# FINANCIAL AUDIT

Commonwealth of Pennsylvania
Pennsylvania Liquor Control Board

State Stores Fund
Liquor License Fund

Audit Report

Harrisburg, Pennsylvania
For the Fiscal Years Ended June 30, 2014 and 2013

December 2014

EUGENE A. DEPASQUALE • AUDITOR GENERAL •

Commonwealth of Pennsylvania
Department of the Auditor General

Eugene A. DePasquale • Auditor General

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# BACKGROUND

## INTRODUCTION

The Pennsylvania Liquor Control Board (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 mandate is the authority to establish, operate and maintain Pennsylvania Fine Wine and Good Spirits stores for the sale of liquor, including wine and spirits.

The PLCB serves as the Commonwealth's responsible retailer of wine and spirits and regulator of the beverage alcohol industry and strives to maximize returns to the people of Pennsylvania.

## 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 (4) 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, to manufacture, import, warehouse and/or transfer alcoholic beverages, and to sell malt or brewed beverages at the wholesale and/or retail level.

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).

# BACKGROUND (Continued)

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 and 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.
- Initial appellate review for citation cases.
- Awarding of money to various organizations, local government entities, and educational institutions in the form of grants.

## RETAIL OPERATIONS

The PLCB operates approximately 606 Pennsylvania wine and spirits stores with gross annual sales of over $2.24 billion USD for Fiscal Year 2013-2014. As of June 30, 2014, the PLCB employs approximately 3,100 full-time salaried employees and approximately 1,900 part-time hourly employees, for a total of approximately 5,000 employees. In Fiscal Year 2013-2014, PLCB employees handled almost 16 million cases of product and sold more than 158 million units.

An ongoing, 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.

# BACKGROUND (Continued)

## 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 State Treasury.
- The PLCB is the largest purchaser of wine and spirits in the United States, and passes significant volume purchase discounts on to customers.
- The PLCB operates approximately 606 stores, which are leased from private landlords, infusing approximately $43 million to Pennsylvania's economy.
- 100% of the required State and Local Sales Taxes are collected by the PLCB and reported to the Pennsylvania Department of Revenue.
- The state liquor tax of 18%, which is in addition 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 contribute more than $42.9 million to Pennsylvania's economy.
- Administrative costs are shared between the operations of the marketing, licensing and alcohol education functions, resulting in true economies of scale.
- There are approximately 26,000 beverage alcohol licenses and permits issued by the PLCB.
- The PLCB has an established formal Bureau of 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 BLCE is responsible for the enforcement of all liquor laws. The PLCB fully funds this function out of operational revenues. In FY 2013-2014, the PLCB transferred nearly $25 million to the BLCE.
- The PLCB policy of "zero tolerance" for sales to minors and intoxicated individuals has resulted in store employees challenging, or "carding," over 1.32 million suspected minors in the 2013 calendar year.

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**AUDITOR GENERAL**

## Independent Auditor's Report

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

The Honorable Joseph E. Brion
Chairman
Pennsylvania Liquor Control Board
Harrisburg, PA 17124

### Report on the Financial Statements

We have audited the accompanying financial statements of the Pennsylvania Liquor Control Board (PLCB) - State Stores Fund, which comprise of the Statements of Net Position as of June 30, 2014 and 2013, and the related Statements of Revenues, Expenses and Changes in Net Position and Statements of Cash Flows for the years then ended, and the related notes to the financial statements; and the PLCB - Liquor License Fund, which comprise of the Statements of Fiduciary Net Position as of June 30, 2014 and 2013, and the related Statements of Changes in Fiduciary Net Position for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

***Auditor’s Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 and financial highlights are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

As discussed in Note A, the financial statements present only the PLCB and do not purport to, and do not, present fairly the financial position of the Commonwealth of Pennsylvania as of June 30, 2014 and 2013, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

***Opinion***

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 Liquor License Fund as of June 30, 2014 and 2013, 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 accordance with accounting principles generally accepted in the United States of America.

***Other Matters***

*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 7 through 11 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

*Other Information*

The Background has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated December 8, 2014, on our consideration of PLCB's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering PLCB's internal control over financial reporting and compliance.

December 8, 2014

Eugene A. DePasquale
Auditor General

# PLCB Management's Discussion and Analysis

## Agency 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 limited wineries and distilleries, are made through the Fine Wine and Good 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, supermarkets and clubs, which sell those beverages.

