

**DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
RICHMOND, VIRGINIA**

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2000**

***AUDITOR OF
PUBLIC
ACCOUNTS***



COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Department of Alcoholic Beverage Control for the year ended June 30, 2000, found:

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

As reported in our last audit, Department staff do not have a good understanding of the processes and software controls within its Production Distribution System (PDS). In addition, continued vendor support for a critical module of PDS remains uncertain. Department management has decided to replace PDS with an in-house developed and maintained Management of Inventory and Product Sales (MIPS) system. While developing MIPS, staff should learn, as much as feasible about the PDS processes and controls. The Department also needs to use strong project management techniques for its MIPS project. These techniques should include defining requirements, evaluating alternative solutions, scheduling, testing, documenting, user approval tests, training and any other techniques that will control the project.

We have also reported that ABC needs to strengthen its computer operating system security and that it needs to follow its employee termination procedures.

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September 29, 2000

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

The Honorable Vincent F. Callahan, Jr.
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, 2000, 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, 2000, 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, 2000, 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, 2000, 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, entitled "Strengthen Project Management for Replacement of the Product Distribution System," "Strengthen Operating System Security," and "Follow Computer Access Deletion Procedures" 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.

Status of Prior Findings

The Department is continuing to address the issues from the previously reported finding "Review Systems Development and Acquisition Methodology." This prior finding is incorporated into this audit's reportable condition entitled "Strengthen Project Management for Replacement of the Product Distribution System," which is included in the section entitled "Internal Control Findings and Recommendations." The Department has taken adequate corrective action with respect to audit findings reported in the prior year that are not reported in this report.

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 4, 2000.

AUDITOR OF PUBLIC ACCOUNTS

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INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Strengthen Project Management for Replacement of the Product Distribution System

The Department continues to face difficulties with its Product Distribution System (PDS). The Department implemented PDS in August 1998 at a cost of over \$8 million. The system, developed by third party software vendors, requires \$55,000 of monthly support fees. PDS accumulates store inventory and sales information, and uses this data to calculate and record financial and forecasting information. In our last audit, we identified several implementation and operational issues that the Department needed to address. These included Department staff not having a thorough understanding of PDS processes or the program logic used by the software developer to accomplish these processes.

During this audit, we found that the Department staff still does not have a good understanding of PDS processes. For example, Department staff cannot adequately explain the data flow or what process controls, if any, the software includes. Most of the problems with the system originate from the lack of a detailed systems requirement phase during the initial acquisition of the system. Also, as previously reported, the vendor support contract for Masterpack, a critical PDS module, expires in 2003. It is unclear if this contract will be renewable, as the software vendor no longer sells this product. The Department is concerned that a shutdown of critical services could occur if Masterpack becomes unsupportable.

Management has decided the best way to address the deficiencies in PDS is to replace the system. This spring, the Department started the Management of Inventory and Product Sales (MIPS) project to replace PDS. The Department estimates the MIPS project will cost \$5 million with implementation completed by the third quarter of 2002. For the following reasons, the Department has decided to internally develop MIPS as opposed to procuring another system from an outside vendor.

- The timeframe to replace Masterpack is short due to the vendor support issue. A Request For Proposal (RFP) could well use up one year of lead-time. In addition, the Department had only two qualified vendors reply to their RFP that resulted with PDS as the solution.
- Cost for a turnkey system, if the Department could find one, would be approximately \$8 million based on prior experience.
- The Department hopes to develop and maintain the new system with well-known products such as Oracle and standard languages (PDS uses a little known database and programming language). This will allow the Department to hire systems personnel for development and maintenance from a much larger labor pool.

Concurrent with the MIPS project, the Department is planning another project to replace the current Point of Sale System (POS). This system, which has antiquated MS-DOS-based cash registers in all stores, feeds daily sales information to the inventory and financial systems. The Department will attempt to find a third-party vendor for a turnkey replacement of its POS. The Departments plans to have the POS replacement implemented in 2002, but has yet to determine the total cost of this replacement.

Recommendation

Due to the past deficiencies in Systems Project Development, we recommend that staff learn, as much as feasible, about the processes of the PDS system. This knowledge will aid in the interim business decisions management must make before a new system becomes available and it will provide insights on what

processes the new system will need to perform. The project development effort should include as many potential system users as possible from the project's inception to help ensure the project addresses all users' needs and all users understand how the system operates.

Management needs to use strong project management techniques with the MIPS development to ensure the success of this system. These techniques should include at a minimum defining requirements, evaluating alternative solutions, scheduling, testing, documenting, user approval tests, and training. We also recommend that Management review systems in other control states and private industry as a resource when developing the new inventory control system. These entities are not competitors and the Department can potentially use them as models of what works and what does not work. It may also be useful to confirm with these entities whether a turnkey solution is available.

Strengthen Operating System Security

We found several weaknesses in the Department's Unix password and file permission schemes that could lead to unauthorized access and/or corruption of data files and programs. Specifically, we found several directories that have inappropriate privileges, as well as user accounts without passwords. Also, the Department has not adequately protected passwords in a separate file.

