design, structures, and operating conditions and procedures of the PDS MasterPack module. The consultant will also validate and correct critical system data. ABC used an emergency procurement to get the consultant's services at an estimated cost of $51,000. In addition, staff had little experience with the PDS software language or the database package. Most staff did not receive training in these areas before the PDS implementation. The Department is currently training staff in the PDS software language and database application. We recommend management continue to train staff in the PDS applications.

- ABC has experienced various processing delays since PDS implementation. PDS users routinely experience delays that hinder their ability to efficiently complete their job responsibilities. In addition, the processing time for many routine jobs performed by the Information Systems division is excessive. For example, routine month end jobs each require between 4 and 24 hours to process, and the PDS forecasting report takes 32 hours to process. PDS does not include a restart process for jobs when interrupted during processing. The lack of a restart procedure has contributed to PDS processing delays. Another contributing factor is the increase in the volume of sales transactions. ABC did not anticipate the increase in sales volume during the system development. This increase has affected the system's processing capabilities. Management has addressed these issues by purchasing additional hardware and is evaluating other ways to process jobs.

- After ABC entered this contract, the sub-vendor decided not to make any additional enhancements to the Masterpack module of PDS. The primary vendor has assured management they will honor the current contract; however, it is unclear whether they will continue to support and maintain PDS after the current service contract expires in 2003. Management should discuss and develop alternatives to support and maintain PDS once the current contract expires.

- The PDS test plan did not include all critical processes and did not adequately assess the system's processing capabilities. In addition, ABC did not properly document the test plan results. ABC determined it was not feasible to conduct parallel testing of PDS with IMAC, or pilot test stores on PDS. Therefore, they developed a test plan that detailed their approach for PDS testing. Their test plan did not include a test to determine if inventory information from the stores would properly transfer to PDS. Also, the plan did not include a test of a critical system report that accounting uses to adjust inventory values in the financial system.

- Since system implementation, ABC staff have spent significant resources resolving PDS issues, and performing manual processes to verify and correct PDS data. ABC could have avoided some of these issues with a more detailed system requirement analysis and additional system testing. The Department formed a PDS Workgroup, which has met weekly since implementation to identify and resolve PDS issues. Some of these issues have resulted in modifications to PDS that were not part of the original contract. These modifications are estimated to cost an additional $1.4 million which includes $700,000 for store software licenses not identified in the original contract.

Overall, we recommend ABC continue to address and resolve issues from the PDS implementation. In addition, ABC should re-examine their system development and acquisition methodology for future system development and implementation projects. On future projects, ABC should ensure that system testing addresses all critical processes and reports. Management should set minimum standards for system test and documentation of results on future projects.

Complete Risk Assessment

ABC has not updated their risk assessment or documented security safeguards for its information systems. Commonwealth of Virginia Information Technology Resource Management Standard 95-1 (COV ITRM Standard 95-1) states that an agency should identify and document potential areas of risk to its information systems and document logical and physical security measures over the systems. The standard requires "that good management practices be followed to implement information technology security safeguards based on the risk assessment." The Department has complied with some of the requirements of Standard 95-1. The Department has an approved disaster recovery plan and has conducted a business impact analysis; however, the Department should update their risk analysis and document security safeguards to fully comply with Standard 95-1.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
BALANCE SHEET
As of June 30, 1999

ASSETS	
Current assets:	
Cash with the Treasurer of Virginia (Note 3)	$ 204,805
Petty cash	130,000
Accounts receivable	1,880,890
Alcohol inventory	22,365,963
Lottery ticket inventory	542,017
Prepaid insurance	912,340
Investments held by Treasurer of Virginia	21,107
Total current assets	26,057,122
Fixed assets (Net of accumulated depreciation) (Note 4)	18,490,450
Total assets	$44,547,572
LIABILITIES AND EQUITY	
Current liabilities:	
Accounts payable	$11,123,243
Deferred revenue	225,376
Compensated absences payable - current portion	20,272
Due to the Commonwealth (Note 6)	27,628,372
Obligations under Securities Lending (Note 7)	21,107
Total current liabilities	39,018,370
Long-term liabilities:	
Compensated absences payable	4,703,788
Total liabilities	43,722,158
Equity:	
Contributed capital	1,600,000
Retained earnings (deficit) (Note 2)	(774,586)
Total equity	825,414
Total liabilities and equity	$44,547,572

The accompanying Notes to Financial Statements are an integral part of this statement.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN RETAINED EARNINGS
For the Year Ended June 30, 1999