On November 27, 2013, House Bill No. 1098 was signed into law. The bill made changes to the Local Option Small Games of Chance Act which allows certain PLCB licensees to obtain a tavern gaming license and offer their patrons small games of chance. PLCB, in conjunction with the Gaming Control Board, review the applications and conduct background investigations as the basis for recommending action on the application by the PLCB Board of Directors.

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 Spirits 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.

# PLCB Management's Discussion and Analysis (Continued)

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 Fine Wine and Good Spirits 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 Drug & Alcohol for alcohol abuse programs, the Department of the Auditor General for auditing services, and the Office of Comptroller Operations assigned to the PLCB. Annual profit transfers are made from this fund to the General Fund.

## Discussion of Basic Financial Statements

The State Stores Fund and the Liquor License Fund are 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 audit report consists of financial statements including the Statement of Net Position; Statement of Revenues, Expenses and Changes in Net Position; and Statement of Cash Flows for the State Stores Fund as of and for the fiscal years ended June 30, 2014 and June 30, 2013; and the Liquor License Fund Statement of Fiduciary Net Position and the Statement of Changes in Fiduciary Net Position as of and for the fiscal years ended June 30, 2014 and June 30, 2013.

The Statement of Net Position provides information about assets and liabilities and reflects the financial position at the fiscal year end. The Statement of Revenues, Expenses and Changes in Net Position 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 Position provides information about assets and liabilities which reflect the position of the Liquor License Fund at the fiscal year end. The Statement of Changes in Fiduciary Net Position illustrates the net asset activities throughout the fiscal year for the Liquor License Fund. The financial statements also include Notes 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.

# PLCB Management's Discussion and Analysis (Continued)

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.

## Executive Summary & Highlights

The PLCB ended Fiscal Year 2013-14 with moderate sales growth (3.2%), higher operating expenses (5.2%), and lower operating income (-2.3%). Sales growth was attained by offering consumers a broader selection of product offerings with a more attractive mix of discounts. We let consumers know about those discounts by focusing our limited advertising resources on high-impact media in targeted markets while also growing our social media presence to communicate directly with consumers. We remain committed to opening rebranded Fine Wine & Good Spirits stores, expanding the number of stores carrying Chairman's Selection products, and continuing to focus on staff training to improve customer service by providing wine information, recommendations and guidance when needed. Operating expense growth was driven mainly by a $16.1 million (16.8%) increase in commonwealth benefit costs.

- Lower reported operating income of $148.3 million nonetheless represents a compound annual growth rate of 21.4% since fiscal year 2009-10.
- Positive operating cash flow growth enabled the PLCB to pay the 2013-14 profit transfer in March 2014.
- Year-end cash and investments increased $62.3 million to $241.2 million due to positive cash flow from operations and no increase in the general fund transfer of $80 million.
- PLCB ended fiscal year 2013-14 with a total of $452.4 million in current assets including $206.5 million in merchandise inventory. Inventory grew from the prior year by $8.7 million which was more than offset by a $19.5 million increase in trade payables.
- After payment of all operating expenses, including inter-agency transfers, transfers to the General Fund, and transfers for Drug & Alcohol Programs, PLCB's net asset position improved by $41.2 million during fiscal year 2013-14.

## Revenues and Costs

### Sales

Sales and tax revenue in fiscal year 2013-14 totaled $2.240 billion, an increase of $68.6 million or 3.2% over fiscal year 2012-13. Sales growth was driven by a 3.5% increase in wine sales, which was paced by a 5.6% increase in the Chairman's Selection product line, and by the offering of optimal selections with a more attractive mix of discounts. During the year, 26 Fine Wine & Good Spirit stores were rebranded or refurbished. In addition, PLCB trained store staff to improve customer service by providing wine information and assisting consumers with

# PLCB Management's Discussion and Analysis (Continued)

their purchases. The Chairman's Selection program has been a tremendous success for the PLCB. In the last five years, Chairman's Selection wine sales have grown at a compound rate of 10.6%. Spirit sales increased a more modest 2.9% for the year. Over two-thirds of the sales increase was driven by volume increases as unit growth for both wine and spirits was higher by 2.3%. The advertising approach featured a year-round presence, with media spots focused on the consumer.

