COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD
AUDIT REPORT
HARRISBURG, PENNSYLVANIA

STATE STORES FUND
LIQUOR LICENSE FUND
FOR THE FISCAL YEARS ENDED JUNE 30, 2010 AND 2009

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JACK WAGNER

AUDITOR GENERAL

BACKGROUND

INTRODUCTION

The PLCB is an entity of the Commonwealth of Pennsylvania authorized by law to regulate the sale and distribution of alcoholic beverages in the Commonwealth. Included within this authority is the authority to establish, operate and maintain Pennsylvania wine and spirits stores for the sale of liquor, including wine and spirits.

The mission of the PLCB is:

- To provide regulation over the beverage alcohol industry in Pennsylvania in a fair and consistent manner.
- To provide the best service to the PLCB's customers through modern, convenient outlets, superior product selection and competitive prices in a controlled environment.
- To provide factual information on alcohol and its effects through a comprehensive alcohol education program.

HISTORY

With the end of Prohibition in 1933, various laws regarding alcohol regulation were passed by the Pennsylvania General Assembly, including the Liquor Control Act and the Beverage License Law. These laws created the Pennsylvania Liquor Control Board ("Board"), an independent administrative board. The Board was given four major functions:

1. Establish a system of state-operated stores for the sale of wine, liquor and alcohol for off-premises consumption. Subsequently, the legislature has authorized the Board to buy and sell other items, such as corkscrews, liquor and wine accessories, trade publications, gift cards/certificates, wine- or liquor-scented candles, and wine glasses. [47 P.S. §§ 2-207(a), 305].

2. License establishments wishing to sell alcoholic beverages for on-premises consumption, for the manufacture and/or transfer of alcoholic beverages and for the wholesale and retail sale of malt or brewed beverages.

3. Develop regulations in order to carry out its functions.

4. Enforce all state laws and regulations involving the sale of alcohol. In 1987, enforcement responsibilities were transferred to the Pennsylvania State Police, Bureau of Liquor Control Enforcement ("BLCE").

Currently, the duties of the Board include:

- Purchase and sale of wines and spirits and accessories.
- Control of the manufacture, possession, sale, consumption, importation, use, storage, transportation and delivery of liquor, alcohol and malt or brewed beverages within the Commonwealth.
- Setting of wholesale and retail prices at which liquor and alcohol shall be sold in its stores.
- Determination of locations of its stores.
- Granting, issuance, of all licenses and permits authorized to be issued under the Liquor Code.
- Leasing, furnishing and equipping of building accommodations as required.
- Adoption, publication and dissemination of regulations necessary for the efficient administration of the Liquor Code.
- Establishment, operation and maintenance of its stores.
- Administration of a statewide alcohol education program.
- Appointments of personnel.
- First line of appeal in citation cases.
- Awarding money to various organizations, local government entities, and educational institutions in the form of grants.

RETAIL OPERATIONS

The PLCB operates approximately 650 Pennsylvania wine and spirits stores, generating approximately $1.9 billion USD in gross sales for Fiscal Year 2009-2010. As of March 31, 2011, the PLCB employs approximately 4,500 individuals. In Fiscal Year 2009-2010, the PLCB handled more than 15.5 million cases of product and sold more than 133 million bottles of wine and spirits.

Recently, an aggressive modernization plan has enabled the PLCB to be more customer-oriented and market-driven in its operations. The PLCB's position as one of the nation's largest purchasers of wine and spirits allows it to leverage its purchasing power and offer competitive prices on an ongoing basis.

KEY FACTS

- All tax moneys collected are transferred to the State Treasury. In fact, all revenues remaining, after payment of PLCB operating expenses and after required appropriations are made to other entities and Commonwealth agencies, are made available to be transferred to the General Fund.

- The PLCB is one of the largest purchasers of wine and spirits in the United States, and passes significant volume purchase discounts on to customers.
- The PLCB operates approximately 650 stores, which are leased from private landlords, infusing approximately $39 million dollars to Pennsylvania's economy.
- 100% of the required State and Local Sales Taxes are collected by the PLCB and reported to the Revenue Department.
- The state liquor tax of 18%, which is additional to the PLCB price, is included in the shelf price of each item.
- The PLCB outsources warehousing services for 3 distribution centers in Pennsylvania, which contributes more than $35.8 million dollars to Pennsylvania's economy.
- There are over 20,000 businesses in Pennsylvania which are licensed by the PLCB.
- The PLCB has an established formal bureau for alcohol education, which provides educational material to youth, legal consumers and beverage alcohol servers.
- The PLCB funds grants to colleges and universities, communities that host these institutions, municipalities, and their organizations such as law enforcement departments and non-profit organizations to develop and/or maintain environmental management prevention strategies and other proven prevention strategies to reduce dangerous and underage drinking.
- The Pennsylvania State Police, Bureau of Liquor Control Enforcement is responsible for the enforcement of all liquor laws. The PLCB fully funds this function out of operational revenues.
- The PLCB's policy of "zero tolerance" for sales to minors has resulted in store employees verifying the age of, and denying sales to, approximately one million individuals in Fiscal Year 2009-2010.

JACK WAGNER

AUDITOR GENERAL

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited the financial statements of the Pennsylvania Liquor Control Board (PLCB) - State Stores Fund and Liquor License Fund as of and for the fiscal years ended June 30, 2010 and 2009, including the Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Fund Net Assets; and Statement of Cash Flows for the State Stores Fund; and the Statement of Fiduciary Net Assets and Statement of Changes in Fiduciary Net Assets for the Liquor License Fund. These financial statements are the responsibility of PLCB's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the PLCB's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the PLCB's internal control over financial reporting. Accordingly, we express no such opinion. 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Pennsylvania Liquor Control Board and do not purport to, and do not, present fairly the financial position of the Commonwealth of Pennsylvania as of June 30, 2010 and 2009, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the PLCB-State Stores Fund and the Liquor License Fund as of June 30, 2010 and 2009, and the results of the State Stores Fund's operations and its cash flows for the fiscal year then ended, and the Liquor License Fund's changes in assets and liabilities for the fiscal year then ended, in conformity with accounting principles generally accepted in the United States of America.

PLCB Management's Discussion and Analysis on pages 7 through 13 is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the PLCB's financial statements. The Background Section is presented for purposes of additional analysis and is not a required part of the financial statements. The Background Section has not been subjected to the auditing procedures applied by us in the audit of the financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 18, 2011 on our consideration of the PLCB's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

April 18, 2011

JACK WAGNER
Auditor General

PLCB Management's Discussion and Analysis

Overview

The statutory authority for the Liquor Control Board is Act 21 of April 12, 1951, P.L. 90; as reenacted by Act 14 of June 29, 1987, P.L. 32. In conformance with the Pennsylvania Liquor Code, the Pennsylvania Liquor Control Board regulates the manufacture, possession, sale, consumption, importation, use, storage, transportation and delivery of liquor, alcohol and malt or brewed beverages in the Commonwealth. All package sales of wines and spirits in Pennsylvania, with the exception of wines sold by licensed Pennsylvania wineries, are made through the Wine and Spirits stores operated by the Liquor Control Board. These include both retail sales to individual consumers and wholesale sales to licensed establishments where wines and spirits are sold by the drink. While malt and brewed beverages are not sold through the system, the Board does regulate those sales through the licensing of the distributors, restaurants, hotels, and clubs, which sell those beverages.

The PLCB, an independent administrative board, is comprised of three members who are appointed by the Governor with the concurrence of two-thirds of the Senate to staggered four-year terms. The board is responsible for the management of the PLCB in the areas of directing the state-operated Wine and Spirit Stores and authorizing the licensing of establishments that manufacture or sell liquor and alcohol. While not mandated, the Board does provide for a comprehensive program of alcohol education aimed at promoting moderation and avoidance of abuse among legal consumers, and prevention of purchase and consumption by minors. The PLCB funds the operations of the Pennsylvania State Police, Bureau of Liquor Control Enforcement, which is responsible for enforcing the laws and regulations governing the trafficking of alcoholic beverages throughout the Commonwealth.

The PLCB is primarily responsible for the accounting and reporting of the Liquor License Fund and the State Stores Fund. The Liquor License Fund is an agency fund which serves as a pass-through account for fees for hotel, restaurant and club liquor and/or beer licenses. These fees are returned semi-annually to the municipalities in which the licenses are located, while interest earned on fund deposits is credited to the General Fund.

The State Stores Fund is an enterprise fund, which serves as the general operating fund for the Liquor Control Board. This fund receives revenues from the sale of goods through State Liquor Stores, fees not credited to the Liquor License Fund, fines and penalties for law violations by licensees, and losses and damages recovered. Expenditures cover all costs associated with the operation and administration of all PLCB functions as outlined and prescribed by the Pennsylvania Liquor Code. In addition, the fund also provides monies to the Pennsylvania State

Police for enforcement of the Liquor Code Law, the Department of Health for alcohol abuse programs, the Office of Auditor General for auditing services, and the Office of the Comptroller assigned to the PLCB. Annual profit transfers are made from this fund to the General Fund.