The Department uses client-server architecture for its inventory and financial accounting systems. The Product Distribution System (PDS) and the Performance Financial Management System (FMS) applications are both housed on Hewlett Packard servers. The underlying operating system for these servers is Unix. Security of any computer system is comprised of two layers. The application layer generally provides control, via menu options or screen presentations, of what users can do within a program. The operating system layer security generally provides controls of who can access the system, delete files, and add files. To have strong Unix operating system security, strong password and strong file permission schemes must be in place.

We recommend that the Department review the Unix configuration on the above-mentioned servers to insure that they comply with standard Unix security procedures. This will help to ensure the integrity of the information maintained on these servers.

Follow Computer Access Deletion Procedures

We found the Department did not follow their procedures to delete computer access for terminated employees. For four of ten employees who terminated employment in June 2000, the Department either did not document the date of computer access removal or had removal dates that were weeks past the termination date. In addition, we found three high level employees who had terminated employment during the year, but still had active accounts at the operating system level.

Strong computer access security requires the immediate removal of terminated employees from any system on their termination date. A systematic procedure to record and perform access removal is important. Failure to do so may allow unauthorized access to critical systems. We recommend the Department enforce its procedures so that timely removal all terminated employees occurs.

FINANCIAL STATEMENTS

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
BALANCE SHEET
As of June 30, 2000

ASSETS

Current assets:	
Cash (Note 2)	\$ 32,175
Petty cash	130,000
Receivables	2,287,462
Inventory-alcohol	24,371,025
Inventory-lottery tickets	511,993
Prepaid insurance	919,743
Investments held by Treasurer of Virginia	<u>23,942</u>
Total current assets	28,276,340
Long term assets:	
Fixed assets (Net of accumulated depreciation) (Note 3)	<u>14,538,103</u>
Total assets	<u><u>\$ 42,814,443</u></u>

LIABILITIES AND FUND EQUITY

Current liabilities:	
Accounts payable	\$ 13,164,573
Deferred revenue	194,060
Due to Commonwealth of Virginia (Note 4)	23,619,562
Obligations under Securities Lending (Note 7)	23,942
Compensated absences payable	<u>51,999</u>
Total current liabilities	37,054,136
Long term liabilities:	
Compensated absences payable	<u>4,931,331</u>
Total liabilities	<u>41,985,467</u>
Fund equity:	
Contributed capital	1,600,000
Retained earnings (Note 5)	<u>(771,024)</u>
Total equity	<u>828,976</u>
Total liabilities and fund equity	<u><u>\$ 42,814,443</u></u>

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, 2000

Operating revenues:	
Sales of alcohol	\$ 296,843,251
Sales of lottery tickets	6,909,288
License and permit fees	7,088,819
Wine wholesalers tax	2,670,498
Penalties	1,002,882
Federal grants and contracts	1,037,840
Mixed beverage tax on common carriers	74,853
Income from Securities Lending Transactions	59,100
Miscellaneous	207,546
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Net operating revenues	315,894,077
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Operating expenses:	
Cost of sales of alcohol	194,190,059
Cost of sales of lottery tickets	6,685,870
Personal services	47,469,547
Continuous charges	9,902,389
Contractual charges	8,586,644
Supplies and materials	1,336,596
Depreciation	4,854,450
Expendable equipment	1,315,883
Expenses for Securities Lending Transactions	59,100
Other	693,261
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Total operating expenses	275,093,799
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Operating income	40,800,278
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Nonoperating revenues:	
Rents	20,520
Seized assets	39,120
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Total nonoperating revenues	59,640
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Net profit before transfers	40,859,918
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Transfers out:	
Transfers of profits to the General Fund of the Commonwealth	(28,058,853)
Appropriation Act transfers	(12,797,503)
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Total transfers	(40,856,356)
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Net income after transfers	3,562
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Retained Earnings (deficit) - July 1, 1999	(774,586)
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Retained Earnings (deficit) - June 30, 2000 (Note 5)	\$ (771,024)
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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, 2000

Cash flows from operating activities:	
Cash received from sales	\$ 303,637,466
Cash received from licenses and fees	7,057,502
Cash received from other revenue	4,820,861
Cash payments for cost of sales	(200,777,908)
Cash payments for personal services	(47,242,004)
Cash payments for other expenses	<u>(21,901,277)</u>
Net cash provided by operating activities	<u>45,594,640</u>
Cash flows from noncapital financing activities:	
Net proceeds, notes payable, and other adjustments	(2,037,163)
Cash received from taxes	90,387,677
Transfers of tax collections to the General Fund of the commonwealth	(77,338,172)
Transfers of tax collections to the Department of Taxation	(12,833,816)
Transfers of profit to the General Fund of the Commonwealth	(30,146,320)
Appropriation Act transfers	<u>(12,797,503)</u>
Net cash used for noncapital financing activities	<u>(44,765,297)</u>
Cash flows from capital financing activities:	
Acquisition of equipment	<u>(1,001,973)</u>
Net decrease in cash and cash equivalents	(172,630)
Cash and cash equivalents - July 1, 1999	<u>334,805</u>
Cash and cash equivalents - June 30, 2000	<u><u>\$ 162,175</u></u>
Reconciliation of net profit to net cash provided by operating activities:	
Net profit before transfer	40,859,918
Adjustments to reconcile net profit to net cash provided by operating activities:	
Depreciation	4,854,450
Change in assets and liabilities:	
Increase in accounts receivable	(406,571)
Increase in inventory	(1,975,037)
Increase in compensated absences	227,543
Increase in accounts payable	2,073,057
Increase in prepaid items	(7,404)
Decrease in deferred revenue	<u>(31,316)</u>
Net cash provided by operating activities	<u><u>\$ 45,594,640</u></u>