Within the PLCB's customer base, retail sales grew 3.7% while licensee sales increased by 0.7%. Retail sales have grown to more than 79% of total stock sales. On a volume basis, wine units comprised 51.8% of units sold, the same as reported last year. Gallonage growth for wine was up 1.9% compared to 1.2% growth for spirits. Debit/credit card purchases represented 59.9% of sales, up from 58.4% last year. Average sale per debit and credit card transaction was $30.21 and $53.94, respectively, up from $30.07 and $53.24 reported last year.

**Gross Margin**

Gross margin decreased to 31.1% in fiscal year 2013-14 from 31.2% last year. The decrease is due in part to a shift in wine mix to Chairman's Selection items and increased sales of luxury and special order spirit products. Gross margin is reduced when the sales mix shifts to favor higher-priced products in which the bottle charge component of the mark-up formula is proportionally lower than in value and standard categories. In fiscal year 2013-14 the proportion of the lower - priced value and standard items fell to 51.6% of total sales mix versus 53.1% last year.

**Operating Income**

Operating income for the year ended June 30, 2014, was $148.3 million, $3.5 million or 2.3% less than $151.9 million reported last year. However, the fiscal year 2012-13 results included an $8.9 million credit to benefit expense for overcharges related to years prior to fiscal year 2012-13. Without the prior year $8.9 million credit, reported operating income in fiscal year 2013-14 would have been $5.4 million, or 3.7% higher than reported last year. Operating income also declined due in part to the small decline in gross margin. In addition, operating expenses for the year were $407.8 million, a $20.3 million or 5.2% increase over last year. The increase in PLCB operating expenses is attributable to state pension contributions, up $7.0 million or 42.9%. Like other state agencies, the PLCB faces skyrocketing pension costs due mainly to the pension plan's underfunded status. Also, debit/credit card service fees increased by $1.4 million or 6.6%, reflecting higher card usage versus other forms of tender. In addition, store rent increased by $1.7 million or 4.1% due to store build-outs associated with store rebranding and refurbishment efforts. These increases were partially offset by reduced IT expenses associated with the decision to defer several system upgrades ($4.0 million) until the next fiscal year, and lower advertising costs ($1.3 million less).

# PLCB Management's Discussion and Analysis (Continued)

## Operating Transfers Out

Pennsylvania State Police received $25.0 million, an increase of $1.0 million or 4.1% from the previous year to fund the operations of its Bureau of Liquor Control Enforcement. Over the last five years, PLCB transfers to Pennsylvania State Police have grown at a compound rate of 5.6% while enforcement fines have declined by 1.6%. Transfers to the Pennsylvania Department of Drug & Alcohol Programs decreased to $2.5 million from $2.6 million transferred last year. The Drug & Alcohol Program transfer is set by statute at 2% of profits and declined as a result of slightly lower reported net income. As directed by the Governor's Budget Office, $80 million was transferred to the General Fund in March 2014. The PLCB generated $525.8 million in contributions to the Pennsylvania Treasury; $4.5 million in license fees were returned to local municipalities; and $8.3 million in local sales tax was collected and fully remitted to Philadelphia and Allegheny counties.