In 2010, the PLCB completed a major ERP (Enterprise Resource Planning) implementation. This implementation, called "Project Spirit", integrated most of the PLCB's data and business processes into a single integrated system. Part of that effort was converting to the Oracle E-Business Suite for its Accounting and Financial Reporting. Conversion to the Oracle E-Business Suite resulted in many improvements to financial reporting and enabled the PLCB to:

- Adopt Best Business Practices for Retail Accounting
- Adhere to Commonwealth Accounting Policies
- Conform to Generally Accepted Accounting Principles

Changes to the financial statements that began in fiscal year 08-09 are as follows:

- Converted from a 13 <u>period</u> fiscal year to a 12 <u>month</u> fiscal year
- Raised the fixed asset threshold from $1,000 to $5,000
- Converted inventory valuation from the uniform cost method to weighted average cost.

<u>Discussion of Basic Financial Statements</u>

The State Stores Fund and the Liquor License Fund is accounted for on a fiscal year basis, comprised of twelve (12) calendar months.

The accounts of the State Stores Fund are reported using the accrual basis of accounting. The accounts of the Liquor License Fund are reported using the accrual basis of accounting for recognizing assets and liabilities. The audited report consists of financial statements including the Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Fund Net Assets; and Statement of Cash Flows for the State Stores Fund for the fiscal years ended June 30, 2010 and 2009; and the Liquor License Fund Statement of Fiduciary Net Assets and the Statement of Changes in Fiduciary Net Assets for the fiscal years ended June 30, 2010 and 2009.

The Statement of Net Assets provides information about assets and liabilities and reflects the financial position at the fiscal year end. The Statement of Revenues, Expenses and Changes in Fund Net Assets reports the operating revenue activity and the expenses related to such activity for the fiscal year. The Statement of Cash Flows outlines the cash inflows and outflows relating to the operations for the fiscal year. The Statement of Fiduciary Net Assets provides information about assets and reflects the position of the Liquor License Fund at the fiscal year end. The Statement of Changes in Fiduciary Net Assets illustrates the net asset activities throughout the fiscal year for the Liquor License Fund. The financial statements also include footnotes that provide additional information that is essential to a full understanding of the data provided in the statements. These statements provide current and long-term information about the PLCB's financial position.

The financial statements present only the Pennsylvania Liquor Control Board and do not present the financial position of the Commonwealth of Pennsylvania. The following is a discussion on the current-year results of operations for the State Stores Fund.

Financial Highlights

- The PLCB remitted $506.4 million to underwrite the overall cost of Commonwealth government during fiscal year 2010. This is a decrease of 2.24% over the $518.0 million remitted in fiscal year 2009.
- Sales net of taxes increased by $19.7 million or 1.32% over the previous year to more than $1.511 billion.
- Operating Income as a percentage of Sales Net of Taxes decreased to 4.61 versus 6.99 in the previous year.
- PLCB operations earned profits (income before operating transfers) for the Commonwealth in fiscal year 2010 of $70.0 million, a decrease of 21.4% from the previous year.
- Net assets decreased by 117.3% or $56.2 million during the fiscal year to end at $(8.27) million.

Financial Analysis

Assets and Liabilities

- PLCB ended fiscal year 2010 with a total of $368.55 million in current assets including $304.55 million in merchandise inventory.

- Temporary Investments decreased by 59.5% from $111.8 million to $45.3 million.

- The Board's total investment in fixed assets is $96.1 million with accumulated depreciation of $43.8 million netting to $52.3 million invested in capital assets.

- In total, assets increased by 6.36% from $395.68 million in fiscal year 2009 to $420.85 million in fiscal year 2010.

- Return on Assets trended downward from 22.50 percent in fiscal year 2009 to 16.62 percent in fiscal year 2010, due to a greater increase in assets as compared to income.

- Total liabilities increased by $81.35 million from the previous year. Trade Accounts Payable increased by $40.7 million or 24.79% as a result of increasing certain vendor payment terms to net 45 days.

- A loan of $110 million from the General Fund supported the Board's working capital needs. The loan amount was not increased from the previous year of $110 million.

Revenues and Costs

The primary source of revenue for the PLCB is derived from the sale of goods within the approximately 650 wine and spirit stores including several newly deployed kiosks operated throughout the Commonwealth.

Sales (net of tax sales increased 1.32% over previous year)

Despite the general decline that occurred within the fiscal year in most sectors of the economy on a national and state basis, PLCB sustained its unbroken sales growth record since 1993-94, with a net sales increase of 1.32% resulting from operations within fiscal year 2009-10.

Over the past four fiscal years, this sales growth trend continued despite the closing of thirty two underperforming or duplicative stores within a general market area. These closings represented 5.2% of total stores with estimated annualized savings of over $7.1 million.

Sunday operation sales grew over 3.80% to over $71.1 million for fiscal year 2009-10. All Sunday operations provide a net return to the respective store while providing this additional level of service to our customers across the Commonwealth. One Stop Shoppes, or stores located in grocery stores, grew by over $2.2 million or 4.51% from the previous year.

Within the PLCB's customer base, retail sales* grew 4.32%, while licensee sales* decreased by 8.61%, as retail sales continue to represent over 77% of total stock sales. On a volume basis, wine gallonage continues to comprise nearly 62% of sales, while spirits continue to represent just over 38% of sales.
***(excludes SLO sales)**

Debit/credit card purchases represent 52.3% of total sales volume. Average sale per debit/credit card transaction was $36.99.

Cost of Goods Sold/Gross Margin

Cost of goods sold increased to 70.23% of sales net of taxes from 68.15% in the previous fiscal year. Gross margin decreased to 29.77% of sales net of taxes from 31.85% in the previous fiscal year. Gross margin declined in part due to a change in accounting in 2009 which reclassified certain freight and distribution expenses from operating expense to cost of sales.

Operating expenses (PLCB and Comptroller expenses)

1. Comptroller operating expenses decreased to 0.36% of Sales net of taxes from 0.44% in the previous year.

2. PLCB operating expenses including Comptroller expenses increased to 25.26% of Sales net of taxes from 24.92% in the previous year.

Non-operating revenues and expenses

Net non-operating revenues/expenses decreased by $15.47 million, changing from a net expense of $(15.24) million in FY08-09 to providing a slight net revenue of $233 thousand in FY09-10. This is primarily due to a change in the threshold used to classify capital assets, which produced an inflated $12.6 million write off in FY08-09 for the loss on disposition of fixed assets.

Operating Transfers Out

1. Pennsylvania State Police received $20.09 million, a decrease of $.09 million from the previous year, to fund the operations of their Bureau of Liquor Control Enforcement.

2. As directed by the Governor's Budget, $105 million was transferred to the General Fund, down from $125 million transferred in the previous year.

3. Department of Health received $1.05 million, a decrease of over $0.73 million from the previous year, towards drug and alcohol programs.

Overall Picture

A change in net assets of $56.2 million decreased Ending Net Assets to $(8.27) million, primarily as a result of the transfer to the General Fund of $105 million which exceeded the cash generated by the business during the current fiscal year.

PENNSYLVANIA LIQUOR CONTROL BOARD
STATE STORES FUND – JUNE 30, 2010
LIQUOR LICENSE FUND – JUNE 30, 2010

Ratio	Formula	Fiscal Year	Amounts	Results
Sales to Expense	Sales net of taxes/	Current	1,511/382	3.96 times
	Total Operating expenses	Prior	1,492/372	4.01 times
Contribution to the	Amount transferred/	Current	506/1,894	26.73%
Commonwealth of Pa./	Gross Sales	Prior	518/1,867	27.73%
as a % of Gross sales				
Return on Assets	Income before transfers/	Current	70/421	16.62%
	Total Assets	Prior	89/396	22.50%

PENNSYLVANIA LIQUOR CONTROL BOARD
STATE STORES FUND – JUNE 30, 2010
LIQUOR LICENSE FUND – JUNE 30, 2010

Condensed, comparative, financial statement information for the State Stores Fund is as follows (amounts in thousands):

	52 weeks Ended 30-Jun-10	53 weeks Ended 30-Jun-09	52 weeks ended 24-Jun-08	2010 Inc/-Dec %	2009 Inc/-Dec %
Description					
Current Assets	368,547	341,748	341,097	7.84%	0.19%
NonCurrent assets	52,307	53,933	48,386	-3.01%	11.46%
Total Assets	**420,854**	**395,681**	**389,483**	**6.36%**	**1.59%**
Current Liabilities	360,157	296,175	247,590	21.60%	19.62%
Noncurrent Liabilites	68,970	51,599	36,057	33.67%	43.10%
Total Liabilities	**429,127**	**347,774**	**283,647**	**23.39%**	**22.61%**
Total Net Assets	**-8,273**	**47,907**	**105,836**	**-117.27%**	**-54.73%**
Sales Net of Taxes	1,511,390	1,491,738	1,413,266	1.32%	5.55%
Less: Cost of Goods Sold	1,061,404	1,016,546	939,781	4.41%	8.17%
Gross profit from sales	449,986	475,192	473,485	-5.30%	0.36%
Less: Operating expenses	381,801	371,738	344,675	2.71%	7.85%
Operating profit from state stores	68,185	103,454	128,810	-34.09%	-19.68%
Other operating rev (exp)	1,537	817	1,994	88.13%	-59.03%
Total Operating income	69,722	104,271	130,804	-33.13%	-20.28%
Nonoperating rev (exp)	233	-15,241	-602	-101.53%	2431.73%
Income before operating transfers	69,955	89,030	130,202	21.43%	-31.62%
Operating transfers-net	126,135	146,959	100,200	-14.17%	46.67%
Change in Net Assets	**-56,180**	**-57,929**	**30,002**	**-3.02%**	**-293.08%**
Net Assets-Beginning	47,907	105,836	75,834	-54.73%	39.56%
Total Net Assets-Ending	-8,273	47,907	105,836	-117.27%	-54.73%