Operating revenues:	
Sales of alcohol	$ 271,345,838
Sales of lottery tickets	6,654,342
License and permit fees	7,337,169
Wine wholesalers tax	2,467,472
Penalties	946,929
Federal grants and contracts	453,402
Mixed beverage tax on common carriers	73,246
Income from Securities Lending Transactions	34,227
Miscellaneous	151,712
Total operating revenues	289,464,337
Operating expenses:	
Cost of sales of alcohol	177,571,230
Cost of sales of lottery tickets	6,299,022
Personal services	43,693,426
Continuous charges	9,614,894
Contractual services	7,377,508
Supplies and materials	1,159,801
Depreciation	2,570,024
Expendable equipment	805,972
Expenses for Securities Lending Transactions	32,687
Other	1,228,472
Total operating expenses	250,353,036
Operating income	39,111,301
Nonoperating revenues:	
Rents	20,520
Seized assets	97,599
Total nonoperating revenues	118,119
Net profit before transfers	39,229,420
Transfers out:	
Transfers of profits to the General Fund of the Commonwealth	(26,407,281)
Appropriation Act transfers	(12,647,941)
Total transfers	(39,055,222)
Net income after transfers	174,198
Retained Earnings (Deficit) - July 1, 1998	(948,784)
Retained Earnings (Deficit) - June 30, 1999 (Note 2)	$ (774,586)

The accompanying Notes to Financial Statements are an integral part of this statement.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 1999

Cash flows from operating activities:	
Sales of alcohol and lottery tickets	$ 278,210,153
Cash received from licenses and fees	7,018,633
Cash received from other revenue	4,012,940
Cash payments for cost of sales	(183,805,936)
Cash payments for personal services	(43,968,001)
Cash payments for other expenses	(20,153,253)
Net cash provided by operating activities	41,314,536
Cash flows from noncapital financing activities:	
Net proceeds on note payable	2,568,696
Cash received from taxes	83,052,031
Transfers of tax collections to the General Fund of the Commonwealth	(71,508,203)
Transfers of tax collections to the Department of Taxation	(11,910,586)
Transfers of profit to the General Fund of the Commonwealth	(25,542,430)
Appropriation Act transfers	(12,647,941)
Net cash used for noncapital financing activities	(35,988,433)
Cash flows from capital financing activities:	
Acquisition of equipment	(5,228,991)
Net increase in cash and cash equivalents	97,112
Cash and cash equivalents - July 1, 1998	237,693
Cash and cash equivalents - June 30, 1999	$ 334,805
Reconciliation of net profit to net cash provided by operating activities	
Net profit before transfer	$ 39,229,420
Adjustments to reconcile net profit to net cash provided by operating activities:	
Depreciation	2,570,024
Change in assets and liabilities:	
Increase in accounts receivable	(22,194)
Decrease in inventory	265,680
Decrease in compensated absences	(274,575)
Decrease in accounts payable	(201,364)
Decrease in deferred revenue	(318,536)
Decrease in prepaid items	66,081
Net cash provided by operating activities	$ 41,314,536

The accompanying Notes to Financial Statements are an integral part of this statement.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 1999

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Department of Alcoholic Beverage Control administers ABC laws with an emphasis on public service and a focus on public safety by ensuring a safe, orderly, and regulated system for convenient distribution and responsible consumption of alcoholic beverages while generating a reasonable profit for the Commonwealth and its localities.

A separate report is prepared for the Commonwealth of Virginia which includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The Department is a component unit of the Commonwealth of Virginia and is included in the general-purpose financial statements of the Commonwealth.

B. Fund Accounting

The activities of the Department are accounted for in an enterprise fund. The enterprise fund is used to account for operations that are financed and operated in a manner similar to private business enterprises where the intent of the governing body is that the costs of providing goods and services to the general public on a continuing basis, including depreciation, be financed or recovered primarily through user charges.

C. Basis of Accounting

The Department's records are maintained on the accrual basis whereby revenues are recognized when earned and expenses are recognized when the liability is incurred.

D. Inventories

Merchandise inventory, purchased for resale, is valued at average cost, which is lower than market value.

E. Compensated Absences

Compensated absences reflected in the balance sheet represent the amounts of vacation, sick, and compensatory leave earned by employees of the Department, but not taken at June 30, 1999. The amount reflects all earned vacation, sick, and compensatory leave payable under the Commonwealth of Virginia's leave payout policies. Information on the Commonwealth's leave payout policies is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

2. DEFICIT RETAINED EARNINGS

The Department ended the year with a deficit retained earnings of $774,586. This is attributable to the difference between the statutory method of calculating transfers to the Commonwealth prior to 1994 and calculating net profit.

3. CASH WITH THE TREASURER OF VIRGINIA

All state funds of the Department are held by the Treasurer of Virginia, pursuant to Section 2.1.177, et. seq., Code of Virginia, who is responsible for the collection, disbursement, custody, and investment of state funds. Each fund's equity in pooled state funds is reported as "Cash with the Treasurer of Virginia" on the balance sheet and is not categorized as to credit risk.

4. FIXED ASSETS

The schedule below shows the breakdown of fixed assets by category at June 30, 1999.

	Total Fixed Assets	Accumulated Depreciation	Net Fixed Assets
Land	$ 1,586,806	$ -	$ 1,586,806
Buildings	9,239,982	8,207,246	1,032,736
Equipment	26,693,855	10,822,947	15,870,908
Total	$ 37,520,643	$ 19,030,193	$ 18,490,450

The following schedule presents the changes in Fixed Assets by category.