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

| | Fiscal Year Ended 30-Jun-14 | Fiscal Year Ended 30-Jun-13 | Fiscal Year Ended 30-Jun-12 | Fiscal Year Ended 30-Jun-11 | Fiscal Year Ended 30-Jun-10 | CAGR * |
|---|---|---|---|---|---|---|
| Sales Net of Taxes | $ 1,786,502 | $ 1,731,463 | $ 1,657,205 | $ 1,571,223 | $ 1,511,390 | 4.3% |
| Gross Profit | $ 555,835 | $ 539,416 | $ 511,738 | $ 490,262 | $ 449,986 | 5.4% |
| Gross Margin | 31.1% | 31.2% | 30.9% | 31.2% | 29.8% | |
| Operating Expenses | $ 407,789 | $ 387,535 | $ 387,057 | $ 386,083 | $ 381,801 | 1.7% |
| Operating Income | $ 148,308 | $ 151,850 | $ 124,991 | $ 103,757 | $ 68,185 | 21.4% |
| Transfers to State Police | $ 24,958 | $ 23,984 | $ 21,738 | $ 20,308 | $ 20,085 | 5.6% |
| Drug & Alcohol Transfers | $ 2,474 | $ 2,567 | $ 2,070 | $ 1,674 | $ 1,050 | 23.9% |
| **Net Income** | **$ 123,683** | **$ 128,366** | **$ 103,494** | **$ 83,704** | **$ 49,870** | **25.5%** |
| Liquor Tax | $ 320,912 | $ 311,248 | $ 298,144 | $ 281,746 | $ 271,015 | 4.3% |
| State Sales Tax | $ 124,880 | $ 121,093 | $ 116,033 | $ 109,652 | $ 105,518 | 4.3% |
| Local Sales Tax | $ 8,270 | $ 8,143 | $ 7,835 | $ 7,386 | $ 6,567 | 5.9% |
| License Fees Returned ** | $ 4,522 | $ 4,436 | $ 4,469 | $ 4,522 | $ 4,500 | 0.1% |
| Number of Stores (not in 000) | 606 | 605 | 608 | 610 | 650 | |
| Average Sales per Store | $ 2,948 | $ 2,862 | $ 2,726 | $ 2,576 | $ 2,325 | |
| Operating Exp./Net Sales | 22.8% | 22.4% | 23.4% | 24.6% | 25.3% | |
| Contributions/Net Sales | 31.7% | 31.9% | 32.0% | 33.8% | 34.0% | |
| Return on Assets | 30.5% | 35.8% | 28.1% | 23.8% | 16.6% | |

* CAGR – Compound Annual Growth Rate

** As provided by statute, a portion of license fees are returned to municipalities. Rates have not increased since 1991.

**PENNSYLVANIA LIQUOR CONTROL BOARD**

# FINANCIAL STATEMENTS

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

| **ASSETS** | **June 30, 2014** | **June 30, 2013** |
|---|---|---|
| Current assets: | | |
| Cash | $ 30,962 | $ 18,407 |
| Temporary investments | 210,266 | 160,552 |
| Accounts and claims receivable, net | 819 | 1,013 |
| Due from other funds | 257 | 48 |
| Merchandise inventories | 206,548 | 197,827 |
| Operating supplies | 240 | 799 |
| Prepaid expenses | 3,299 | 2,782 |
| Total current assets | $ 452,391 | $ 381,428 |
| Noncurrent assets – Note D: | | |
| Non-depreciable capital assets: | | |
| Land | $ 323 | $ 323 |
| Depreciable capital assets: | | |
| Building | 19,558 | 19,620 |
| Leasehold improvements | 2,478 | 2,912 |
| Machinery and equipment | 40,384 | 39,268 |
| Intangibles | 50,742 | 59,557 |
| Less: accumulated depreciation | (78,428) | (77,268) |
| Net depreciable capital assets | $ 34,734 | $ 44,089 |
| Total noncurrent capital assets | $ 35,057 | $ 44,412 |
| Total assets | $ 487,448 | $ 425,840 |
| **LIABILITIES** | | |
| Current liabilities: | | |
| Trade accounts payable | $ 259,333 | $ 239,798 |
| Miscellaneous accounts payable | 9,985 | 18,808 |
| Accrued expenses | 17,916 | 19,170 |
| Due to other funds – Note E | 10,432 | 6,793 |
| Due to fiduciary funds | 1,777 | 1,303 |
| Due to other governments | 765 | 717 |
| Total current liabilities | $ 300,208 | $ 286,589 |
| Noncurrent liabilities: | | |
| OPEB – Note C | 63,630 | 57,379 |
| Self-Insurance – Note K | 25,969 | 25,920 |
| Compensated absences | 20,452 | 19,972 |
| Total noncurrent liabilities | $ 110,051 | $ 103,271 |
| Total liabilities | $ 410,259 | $ 389,860 |
| **NET POSITION** | | |
| Investment in capital assets, net of related debt | $ 35,057 | $ 44,412 |
| Restricted for: | | |
| State Stores Fund (Deficit) | 42,132 | (8,432) |
| Total net position | $ 77,189 | $ 35,980 |