PENNSYLVANIA LIQUOR CONTROL BOARD
STATE STORES FUND
COMPARATIVE STATEMENT OF NET ASSETS
(EXPRESSED IN THOUSANDS)

ASSETS	**June 30, 2010**	**June 30, 2009**
Current assets:		
Cash	$ 11,085	$ 17,603
Temporary investments	45,270	111,797
Accounts and claims receivable, net	2,931	1,609
Due from other funds	13	68
Merchandise inventories	304,549	206,135
Operating supplies	269	239
Suspense items	-	2,431
Prepaid expenses	4,430	1,866
Total current assets	368,547	341,748
Noncurrent assets – Note D:		
Non-depreciable capital assets:		
Land	$ 323	$ 323
Depreciable capital assets:		
Building	19,598	19,598
Leasehold improvements	2,568	2,229
Machinery and equipment	27,095	28,377
Intangibles	46,521	36,532
Less: accumulated depreciation	(43,798)	(33,126)
Net depreciable capital assets	51,984	53,610
Total noncurrent capital assets	52,307	53,933
Total assets	$ 420,854	$ 395,681
LIABILITIES		
Current liabilities:		
Trade accounts payable	$ 204,703	$ 164,040
Security Lending Obligations	80	0
Miscellaneous accounts payable	22,651	1,822
Accrued expenses	18,496	13,135
Due to other funds-Note E	3,259	6,427
Due to fiduciary funds	367	236
Due to other governments	601	515
Advances from the General Fund	110,000	110,000
Total current liabilities	$ 360,157	$ 296,175
Noncurrent liabilities:		
OPEB – Note C	25,013	12,307
Self-Insurance – Note M	22,271	16,719
Compensated absences	21,686	22,573
Total noncurrent liabilities	68,970	51,599
Total liabilities	$ 429,127	$ 347,774
NET ASSETS		
Invested in Capital Assets, net of related debt	$ 52,307	$ 53,932
Deficit	(60,580)	(6,025)
Total Net Assets	$ (8,273)	$ 47,907

- The notes to the financial statements are an integral part of this statement. –

PENNSYLVANIA LIQUOR CONTROL BOARD
STATE STORES FUND
COMPARATIVE STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS
(EXPRESSED IN THOUSANDS)

	Fiscal Year Ended June 30, 2010	Fiscal Year Ended June 30, 2009
Sales net of taxes	$1,511,390	$1,491,738
Less: Cost of goods sold	1,061,404	1,016,546
Gross profit from sales	449,986	475,192
Less: Operating expenses:		
Purchasing, storage and transportation	18,520	27,017
Stores' operations and supervision	281,049	273,527
Central administrative support	66,814	51,909
Comptroller operations	5,485	6,619
Commonwealth-provided services	9,933	12,666
Total	381,801	371,738
Operating profit from state stores	68,185	103,454
Other operating revenues (expenses):		
Enforcement fines	1,888	2,500
License fees	11,467	11,343
Miscellaneous income	3,253	1,932
Administrative law judge	(1,985)	(2,113)
Legal	(2,840)	(2,773)
Licensing and investigations	(10,246)	(10,072)
Total	1,537	817
Total operating income	69,722	104,271
Nonoperating revenues (expenses):		
Investment income/loss	369	(2,598)
Other	(136)	0
Loss on disposition of capital assets	0	(12,643)
Total	233	(15,241)
Income before operating transfers	69,955	89,030
Operating transfers out:		
PSP enforcement-Note J	20,085	20,178
Income after enforcement/before other transfers	49,870	68,852
Other operating transfers:		
Transfers Out:		
General Fund-Note H	(105,000)	(125,000)
Drug and alcohol programs-Note I	(1,050)	(1,781)
Total	(106,050)	(126,781)
Change in Net Assets	(56,180)	(57,929)
Net Assets – Beginning	47,907	105,836
Total Net Assets - Ending	$ (8,273)	$ 47,907

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

PENNSYLVANIA LIQUOR CONTROL BOARD
STATE STORES FUND
COMPARATIVE STATEMENT OF CASH FLOWS
(EXPRESSED IN THOUSANDS)

	June 30, 2010	June 30, 2009
Cash flows from operating activities:		
Receipts from customers	$ 1,526,731	$ 1,506,499
Other receipts/payments	-	(155)
Payments to suppliers	(1,464,772)	(1,340,724)
Net cash provided by (Used for) operating activities	61,959	165,620
Cash flows from noncapital financing activities:		
Operating transfers out	(126,135)	(146,959)
Net borrowings under advances from other funds	-	25,000
Other	(136)	-
Net cash used for noncapital financing activities	(126,271)	(121,959)
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(9,182)	(24,577)
Disposition of capital assets	-	155
Net cash used for capital and related financing activities	(9,182)	(24,422)
Cash flows from investing activities:		
Purchase of investments	(878,486)	(1,075,597)
Proceeds from sale and maturities of investments	945,013	1,084,992
Investment income	369	(2,598)
Change in securities lending obligations	80	(25,689)
Net cash used in investing activities	66,976	(18,892)
Net increase in cash	$ (6,518)	$ 347
Cash-beginning of year	$ 17,603	$ 17,256
Cash-end of year	$ 11,085	$ 17,603
Reconciliation of operating income (loss) to net cash provided by (used for) operating activities:		
Operating income	$ 69,722	$ 104,271
Adjustments to reconcile net operating income (loss) to net cash provided by (used for) operating activities:		
Depreciation	10,807	6,387
Loss on disposition of capital assets	-	(155)
Decrease in receivables (net of allow)	(1,322)	879
Increase in inventory	(96,013)	(8,685)
Increase in due from other funds	55	(32)
Increase in other operating net assets	(2,564)	(1,861)
Increase in accounts payable and accrued liabilities	66,854	46,804
Increase in due to other funds	(3,037)	2,671
Decrease in due to other governments	86	(201)
Increase in other liabilities	17,371	15,542
Total adjustments	(7,763)	61,349
Net cash provided by (used for) operating activities	$ 61,959	$ 165,620

- The notes to the financial statements are an integral part of this statement. –

PENNSYLVANIA LIQUOR CONTROL BOARD
LIQUOR LICENSE FUND
STATEMENT OF FIDUCIARY NET ASSETS
(EXPRESSED IN THOUSANDS)

ASSETS

	June 30, 2010	June 30, 2009
Current assets:		
Cash	$ 125	$ 107
Temporary investments	2,392	2,419
Interest receivable	1	1
Total current assets	$ 2,518	$ 2,527

LIABILITIES

	June 30, 2010	June 30, 2009
Current liabilities:		
Due to municipalities	$ 2,515	$ 2,526
Other liabilities	3	1
Total current liabilities	$ 2,518	$ 2,527

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

PENNSYLVANIA LIQUOR CONTROL BOARD
LIQUOR LICENSE FUND
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS – 2009 and 2010
(EXPRESSED IN THOUSANDS)

	Balance June 30, 2009	Additions	Deductions	Balance June 30, 2010
ASSETS				
Cash-Note L	$ 107	$ 9,144	$ 9,126	$ 125
Temporary investments-Note L	2,419	4,485	4,512	2,392
Interest receivable	1	1	1	1
Total assets	$ 2,527	$ 13,630	$ 13,639	$ 2,518
LIABILITIES				
Due to municipalities-Note L	$ 2,526	$ 4,629	$ 4,640	$ 2,515
Other liabilities	1	3	1	3
Total liabilities	$ 2,527	$ 4,632	$ 4,641	$ 2,518

- The notes to the financial statements are an integral part of this statement. –

PENNSYLVANIA LIQUOR CONTROL BOARD
LIQUOR LICENSE FUND
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS – 2008 and 2009
(EXPRESSED IN THOUSANDS)

	Balance June 30, 2008	Additions	Deductions	Balance June 30, 2009
ASSETS				
Cash-Note L	$ 84	$ 9,100	$ 9,077	$ 107
Temporary investments-Note L	2,722	4,399	4,702	2,419
Interest receivable	5	1	5	1
Total assets	$ 2,811	$ 13,500	$ 13,784	$ 2,527
LIABILITIES				
Due to municipalities-Note L	$ 2,527	$ 4,680	$ 4,681	$ 2,526
Security Lending Obligation	278	0	278	0
Other liabilities	6	1	6	1
Total liabilities	$ 2,811	$ 4,681	$ 4,965	$ 2,527

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies employed by the Pennsylvania Liquor Control Board (PLCB) in the preparation of the accompanying financial statements are as follows:

Fund Accounting: The PLCB is primarily responsible for the accounting and reporting of the State Stores Fund and the Liquor License Fund. The State Stores Fund is an enterprise fund primarily used to account for wine and spirit sales and related operating expenses. The Liquor License Fund is an agency fund used for the collection and subsequent disbursement of certain annual license fees, which are returned to municipalities.

The preparation of financial statements in conformity with generally accepted accounting principles requires the PLCB to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Accounting Period: The State Stores Fund previously operated on the basis of a fifty-two week fiscal year, composed of 13 four-week periods (i.e., 364 days) ending on the Tuesday nearest June 30. Beginning fiscal year 2008-09, the State Stores Fund began operating on a twelve (12) calendar months, fiscal year basis. As a result, on a one-time basis in the 2008-09 transition year, the State Stores Fund's Statement of Revenues, Expenses, and Changes in Fund Net Assets and Statement of Cash Flows for the fiscal year ended June 30, 2009 includes six additional business days of activity (June 25, 2008 to June 30, 2008).