	Balance at June 30, 1998	Acquired	Deleted	Balance at June 30, 1999
Land	$ 1,586,806	$ -	$ -	$ 1,586,806
Buildings	9,239,982	-	-	9,239,982
Equipment	22,210,059	5,228,991	(745,195)	26,693,855
Total	$ 33,036,847	$ 5,228,991	$ (745,195)	$ 37,520,643

Property, plant, and equipment are stated at cost and at the time of acquisition are set up in a comprehensive fixed asset system. Depreciation of the cost of property, plant, and equipment is provided on a straight-line basis over their estimated lives of from ten to thirty years on buildings and from four to eight years on equipment.

5. LEASE COMMITMENTS

The Department is committed under various operating lease agreements for store buildings. Rent expense under operating lease agreements amounted to $7,380,134 for the year. A summary of future obligations under lease agreements as of June 30, 1999, follows.

2000	$ 5,550,081
2001	4,415,256
2002	2,821,397
2003	1,514,247
2004	658,065
Later years	299,751
Total obligations	$15,258,797

6. DUE TO THE COMMONWEALTH

A. Note Payable

The Department has a line of credit for $25,000,000 with the Treasurer of Virginia. Repayment is made from revenue collections pursuant to Title 4.1, Chapter 1 of the Code of Virginia. As of June 30, 1999, the Department had outstanding $23,719,471 of its available line of credit to extinguish a cash overdraft.

B. General Fund

The Department collects certain taxes on behalf of the General Fund of the Commonwealth. The state tax on sales is collected from store sales and is paid quarterly to the General Fund of the Commonwealth. The liter tax is collected on wholesalers' direct wine shipments. Twelve percent of the liter tax is retained by the Department and reported as wine wholesalers' tax on the Department's financial statements. The remainder is paid to the General Fund of the Commonwealth quarterly. Of the liter tax paid to the General Fund, the Commonwealth subsequently transfers 50 percent to localities. Collections and transfers of state tax on sales and liter tax are not reported on the Statement of Revenues, Expenses, and Changes in Retained Earnings. Activity relating to the amounts due to the General Fund for the year ended June 30, 1999, is summarized below.

	State Tax On Sales	Liter Tax On Wine	Total
Balance due to the General Fund July 1, 1998	$ 574,655	$ 270,918	$ 845,573
Receipts for fiscal year	53,232,248	17,846,666	71,078,914
Transfers to the General Fund	(53,688,472)	(17,819,731)	(71,508,203)
Balance due to the General Fund June 30, 1999	$ 118,431	$ 297,853	$ 416,284

C. Department of Taxation - Sales Tax

The Department collects sales tax on all sales of alcohol and remits collections monthly to the Department of Taxation. Sales tax collections and transfers are not reported on the Statement of Revenues, Expenses, and Changes in Retained Earnings. Activity relating to the amounts due to the Department of Taxation for the year ended June 30, 1999, is summarized below.

Balance due to the Department of Taxation, July 1, 1998	$ 880,997
Sales tax collections	11,973,117
Transfers to the Department of Taxation	(11,910,586)
Balance due to the Department of Taxation, June 30, 1999	$ 943,528

D. Earned Surplus

The Appropriation Act, Chapter 924 of the 1998 Acts of Assembly, requires the Department to transfer an estimate of its fourth quarter profits in the month of June. In accordance with the Alcoholic Beverage Control Act, Section 4.1-116 of the Code of Virginia, the Department transfers any additional net profit to the General Fund of the Commonwealth 50 days after the last day of the quarter. The Department underestimated profit for the fourth quarter resulting in an additional $2,549,089 due to the General Fund at June 30, 1999.

7. SECURITIES LENDING TRANSACTIONS

Investments held by the Treasurer of Virginia represent the Department's allocated share of cash collateral received and reinvested and securities received for the State Treasury's securities lending program. Information related to the credit risk of these investments and the State Treasury's securities lending program is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

8. COLLECTIONS OF MALT BEVERAGE TAX

During the year ended June 30, 1999, the Department collected $39,945,570 in malt beverage taxes. These funds are deposited by the Department directly with the Treasurer of Virginia for credit to the General Fund of the Commonwealth and are not available to the Department to meet current operating needs and are not included in the financial statements.

9. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

The employees of the Department are employees of the Commonwealth. The employees participate in a defined benefit plan administered by the Virginia Retirement System (VRS). The VRS also administers life insurance and health related plans for retired employees. Information related to these plans is available on a statewide level only in the Commonwealth of Virginia's Comprehensive Annual Financial Report. The Commonwealth, not the Department, has overall responsibility for contributions to these plans.

10. SURETY BOND

The employees of the Department were covered by a Faithful Performance Duty Bond administered by the Commonwealth of Virginia's Department of General Services, Division of Risk Management with liability limits of $500,000 for each occurrence. Information relating to the Commonwealth's self-insurance plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
Richmond, Virginia

BOARD MEMBERS

Clarence W. Roberts, Chairman

Sandra C. Canada

Clater C. Mottinger