The accompanying notes to financial statements are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 2000

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, 2000. 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. 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" on the balance sheet and is not categorized as to credit risk.

3. FIXED ASSETS

The schedule below shows the breakdown of fixed assets by category at June 30, 2000.

	<u>Total Fixed Assets</u>	<u>Accumulated Depreciation</u>	<u>Net Fixed Assets</u>
Land	\$ 1,577,406	\$ -	\$ 1,577,406
Buildings	9,216,382	8,331,125	885,257
Equipment	<u>24,371,222</u>	<u>12,295,782</u>	<u>12,075,440</u>
Total	<u>\$35,165,010</u>	<u>\$20,626,907</u>	<u>\$14,538,103</u>

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

	<u>Balance at June 30, 1999</u>	<u>Acquired</u>	<u>Deleted</u>	<u>Balance at June 30, 2000</u>
Land	\$ 1,586,806	\$ -	\$ (9,400)	\$ 1,577,406
Buildings	9,239,982	-	(23,600)	9,216,382
Equipment	<u>26,693,855</u>	<u>1,001,973</u>	<u>(3,324,606)</u>	<u>24,371,222</u>
Total	<u>\$37,520,643</u>	<u>\$1,001,973</u>	<u>\$(3,357,606)</u>	<u>\$35,165,010</u>

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 three to eight years on equipment.

4. 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, 2000, the Department had outstanding \$21,582,438 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, 2000, is summarized below.

	<u>State Tax On Sales</u>	<u>Liter Tax On Wine</u>	<u>Total</u>
Balance due to the General Fund July 1, 1999	\$ 118,431	\$ 297,853	\$ 416,284
Receipts for fiscal year	58,316,888	19,108,558	77,425,446
Transfers to the General Fund	<u>(58,359,313)</u>	<u>(18,978,859)</u>	<u>(77,338,172)</u>
Balance due to the General Fund June 30, 2000	<u>\$ 76,006</u>	<u>\$ 427,552</u>	<u>\$ 503,558</u>

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, 2000, is summarized below.

Balance due to the Department of Taxation, July 1, 1999	\$ 943,528
Sales tax collections	12,962,232
Transfers to the Department of Taxation	<u>(12,833,816)</u>
Balance due to the Department of Taxation, June 30, 2000	<u>\$ 1,071,944</u>

D. Earned Surplus

The Appropriation Act, Chapter 935 of the 1999 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 \$461,622 due to the General Fund at June 30, 2000.

5. DEFICIT RETAINED EARNINGS

The Department ended the year with a deficit retained earnings of \$771,024. This is attributable to the difference between the statutory method of calculating transfers to the Commonwealth prior to 1994 and calculating net profit.

6. LEASE COMMITMENTS

The Department is committed under various operating lease agreements for store buildings. Rent expense under operating lease agreements amounted to \$7,748,967 for the year. A summary of future obligations under lease agreements as of June 30, 2000, follows.

2001	\$ 5,441,267
2002	3,832,473
2003	2,473,283
2004	1,508,545
2005	504,303
Later years	<u>169,423</u>
Total obligations	<u>\$13,929,294</u>

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, 2000, the Department collected \$40,746,268 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. RISK MANAGEMENT AND EMPLOYEE HEALTH CARE PLANS

The Department participates in two self-insurance plans maintained by the Commonwealth of Virginia. The state employee health care plan is administered by the Department of Human Resource Management (formerly the Department of Personnel and Training) and the risk management insurance plans are administered by the Department of General Services, Division of Risk Management. Risk management insurance includes worker's compensation, property, general (tort) liability, and automobile plans. Information relating to the Commonwealth's self-insurance plans is available at the statewide level in the Commonwealth's Comprehensive Annual Financial Report

11. 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.

12. CONTINGENT LIABILITIES

The Department is named as a party in several legal proceedings. It is not possible at the present time to estimate ultimate outcome or liability, if any, of the Department in respect to the various proceedings; however, it is believed that any ultimate liability resulting from these suits will not have a material, adverse effect on the financial condition of the Department.

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
Richmond, Virginia

BOARD MEMBERS

Clarence W. Roberts, Chairman

Sandra C. Canada

Clater C. Mottinger