The Liquor License Fund is accounted for on a fiscal year basis, comprised of twelve (12) calendar months.

Basis of Accounting: The financial statements of the State Stores Fund and Liquor License Fund are presented on the accrual basis of accounting according to Government Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments. Under this basis, revenues are recognized in the periods earned and expenses are recognized in the period incurred. The PLCB adopted GASB Statement 20 "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting." The PLCB has elected not to apply Statements and Interpretations issued by the Financial Accounting Standards Board after November 30, 1989.

Cash: Cash includes PLCB funds held at the Treasury Department, imprest balances held at financial institutions and change used at state stores.

Temporary Investments: The PLCB participates in the Treasury Investment Program (TIP) with other Commonwealth agencies. Practically all individual funds which are part of the Commonwealth are participants in the TIP. The Treasury Department accounts for each participating fund's equity (considered "shares") in the TIP on a daily basis. "Share" balances of participating funds fluctuate considerably during the fiscal year, based on the timing of cash receipts and disbursements in the participating fund, and are reported as temporary investments. The TIP is considered an internal investment pool. Temporary investments are stated at cost, which approximates fair value.

Cash Equivalents: No investments which could be defined as cash equivalents have been treated as such on the Statement of Cash Flows; therefore, only net changes in cash are displayed.

Inventories: Liquor purchases are generally included in inventories upon receipt at warehouse facilities used by the PLCB. The majority of liquor purchases are F. O. B. destination. Inventories were stated at actual cost through March 1, 2009. Effective March 2, 2009, the PLCB changed its method of accounting for expenses incurred for product warehousing and transportation for product delivery to retail stores. Such expenses were formerly charged to operating expenses as incurred and merchandise inventories were formerly reported based on actual product costs, including transportation costs to warehouses. Effective March 2, 2009 product warehousing and handling, as well as transportation to store costs, are reported as part of merchandise inventories and are charged to cost of goods sold as product is sold.

Capital Assets and Depreciation: Capital assets are reported at cost in the Statement of Net Assets. The cost of land is reported; for other types of capital assets, the following minimum dollar reporting thresholds are used:

Building	$5,000
Leasehold improvements	$5,000
Machinery and equipment	$5,000
Intangible assets	$5,000

Capital assets (excluding land) are depreciated over the useful lives using the straight-line method. The following useful lives are being used:

Building	10-20 years
Leasehold improvements	3-15 years
Machinery and equipment	5-10 years
Intangible assets	5-10 years

Taxes: An 18 percent state liquor excise tax and a 6 percent state sales tax are collected and remitted monthly to the Department of Revenue for the General Fund. The PLCB also collects and remits a 1 percent local sales tax for Allegheny County and a 2 percent local sales tax for Philadelphia County; the Philadelphia tax increased from 1 to 2 percent on October 8, 2009.

Compensated Absences: Employees accumulate annual leave based on 2.7 percent to 10 percent of regular hours paid. A maximum of 45 days may be carried forward at the end of each calendar year. Employees are paid for accumulated annual leave upon termination or retirement.

Employees earn sick leave based on 5 percent of regular hours paid. A maximum of 300 days may be carried forward at the end of each calendar year. Retiring employees that meet service, age or disability requirements are paid in accordance with the following schedule:

Days Available at Retirement	Percentage Payment	Maximum Days Paid
0-100	30%	30
101-200	40%	80
201-300	50%	150
Over 300 (in last year of employment)	100% of days over 300	13

The accumulated annual and sick leave and related payroll benefits payable reported for the fiscal year ended June 30, 2010 and June 30, 2009 (in thousands) was $25,817 and $25,651, respectively. It is the PLCB's policy to record the cost of annual and sick leave in accordance with GASB Statement 16. The expense and corresponding liability are reflected in the financial statements.

NOTE B – DEPOSITS AND INVESTMENTS

The Treasury Department has the authority to manage, invest, and reinvest the moneys of all funds which are not legally authorized to be invested by a board, commission or State officer. The Pennsylvania Liquor Control Board participates in the Treasury Investment Program's (TIP) investment pools. Treasury accounts for each participating fund's equity, or shares, in the pools on a daily basis. Shares are recorded at average cost during the year and are adjusted to fair value at year-end. Share balances of participating funds vary considerably during the fiscal year, based on the timing of cash receipts and disbursements. PLCB has reported the fair value of its shares as of June 30, 2010, the fund's year-end. Shares in the TIP investment pools are reported as temporary investments.

The TIP pools are considered internal investment pools of the Commonwealth of PA and are subject to the requirements of GASB Statement No. 40. GASB Statement No. 40 requires state and local governments to make certain disclosures relating to investment risk, consisting of credit

risk (including custodial credit risk and concentrations of credit risk), interest rate risk, and foreign currency risk, in addition to custodial credit risk and foreign currency risk on deposits. The Treasury Department has formally adopted written investment policies to address these investment risks and has disclosed those risks associated with its total pooled deposits and investments in the Commonwealth of Pennsylvania's June 30, 2010 Basic Financial Statements.

PLCB's total deposit balance of $11.2 million was not exposed to either custodial credit risk or foreign currency risk.

As a participant in Treasury's TIP investment pool, PLCB's investments are exposed to credit risk and interest rate risk mentioned above. Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of fixed income instruments susceptible to credit quality rating is measured by nationally recognized statistical rating agencies (or NRSRAs) such as Moody's Investors Service. Treasury's TIP investment pool is not rated by an NRSRA. Interest rate risk is the risk that an investment's value will change, advantageously or adversely, due to a change in the absolute value of interest rates. The Treasury Department measures interest rate risk using duration. To limit Treasury's exposure to fair value losses arising from rising interest rates, Treasury's long-term asset allocation policy diversifies its fixed income core segment between intermediate duration and longer duration strategies. Duration is a measure of an investment's sensitivity to changes in interest rates. The higher the duration, the greater the changes in fair value when interest rates change. The average duration of Treasury's TIP investment pool at June 30, 2010 is approximately 0.083 years.

Treasury's TIP pools participate in a securities lending program. A contract between the Treasury Department and its custodian, acting as lending agent, provides that the custodian lends securities owned by the pools to independent brokers, dealers and banks, acting as borrowers. Lending agreements between the custodian and borrowers require that borrowers provide the custodian with collateral in exchange for securities lent. Cash received as collateral is invested in accordance with reinvestment guidelines approved by Treasury. Collateral consisting of cash and investments purchased with that cash and the related securities lending obligation is reported on the Balance Sheet or Statement of Net Assets of each fund participating in TIP pools on a pro-rata basis. The PLCB reported its share of the collateral as part of temporary investments and reported a liability for the related securities lending obligation at year-end. At June 30, 2010 this amount was $0.08 million. At June 30, 2009, there was no participation in the program and therefore no securities lending obligation.

NOTE C – PENSION AND OTHER POSTEMPLOYMENT BENEFITS

Plan Description: To provide pension benefits for employees of state government and certain other organizations, the State Employees' Retirement System (SERS) administers a cost-sharing multiple-employer defined benefit retirement plan. The plan, covering substantially all Commonwealth employees, is a contributory defined benefit pension plan as established by Commonwealth laws.

Under the plan, retirement benefits vest after 5 years of credited service. Generally, employees who retire at age 60 or, if under age 60, with 35 years of service are entitled to a normal (unreduced) annual retirement benefit. The general annual benefit is 2 percent of a Class A member's high three-year average salary times years of service. This annual benefit is 2.5 percent for Class AA members.

Summary of Significant Accounting Policies: The SERS financial statements are prepared on the accrual basis of accounting, whereby expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of the related trade date. Member and employer contributions are recognized in the period in which employee salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

SERS issues stand-alone financial statements which are available to the public. Written requests for financial statements should be directed to the following address:

State Employees' Retirement System
30 North Third Street, Suite 150
Harrisburg, PA 17101-1716

Funding Policy: All member contribution rates are determined by Commonwealth law. For most employees, the active plan member contribution rate is 6.25 percent of covered payroll. The SERS Board has the authority to establish or amend periodic employer contributions at actuarially determined rates, expressed as a percentage of annual covered payroll. Additionally, during each of the three years ended December 31, the annual required employer contributions (for all organizations participating in SERS) (in thousands) and the related percentage of that amount actually contributed are as follows:

Year Ended December 31	Annual Required Contribution	Percentage Contributed
2009	$ 643,861	39.1
2008	$ 584,248	39.9
2007	$ 617,253	39.3

The PLCB's contributions (in thousands) for the fiscal years ended June 30, 2010 and June 30, 2009 were $5,153 and $4,944, respectively.

Postemployment Health Care Benefits: The Commonwealth established and sponsors a Retired Employees Health Program (REHP) plan which provides postemployment benefits other than pensions (OPEB). This plan is administered by the Pennsylvania Employee Benefits Trust Fund (PEBTF), which acts as a third-party administrator and administers the REHP under an administrative agreement with the Commonwealth. The plan is a single employer defined benefit OPEB plan. The PLCB participates in the REHP, which provides a variety of healthcare benefits to eligible retirees. The OPEB plan and benefit provisions therein have been established under pertinent statutory authority. The OPEB plan does not issue a stand-alone financial report nor is included in the financial statements of a public employee retirement system.

REHP contribution requirements are established by the Office of Administration and the Governor's Budget Office. The PLCB contributes $240 for each active employee paid and reported as part of biweekly payroll expenses for its employees. For the fiscal year ended June 30, 2010, the PLCB's allocated share of the total REHP annual required contribution (ARC) of $850.44 million (for the Commonwealth's fiscal year ended June 30, 2010) was $32.32 million. The entire REHP ARC, for all REHP-participating organizations, was fully funded for the fiscal year ended June 30, 2008. The total REHP ARC's for the fiscal years ended June 30, 2009 and 2010 were not fully funded. Therefore, OPEB liabilities were reported as of June 30, 2009 and 2010. The PLCB's allocated OPEB liability was $12.30 million as of June 30, 2009 and, cumulatively, $25.01 million as of June 30, 2010.

Additional pertinent information on the REHP, outside the scope of PLCB reporting, including overall actuarial liabilities and assumptions related to the Commonwealth as a whole, are published each year as part of the Commonwealth of Pennsylvania's Basic Financial Statements included in the Comprehensive Annual Financial Report.

NOTE D – CAPITAL ASSETS

Changes in capital assets for the fiscal year ended June 30, 2010 are as follows (amounts in thousands):

	Balance June 24, 2009	Additions	Retirements	Balance June 30, 2010
Non-Depreciable Capital Assets:				
Land…………………………..	$ 323	$ 0	$ 0	$ 323
Depreciable Capital Assets:				
Building………………………..	19,598	0	0	19,598
Leasehold Improvements……...	2,229	339	0	2,568
Machinery and Equipment….…	28,377	(1,146)	136	27,095
Intangibles ……………………	36,532	9,989	0	46,521
Total capital assets…………….	$ 87,059	$ 9,182	$ 136	$ 96,105

The PLCB has capitalized $9,989 (in thousands) of its ERP Project Costs for the fiscal year ended June 30, 2010.

Changes in capital assets accumulated depreciation for the fiscal year ended June 30, 2010 are as follows (amounts in thousands):

	Balance June 24, 2009	Additions	Retirements	Balance June 30, 2010
Buildings……………………	$ 7,066	$ 994	$ 0	$ 8,060
Leasehold Improvements…...	1,933	106	0	2,039
Machinery and Equipment….	18,686	1,331	136	19,881
Intangibles……….………….	5,441	8,376	0	13,817
Total accumulated depreciation	$ 33,126	$ 10,807	$ 136	$ 43,797

Depreciation and amortization expenses related to capital assets for the fiscal year ended June 30, 2010 amounted to $10,807.

NOTE E – DUE TO OTHER FUNDS

At June 30, 2010 and June 30, 2009, a total (in thousands) of $3,259 and $6,427, respectively, was due to other funds. This total was due to various funds.

NOTE F – ADVANCES FROM GENERAL FUND

The PLCB received a loan from the General Fund in the amount of $110,000 (in thousands) for working capital purposes, which was classified at June 30, 2010 and June 30, 2009, as an advance from the General Fund.

NOTE G – LEASE COMMITMENTS

The PLCB, through the Department of General Services, has operating leases covering all of its Wine and Spirit Shoppe locations and some equipment. The leases generally provide for an initial term of three to ten years. Most leases have options for renewal.

Rental expenses (in thousands), for the fiscal years ended June 30, 2010 and June 30, 2009 were $38,730 and $38,323, respectively.

The following is a schedule of future minimum rental commitments for noncancelable operating leases in effect as of June 30, 2010, (expressed in thousands):

Fiscal Year Ended June	Wine and Spirit Shoppe Leases	Total
2011	$31,368	$31,368
2012	21,450	21,450
2013	14,545	14,545
2014	10,372	10,372
2015	6,741	6,741
Total Minimum Lease Payments	$84,476	$84,476

NOTE H – OPERATING TRANSFERS TO GENERAL FUND

The PLCB is subject to profit transfer requirements, determined annually by the Governor's Office, whereby stipulated funds are transferred to help finance the General Fund. The required transfer was $105,000 and $125,000 (in thousands) for the fiscal years ended June 30, 2010 and June 30, 2009, respectively.

NOTE I – OPERATING TRANSFER FOR DRUG AND ALCOHOL PROGRAMS

Per Act 1987-14, 2 percent of the PLCB's profits from the sale of alcohol shall be transferred to the Department of Health for drug and alcohol rehabilitation programs. The PLCB establishes a liability for the amount due to the Department of Health and transfers the payment in the subsequent fiscal year. The amount of the liability established to the Department of Health for the fiscal years ended June 30, 2010 and June 30, 2009 (in thousands) was $1,050 and $1,781, respectively.

NOTE J – OPERATING TRANSFER FOR LIQUOR CONTROL ENFORCEMENT

The PLCB provides the funding for the Pennsylvania State Police, Bureau of Liquor Control Enforcement, which is responsible for enforcing the laws and regulations governing the trafficking of alcoholic beverages throughout the Commonwealth. The transfer (in thousands) was $20,085 and $20,178 for the fiscal years ended June 30, 2010 and June 30, 2009, respectively.

NOTE K – CONTINGENCIES-LITIGATION

The PLCB is a defendant in various legal proceedings pertaining to matters normally incidental to routine operations. Based on the current status of these legal proceedings, it is the opinion of the PLCB's management and counsel that they will not have a material effect on the PLCB's financial position.

NOTE L – STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS

The Statement of Changes in Fiduciary Net Assets illustrates the net asset activities throughout each fiscal year for the Liquor License Fund.

Cash additions include cash received from license application fees as well as cash resulting from the sale of temporary investments. Cash deductions include the purchase of temporary investments as well as cash remitted to the municipalities.

Temporary investments' additions and deductions result from the purchase and sale of securities.

Due to municipalities' additions include monies received from license application fees. Due to municipalities' deductions include payments remitted to municipalities.

NOTE M – SELF-INSURANCE LIABILITIES

The Commonwealth is self-insured for statutory workers' compensation and medical payments for its employees injured on the job. The Commonwealth is also self-insured for annuitant medical/hospital claims and for tort liability claims. Major tort risks include automobile, employee and general torts. For property losses, the Commonwealth has a $1 million retention with excess commercial insurance coverage up to $350 million per occurrence. There was no reduction in commercial insurance coverage during the fiscal year ended June 30, 2010. No settlements exceeded commercial insurance coverage during each of the past three fiscal years. The Commonwealth has established various administrative policies, which are intended to avoid or limit the aforementioned risks.

PLCB participates in each Commonwealth self-insurance program and pays prescribed program amounts or rates throughout its fiscal year. These amounts, reported as current fiscal year expenses, finance a portion of cumulative, estimated self-insurance liabilities incurred, in amounts sufficient to fund ongoing program needs. These amounts do not finance all cumulative, estimated self-insurance liabilities incurred. Therefore, accrued liabilities for employee disability and annuitant medical/hospital claims are reported based on reserves computed from the Commonwealth's claim experience; such claims are not discounted and do not include non-incremental claims adjustment expenses.

At June 30, 2010 and June 30, 2009, the State Stores Fund reported a $26.49 million liability ($4.22 million as current and $22.27 million as non-current) and $20.60 million liability ($3.88 million as current and $16.72 million as non-current) for employees disability claims.

As stated above for Postemployment Health Care Benefits, at June 30, 2010, there is a cumulative $25.01 million non-current liability.

JACK WAGNER

AUDITOR GENERAL

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*

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited the financial statements of the Pennsylvania Liquor Control Board (PLCB) - State Stores Fund and Liquor License Fund as of and for the fiscal years ended June 30, 2010 and 2009, including the Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Fund Net Assets; Statement of Cash Flows for the State Stores Fund; and the Statement of Fiduciary Net Assets and Statement of Changes in Fiduciary Net Assets for the Liquor License Fund, and have issued our report thereon dated April 18, 2011. We conducted our audit 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered PLCB's internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PLCB's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PLCB's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

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 detect misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the PLCB's financial statements will not be prevented, or detected on a timely basis. We consider the deficiencies described in the accompanying Finding Section to be material weaknesses. The material weaknesses are described in Findings No. 1 and No. 2.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the PLCB's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 or other matters that are required to be reported under *Government Auditing Standards*.

PLCB's responses to Findings No. 1 and No. 2 identified in our audit are described in the accompanying Finding Section. We did not audit PLCB's responses and accordingly, we express no opinion on them. However, we would like to acknowledge that PLCB has taken positive corrective action to make our recommended improvements to its new inventory systems as discussed in Finding No. 1.

This report is intended solely for the information and use of the board of directors and management of PLCB, and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

April 18, 2011

JACK WAGNER
Auditor General

Finding No. 1 – PLCB's Oversight of the New Enterprise Resource Planning System Needs Improvement

Condition: Since 2007, the PLCB has been implementing a new Enterprise Resource Planning (ERP) system to integrate all of its information technology functions related to purchasing, inventory warehousing, and store sales with financial accounting. Each year, as part of our PLCB financial statement audit, we observe year-end inventory taken by the PLCB. During our most recent observation of the 2010 inventory, we noted that the PLCB's new ERP system caused the PLCB to experience inventory shortages (as explained in more detail below) at distribution centers, which led to shortages at the 621 PLCB wine and spirit shops. To compensate for these shortages, the PLCB ordered double the amount of inventory by hundreds of thousands of cases of wine and spirits. In time, the volume of merchandise exceeded the storage capacity of existing warehouses, causing the PLCB additional costs and jeopardizing the quality of some merchandise that had to be stored in non-temperature-controlled tractor trailers. We also understand that this significantly depleted the PLCB cash reserves, which potentially caused cash flow problems for the PLCB.

We have also previously reported to the PLCB the following issues related to this new $66.6 million ERP system contract and the PLCB's oversight of it:

- In August 2007, the PLCB initially awarded a $25.8 million contract for an ERP system, as described above. This award was highlighted in the Department of the Auditor General's 2009 special performance audit of information technology procurements which noted multiple weaknesses in the PLCB award process, including lack of documentation. As a result, we could not verify that the PLCB adhered to proper procurement standards or exercised proper due diligence in awarding the contract. These weaknesses were noted as factors that could have had a major impact on subsequent contract amendments that increased the original contract costs by 135 percent to $60.6 million as of June 30, 2009. As of June 30, 2010, the ERP contract had increased with another $6 million in contract amendments to $66.6 million.

- The 2009 PLCB financial statement audit noted major variances in the new ERP system due to inadequate controls to ensure inventory items and related cost values were accurately and properly recorded. The audit also disclosed a $2.6 million understatement of year-end inventory caused by shipping and handling up-charges not being properly accounted for. This also caused significant audit delays and increases in auditor and PLCB time devoted to this issue, until the accounting systems were properly reconciled, partly because the contractor failed to develop all the standard reports that were initially identified in the system design documents and PLCB employees had not received sufficient training specified in the contract. In our 2010 audit, while we noted improvements in PLCB's inventory system management, similar variances and audit difficulties continued to occur, so these accounting issues remained unresolved.

- In our inventory audit work at PLCB's liquor stores during 2009/10, we noted a significant increase in the number of differences between physical counts and store records. These differences resulted from PLCB's recent implementation of the new inventory system. Although we communicated these store inventory differences on-site at the stores and to management via e-mails throughout 2010, we have received little response from management to demonstrate its follow up and resolution to ensure that store inventories are properly accounted for.

The following describes in more detail our most recent concerns related to the inventory shortages, overages, and associated added costs related to the 2010 PLCB inventory.

Implementation of the PLCB's Inventory Forecasting System Created Shortages at Warehouses and Retail Stores

Warehouse Issues

Although the majority of the inventory management module of the ERP system was implemented in March 2009, PLCB stated that the forecasting application within the new system did not go live until September 2009. In January 2010, management discovered something was wrong; the amount of inventory at the distribution centers was getting too low and steadily declining. PLCB management indicated that this problem would have been noticed sooner but the problem was masked by the traditional build-up of inventory for the holiday season. Management eventually determined that the inventory problem was related to a vendor's forecasting software in the inventory management module of the ERP system. As a result, management contacted the vendor who supplied the inventory forecasting software to the PLCB and the consultant that designed the new $66 million system, and asked that the vendor provide the inventory forecasting formulas so the PLCB could correct the problem. The vendor refused the PLCB's request, claiming that the information requested by the PLCB was proprietary information. The vendor's rejection left the PLCB with no choice but to solve the problem on its own. This raises questions about the PLCB's ability to adequately contract for information technology solutions. It also raises the question why the inventory parameters were not properly set from the start and apparently were incorrect. In addition, the PLCB had to address the problem without the services of a key employee in its Inventory Management Division who retired in late 2009. Less than a year later, in July 2010, after approximately one year of employment with the PLCB, the Director responsible for managing PLCB inventory resigned.

PLCB eventually determined that certain inventory parameters were set too low and that it needed to severely increase these inventory parameters. The PLCB also made other decisions to address the inventory shortage at the warehouse and the inventory shortages and hoarding that were occurring simultaneously at the retail stores. These issues are discussed below.

Retail Issues

According to PLCB management, the new inventory management module of the ERP system theoretically is designed to order inventory based on the aggregate of all sales. However, in January 2010, the inventory levels at the distribution centers were too low and by February 2010, retail stores had already begun to experience inventory shortages. In response to the existing inventory shortages, and because of a lack of understanding about how the new inventory system was to function, some of the retail store managers began requesting more weekly inventory to be sent to their stores than actually needed to meet weekly sales. For example, a store manager would order four cases of merchandise instead of the two cases needed to meet the week’s sales. This would potentially result in another store being shorted two cases of the same merchandise because the system only ordered from vendors the number of cases all stores need collectively for the week. In other words, retail store managers began hoarding some merchandise items, leaving other retail stores without that merchandise. This exacerbated the existing inventory shortage at stores; items were out of stock and unavailable to customers and licensees (commercial customers).

In July 2010, we interviewed 59 PLCB retail store managers regarding inventory shortages in 2010. Of these 59, 53 (or 90 percent) reported that particular merchandise products have been out of stock and unavailable for purchase by licensees and the public. According to retail store managers, normally, it takes three to four weeks to replenish merchandise that is out of stock. However, one manager stated that it took four months before a particular product finally arrived at the store. In addition, a majority of the managers indicated that stores were not receiving sale merchandise on time, noting that merchandise even arrived after a sale had ended. Moreover, 29 of 59 (or 49 percent) store managers interviewed by our auditors reported that they received merchandise that they did not need. In addition, these managers also indicated that they did not receive merchandise that they actually needed.

In Response to Inventory Shortages at the Retail Stores, PLCB Central Office Manually Overrode Its New Inventory Forecasting System and Began Purchasing More Than 1 Million Cases of Excessive Inventory

To alleviate the shortages at retail stores and to ensure that merchandise orders and shipments were again in line, management at the central office in Harrisburg informed its purchasers in early March 2010 to order excessive merchandise beyond what the system was telling them to order. By doing this, PLCB intended to buy itself out of the out-of-stock and hoarding situations. As a result, throughout the month of March, the purchasers ordered excessive inventory to build up the inventory at the distribution centers, which in turn would alleviate the out-of-stock situations occurring at the stores. However, as noted below, this purchasing of excessive inventory resulted in the distribution centers exceeding their capacity and, in turn, necessitated the need for excess storage areas, as noted below.

Scranton:
Management at the distribution center in Scranton saw its inventory climb beyond the usual 300,000 cases to 606,383 cases in 2010. Consequently, management procured space in an additional warehouse to deal with the substantial increase in its inventory, which exceeded the storage capacity of the distribution center already in use.

Pittsburgh:
Management at the distribution center in Pittsburgh saw its inventory soar from a normal level of 300,000 cases to 575,000 cases in 2010, exceeding the storage capacity of the distribution center. As a result, management made the decision to stockpile 72,277 cases of excess merchandise in 57 non-temperature-controlled trailers, with 30 of the trailers located off site and the remaining 27 trailers located adjacent to the distribution center.

Before positioning the merchandise in the non-temperature-controlled trailers, management did attempt to identify merchandise that was temperature sensitive although it failed to ensure that all temperature-sensitive merchandise was adequately stored. (See below for additional information). Management eventually relocated the merchandise from the trailers to another warehouse located in Cranberry Township, near Pittsburgh.

Philadelphia:
The distribution center located in Philadelphia initially accommodated the increased inflow of merchandise, which reached 763,470 cases. However, management eventually made the decision to procure 16 non-temperature-controlled trailers for the storage of 20,240 cases of excess merchandise because the storage capacity of this distribution center was exceeded. The trailers containing the merchandise were located off site and were in use for at least six weeks when our auditors uncovered the PLCB's use of these non-temperature-controlled trailers.

Excess Inventory Created Additional Costs

In addition to the PLCB acknowledging that it tried to buy itself out of the out-of-stock and hoarding situations, management also indicated that it could not change the volume of inventory coming into the distribution centers even though they were overflowing with excess product because vendors had already processed these orders. Lead times in purchasing product are as high as 16 weeks, which explains why inventory continued to increase through June 2010. PLCB management stated that it did not expect that the excessive purchasing would lead to the distribution centers capacity to be exceeded. Instead, it believed that the outflow of merchandise to the stores would offset the excessive inflow of merchandise. However, that did not occur. As a result, the PLCB had to incur additional costs (trailer rentals, personnel costs of guard to secure the trailers, etc.) associated with the excess inventory. Comptroller management initially indicated that it did not know how much the additional costs were, but later estimated it at approximately $500,000.

Potential Spoilage of Merchandise Due to Inadequate Storage in Excessive Heat

During our interviews with PLCB Comptroller's Office management, they indicated that there was no risk of spoilage to the merchandise stored in the non-temperature-controlled trailers because it made sure that the merchandise placed in these trailers was not susceptible to extreme temperatures (i.e., hard liquor). However, based on observations made by our auditors who were at the distribution center locations and subsequent verification by the suppliers of certain merchandise, we found that some of the merchandise stockpiled in the non-temperature-controlled trailers such as wine and champagne actually was more susceptible to high heat or extreme fluctuation in temperatures than spirits such as whiskey.

The suppliers of merchandise indicated that it should be stored in a location that is cool and dry. One supplier suggested that, if the temperature reached ninety degrees Fahrenheit (90°F), it is possible that the high temperature affected the quality of the merchandise. Nevertheless, numerous cases of excess merchandise remained in non-temperature controlled-trailers when outside temperatures at the distribution centers climbed above ninety degrees Fahrenheit (90°F) and even surpassed one hundred degrees Fahrenheit (100°F).

Additionally, contracts between the PLCB and the vendors that manage warehouse operations establish that the PLCB designates merchandise that is to be stored, handled, or transported under temperature-controlled and/or protected conditions. Such PLCB contracts include a clause(s) for temperature-controlled or protected areas. Accordingly, vendors must maintain an area in the facility designed to provide the storage, picking, and handling of merchandise in an environment not exceeding seventy-five degrees Fahrenheit (75°F).

The Stockpiling of Inventory Reduced PLCB's Cash Flow, Which Could Have Resulted in PLCB Transferring Less Money to the Commonwealth's General Fund

Each year, upon the request of the Governor, PLCB transfers excess profits to the General Fund of the Commonwealth of Pennsylvania. In 2010, PLCB transferred $105 million. The significant build-up of excess merchandise stockpiled in makeshift storage facilities resulted in the significant drawdown of the financial resources of the PLCB, which, in turn, reduced PLCB cash flow and cash surplus at year end and jeopardized PLCB's ability to transfer mandated cash payments to the General Fund. We noted that cash and short-term investments went from $129 million at June 30, 2009 to $56 million at June 30, 2010, a decrease of $73 million or 56%. According to Comptroller management, subsequent to the transfer, total net assets as of June 30, 2010, were negative $8 million.

Criteria: Good internal control dictates that PLCB management should operate its new ERP system in a reasonable and efficient manner and have controls in place to minimize unnecessary inventory shortages, stockpiling, and related costs, minimize the risk of inventory spoilage, and ensure appropriate cash flow and cash surplus to comply with mandated transfers to the General Fund.

Cause: PLCB management stated the following as it relates to the cause:

> "The problems encountered by the Board with its inventory management system are of the type of problems that occur when a new ERP system is implemented. An unfortunate confluence of circumstances exacerbated the problem. Specifically, the employee who would have been in charge of inventory management retired somewhat unexpectedly just as the ERP system went into operation. The remaining personnel involved in inventory management were forced to learn how to acquire the information available in ERP, and how to best use it while simultaneously operating the state store system. During this transition, some shortages occurred. Store managers, used to operating under the old legacy systems responded by overriding the orders produced by the system in order to hoard product. This in turn led to increased ordering by other stores to prevent shortages at their stores. In addition, inventory managers reacted to low inventory and out-of-stocks by ordering more product. The result of this cycle was the excess inventory noted in your report."

PLCB management oversight needs to be improved. The PLCB needs to do a better job ensuring it has the expertise (either in-house or possibly with the assistance of Office of Administration's Office for Information Technology) to contract for information technology solutions. Because of insufficient knowledge transfer from its vendors, PLCB had an inadequate understanding of the system forecasting model and how it reacts to inventory parameters, as well as inventory levels at the stores and distribution centers. The PLCB also needs to improve communication with store managers so they are fully aware of what they should expect with regard to system changes or upgrades, and how they should react to avoid panic. Management also needs to monitor spoilable inventory, to determine where it is stored and if it was spoiled so that spoiled inventory is not sold to licensees or the public.

Effect: As a result of the internal control weaknesses noted above, PLCB provided little assurance that: 1) its new ERP system operated in a reasonable and efficient manner, 2) the additional costs associated with shortages and excessive inventory are necessary and appropriate, 3) excess inventory is stored in an appropriate manner which properly limits the risk of spoilage, and 4) PLCB's cash flow and cash surplus are appropriate to not jeopardize management's ability to transfer mandated cash payments to help alleviate the budget crisis in the General Fund.

We also noted that, despite continued increases in sales over the past three fiscal years, PLCB's net profit from its liquor store operations has declined significantly in this same time period. In particular, while overall sales have increased about 7%, or $98 million, from $1.413 billion in FYE June 30, 2008 to $1.511 billion in FYE June 30, 2010, net profits from store operations have declined by about 47%, or $61 million, from $129 million down to $68 million in this same time period. We believe that the problems and extra costs associated with PLCB's new $66.6 million inventory management system appear to be one of the primary causes of this major downturn in profits.

PLCB management stated the following as it relates to effect:

> "Of greatest import is the fact that there were no significant business disruptions. While it is true that the excess inventory resulted in some additional storage costs, the costs were minimal. While that figure was not previously available to you, we estimate it at approximately five hundred thousand dollars ($500,000). Certainly, the Board does not want to incur any unnecessary costs but these costs were relatively small in relation to the Board's almost two billion dollar operation. On a positive note, all the product was eventually sold to consumers and the profits from those sales was part of the transfer to the general fund. Further, while your office was concerned that spoilage of product may have occurred, the Board is not aware of any such spoilage. Indeed, a review of customer comments to the Board as well as the rate of returns for the period in question failed to indicate that any additional spoilage resulted. As to the concern that the Board's excess inventory jeopardized the previously scheduled transfer of one hundred five million dollars ($105,000,000) from the state store fund to the General Fund, the transfer occurred as planned."

The PLCB also believes that the issues that led up to the inventory fluctuation have been addressed by the inventory management better understanding the ERP system and being able to now track changes in orders made by the store managers and that store managers now understand the effect of hoarding.

Recommendations: While the PLCB believes that the matter is now in hand, the PLCB needs to use all the lessons learned from this difficult inventory situation to avoid similar situations in the future. As a result, we recommend that:

- Management should fully understand the forecasting model and how it reacts to inventory parameters as well as inventory levels at the stores and the distribution centers in order to avoid too little or too much inventory;

- Management should communicate with the store managers to ensure that they are fully aware of what they should expect with regard to any changes or upgrades to the system and how they are to react to avoid panic;

- Management should ensure that inventory is stored according to industry and contract standards and, when not stored in that manner, have policy and procedures in place to monitor for spoilage prior to selling it to consumers.

- Management should ensure that PLCB employees are now fully knowledgeable in all aspects of maintenance and operation of the ERP system. If complete knowledge transfer from the consultants has not yet occurred, management should give it top priority.

- Prior to embarking on any new system development, PLCB management should ensure that it possesses adequate information technology contracting expertise or consider consulting with the Office of Administration's Office for Information Technology, or another independent expert, for assistance in information technology contracting and developing policies, training, and best practice documents to avoid similar systemic failures in the future.

Agency Response: On behalf of the Pennsylvania Liquor Control Board ("Board"), thank you for this opportunity to respond to your recommendations. Beyond the financial review of this audit, you have made certain additional findings and recommendations to the Board, primarily regarding its Enterprise Resource Planning ("ERP") system. Specifically, you note that during fiscal year 09/10, the Board experienced significant inventory fluctuations. These fluctuations were in part a result of the Board's personnel learning to fully and properly utilize its ERP system. While the Board's inventory is now at an appropriate level, your recommendations are designed to help the Board avoid future inventory issues.

Your five (5) specific, interrelated recommendations to the Board are that it take steps to ensure that: (1) its management staff fully understand the forecasting model and how it reacts to inventory parameters and existing inventory; (2) its management staff communicate with its store managers so that the store managers understand how they should react to changes or upgrades of the system; (3) inventory is stored in accordance with industry and contract standards and policies and procedures be implemented to monitor for spoilage of product; (4) all remaining knowledge transfer necessary to operate the ERP system occur at an expedited basis: and (5) it possesses adequate information technology contracting expertise prior to embarking on any new system development.

As your office is aware, implementation of the ERP system has been a massive multi-year undertaking contemporaneously implemented while the Board continues to operate its almost two billion dollar wholesale and retail operation, its alcohol education efforts and its licensing and oversight of over seventeen thousand private licensees. The legacy systems used by the Board prior to ERP were in some cases so old that not only was it not cost effective to maintain the existing system, it was no longer possible to because the necessary hardware and expertise no longer existed. Implementing the ERP system required that the Board identify its “As is” and “To be” processes to utilize the new ERP system to its best advantage and to convey that knowledge to the contractor so that outside contractor could understand the admittedly unique method in which Pennsylvania regulates alcohol. In turn, the contractor’s personnel had to transfer to the Board’s personnel, knowledge of how the ERP system would process and incorporate the Board’s existing requirements and how the ERP system could allow the Board to engage in new, more efficient methodologies. Thus, an ERP implementation is much like two parties translating and updating a document where one party knows the language but not the subject and the other party knows the subject but not the language. Not surprisingly, problems associated with implementing such a massive ERP system are certainly neither unique nor exclusive to the Board and have been experienced by many established and successful companies.

As to your first recommendation, while the problems encountered by the Board with its inventory management system are of the type of problems that occur when a new ERP system is implemented, the problems were exacerbated by the unexpected retirement of the employee who would have been in charge of inventory. The personnel in Harrisburg assigned to inventory management have now had a year to work with and better understand the relevant ERP system and fine tune where necessary. Further, they can now track changes in orders made by the store managers to better understand their cumulative impact. Nonetheless, the Board appreciates the recommendation and will continue to take steps to implement it.

As to your second recommendation, the inventory fluctuations of the preceding fiscal year have helped the Board more fully appreciate the need to have an ongoing dialogue with its store managers and to provide them feedback on the aggregate effect of their individual decisions. As noted earlier, the Board can now track changes in orders made by the store managers to better understand their cumulative impact. The Board appreciates the recommendation and will continue to fine tune its internal communications.

As to your third recommendation, let me again note that there is no evidence, anecdotal or otherwise, that the Board's high inventory levels during parts of the previous fiscal year lead to spoilage of product. It did lead to additional storage costs and while these costs were relatively small in relation to the Board's almost two billion dollar operation, they are additional costs and the Board will do all it can to avoid them in the future. By maintaining better control of its inventory, the Board is confident that such additional costs will be avoided in the future. The Board appreciates the recommendation.

As to your fourth recommendation, all necessary knowledge transfers have occurred, although the contractor continues to provide day-to-day mentoring of Board employees as needed. Of course, the Board's proficiency with its ERP system will continue to increase as its experience with the system increases over time. The Board appreciates the recommendation.

As to your fifth recommendation, we again note that problems associated with implementing of an ERP system are neither unique nor exclusive to the Board and have been experienced by many established and successful companies. Nonetheless, the Board will certainly redouble its efforts to ensure that it is as prepared as it can be prior to embarking on any new system developments. The Board appreciates the recommendation.

In conclusion, we are confident that the inventory fluctuations noted in your findings will not become a reoccurring problem. We concur with and have already adopted the substance of your recommendations.

Auditors' Conclusion: Based on discussions with PLCB management and our review of the above agency response, we acknowledge that PLCB has taken positive corrective action in improving its new inventory systems to prevent similar problems from recurring in the future. We commend PLCB for its efforts so far, and we will review management's corrective action in our subsequent audit.

Finding No. 2 – General Computer Controls in PLCB Need Improvement (A Similar Condition Was Noted in Prior Year Finding No. 1)

Condition: Our review of general computer controls at PLCB during the 2009-2010 fiscal year disclosed the following internal control deficiencies that need to be addressed by PLCB management:

1. Physical access controls are lacking over the point of sale and warehouse management systems.
2. PLCB did not establish adequate password complexity and logical access rules for the warehouse management application, the point of sale system, and the Oracle applications.
3. Individuals accessing Oracle Retail Management System cannot change their own passwords.
4. A monitoring process has not been implemented over the production environment to detect changes moved into production that did not follow the standard process in the warehouse management system.
5. Periodic access reviews to determine the appropriateness of users with privileged access have not been implemented in the Oracle and the point of sale systems.
6. A number of contractors have “administrative” or “super user” access in the Oracle system, and PLCB has no policies or procedures in place to monitor the contractors’ use of these powerful attributes.
7. A post implementation review was not completed for Oracle Wave IV. Oracle Wave IV was titled “Vendor Order Portal,” which enabled licensees to look up information in Oracle before ordering.
8. Monitoring of user activity for access violations in the point of sale and warehouse management system is not conducted.
9. PLCB was unable to provide system-generated evidence of segregation of duties between application developers and those who can promote changes into production in the Oracle, warehouse management, and point of sale systems.
10. PLCB formed a “Change Control Board” (CCB) in August 2009 and developed a “Change Control Procedure” document. However, these change control procedures are not consistently applied to all program changes, e.g., “break/fix”, all application enhancement, and all new system development projects. Further, the actions of the CCB are not consistently documented, approval for Oracle Wave IV “go live” was not documented, and certain changes have been made to the Oracle production environment by the outside vendor without approval by the CCB.

11. Management has not implemented standardized policies to address IT controls related to access, change control, development, and backup of end user computing programs and supporting data. End-user computing programs are defined as spreadsheets, databases, and other customized programs developed to support existing applications in calculating data that may be used to support financial reporting.

Criteria: A well-designed system of internal controls dictates that sound general computer controls be established and functioning to best ensure that overall PLCB operations are conducted as closely as possible in accordance with management's intent.

Cause: The weaknesses noted in the Oracle system were because of software limitations (i.e., users' inability to change their own passwords) or were caused by issues in the ongoing development of a new change control system. Also, weaknesses in the warehouse management system were not addressed due to management's plans to convert its inventory to a bailment system, in which LCB no longer owns the inventory in the warehouses but only assumes ownership when warehouse inventory is shipped to LCB's liquor stores, as well as management's plans to consolidate and outsource the distribution centers. Additionally, the weaknesses noted in the point of sale system were not addressed as management is implementing a new point of sale system in Oracle.

Effect: If general computer control areas are not improved, computer and other agency operations may not be conducted in accordance with PLCB management's intent. Specifically and most importantly, because PLCB is not adequately monitoring the outside vendor's actions as noted in #6 and #10 in the condition above, the outside vendor could be performing system actions that are not in accordance with PLCB management's intent.

Collectively, we consider the above exceptions to be a material weakness under generally accepted auditing standards. The auditing standards define a material weakness as a deficiency, or 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.

Recommendation: We recommend that PLCB management review the general computer control deficiencies noted above and take the necessary actions to resolve them, especially those deficiencies related to the lack of monitoring of the outside vendor.

Agency Response:

[The board repeated each Auditor General condition as an introduction to each management response. For the sake of brevity, these repetitions have been removed.]

[Response to Condition 1]:
POS – This will be corrected with the new POS System being rolled out second quarter 2011.
WMS [*Warehouse Management System*] – Physical access controls were not addressed this year due to the possibility of warehouse consolidation. This is planned prior to the end of Fiscal Year 2010-2011.

[Response to Condition 2]:
WMS – The Warehouse Management System incorporates the following criteria for user password standards: 90-day expiration, minimum 7 characters, no uppercase, cannot be the same as the last 5 passwords, 5 unsuccessful tries in 5 minutes locks the user's screen for 5 minutes.
POS – Our current password standards are as follows: 90 expiration, must consist of (8) letters and numbers, cannot contain consecutive numbers, spaces or special characters in sequence and the password cannot be the same as the last (6) passwords used. POS will automatically logoff the user after 15 minutes of inactivity. If an individual's password is not known the only way an employee can obtain a new password is to call the help desk. The help desk will delete the employee and assist in adding the employee in Employee Control Maintenance.
Oracle – We need to work within the constraints of the Oracle software product. At present, there is no way for the end user to change their password in RMS, so as a result our Security section sends out new passwords to the end users every 90 days. As far as the rest of the Oracle systems, they function in a similar fashion to CWOPA where by asking the end user to change their password every 90 days. There are however, different application specific password standards in Oracle.

[Response to Condition 3]: Our Oracle RMS software does not currently allow individual users to change their own passwords. We hope this feature will be available in upcoming releases. We do however, change Oracle RMS passwords every 90 days and distribute them to users. The passwords are randomly generated so there is no specific pattern to their makeup.

[Response to Condition 4]: Changes to the Robocom Inventory Management System (RIMS) are managed centrally and pushed out to the warehouses by Tech Support. As with any application system where the servers are remotely managed there is the possibility for changes to be introduced. The PLCB will research ways to better monitor the application servers in the warehouses.

[Response to Condition 5]:
Oracle – At the meeting held, February 24, 2011, privileged access was defined as anyone who has the ability to change data, settings or configuration or to access tables directly from the backend. As a result of this audit the PLCB has started to review access by contractors, its own COE and end user community. It is the intent of the PLCB to review this access annually at a minimum.

POS – User access of "Admin" in Point of Sale is only granted to specific users – Help Desk, Second Level Technical Support and Technical Support. This access is only granted by [*names removed*].

[Response to Condition 6]: At the meeting held, February 24, 2011, "super user" access was defined as administrative or privileged access. Attached, are a series of agency IT specific policies on Production Environment Security Administration, Required Use of Unique Application User IDs, Generic System Admin Level User ID Usage and Granting Access to LCB Systems. In addition, the PLCB has started to review access by contractors, its own COE and end user community. It is the intent of the PLCB to review this access annually at a minimum.

[Response to Condition 7]: The PLCB will be transitioning over the next two years to adopt ITIL standards. As a result the PLCB will be starting to conduct post implementation reviews for all projects over a given number of hours.

[Response to Condition 8]:
POS – We currently use Storegazer software to monitor access and user activity, plus we send message and audit log file data to the Central Office on a nightly basis.
WMS – There is an OS level report generated on a daily basis that details user activity and notates those users who had difficulty signing onto the WMS in the last 24 hours.

[Response to Condition 9]:
Oracle – The PLCB recognizes that we need to strengthen our monitoring for segregation of duties issues especially as it relates to contractors hired to make system changes. As such, the agency is implementing periodic reviews of all persons with privileged or administrative access on an annual basis at a minimum.
WMS – Currently there is no UNIX based system generated evidence of segregation of duties. Only our Tech Support section has access to the root user profile to make changes to production.
POS – During development and pilot, our vendor SkillNet, has separate application developers vs the database administrators who deploy code to production. It is PLCB's intention to follow the same methodology internally after rollout.

[Response to Condition 10]: The agency is continuing to evolve its change control process and the IT Steering Committee for prioritization of projects. The Change Control Board is being changed to a Change Advisory Board (CAB). ITIL standards are being introduced into the organization and an OA Remedy Help Desk solution is scheduled to be rolled out in 2011. With an OA Remedy Change Management pilot closely following thereafter. All of this is an effort to make the systems and processes more stable and repeatable. The agency has also recently hired a Quality Assurance Manager and a Testing Manager.

[Response to Condition 11]: In accordance with the Office of Administration guidelines (IT Bulletins), we adopt the Commonwealth's policies currently in effect.

[Response to Recommendation]: The PLCB COE has established a Quality Assurance team. Using ITIL standards, the team will over the next two years be establishing standards, policies and procedures step by step for both internal staff and vendor staff for controlled:

- Change Management
- Release Management
- Configuration Management
- Version Control
- Incident and Problem Management
- Risk Management
- Testing
- Service Request Management
- Deployment Management

Auditors' Conclusion: For the control deficiencies noted above, our finding and recommendation remain as previously stated, and we will review the corrective action in our subsequent audit.

JACK WAGNER

AUDITOR GENERAL

COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD
JUNE 30, 2010
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