- 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 NET POSITION**
**(EXPRESSED IN THOUSANDS)**

| | **Fiscal Year Ended June 30, 2014** | **Fiscal Year Ended June 30, 2013** |
|---|---|---|
| Sales net of taxes | $1,786,502 | $1,731,463 |
| Less: Cost of goods sold | 1,230,667 | 1,192,047 |
| Gross profit from sales | $ 555,835 | $ 539,416 |
| Less: Operating expenses: | | |
| Purchasing, storage and transportation | 16,228 | 16,287 |
| Stores' operations and supervision | 311,294 | 286,346 |
| Central administrative support | 62,669 | 68,596 |
| Comptroller operations | 4,864 | 4,889 |
| Commonwealth-provided services | 12,734 | 11,417 |
| Total | $ 407,789 | $ 387,535 |
| Operating profit from state stores | $ 148,046 | $ 151,881 |
| Other operating revenues (expenses): | | |
| Enforcement fines | 1,767 | 1,346 |
| License fees | 12,050 | 11,902 |
| Miscellaneous income | 3,048 | 2,348 |
| Administrative law judge | (2,314) | (2,122) |
| Legal | (3,247) | (2,723) |
| Licensing and investigations | (11,042) | (10,782) |
| Total | $ 262 | $ (31) |
| Total operating income | $ 148,308 | $ 151,850 |
| Nonoperating revenues (expenses): | | |
| Interest income/loss | 420 | 503 |
| Other | (87) | (3) |
| Total | $ 333 | $ 500 |
| Income before operating transfers | $ 148,641 | $ 152,350 |
| Operating transfers out: | | |
| PSP enforcement – Note I | 24,958 | 23,984 |
| Income after enforcement/before other transfers | $ 123,683 | $ 128,366 |
| Other operating transfers: | | |
| Transfers out: | | |
| General Fund – Note G | (80,000) | (80,000) |
| Drug and alcohol programs – Note H | (2,474) | (2,567) |
| Total | $ (82,474) | $ (82,567) |
| Change in net position | $ 41,209 | $ 45,799 |
| Net position – beginning | $ 35,980 | $ (9,819) |
| Total net position – ending | $ 77,189 | $ 35,980 |

- 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)**

| | Fiscal Year Ended June 30, 2014 | Fiscal Year Ended June 30, 2013 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Receipts from customers | $ 1,803,352 | $ 1,763,802 |
| Payments to suppliers | (1,630,134) | (1,557,645) |
| Net cash provided by (used for) operating activities | $ 173,218 | $ 206,157 |
| **Cash flows from noncapital financing activities:** | | |
| Operating transfers out | (107,432) | (106,550) |
| Net borrowings under advances from other funds | - | (110,000) |
| Net cash used for noncapital financing activities | $ (107,432) | $ (216,550) |
| **Cash flows from capital and related financing activities:** | | |
| Acquisition and construction of capital assets | (3,937) | (6,715) |
| Net cash used for capital and related financing activities | $ (3,937) | $ (6,715) |
| **Cash flows from investing activities:** | | |
| Purchase of investments | (1,400,225) | (1,381,078) |
| Proceeds from sale and maturities of investments | 1,350,511 | 1,384,065 |
| Investment income | 420 | 503 |
| Net cash used in investing activities | $ (49,294) | $ 3,490 |
| Net increase in cash | $ 12,555 | $ (13,618) |
| Cash – beginning of year | 18,407 | 32,025 |
| Cash – end of year | $ 30,962 | $ 18,407 |
| **Reconciliation of operating income (loss) to net cash provided by (used for) operating activities:** | | |
| Operating income | $ 148,308 | $ 151,850 |
| Depreciation | 13,205 | 15,424 |
| Change in assets and liabilities: | | |
| Accounts receivable | 194 | 16,742 |
| Inventory | (8,162) | (22,030) |
| Due from other funds | (209) | (17) |
| Other operating net assets | (517) | (330) |
| Accounts payable and accrued liabilities | 9,458 | 32,152 |
| Due to other funds | 3,639 | 203 |
| Due to pension trust funds | 474 | 354 |
| Due to other government | 48 | 159 |
| Other post-employment benefit obligations | 6,251 | 11,232 |
| Self-insurance liabilities | 49 | 197 |
| Compensated absences | 480 | 221 |
| Total adjustments | $ 24,910 | $ 54,307 |
| Net cash provided by (used for) operating activities | $ 173,218 | $ 206,157 |

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

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

| | June 30, 2014 | June 30, 2013 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash | $ 62 | $ 69 |
| Temporary investments | 2,351 | 2,292 |
| Total assets | $ 2,413 | $ 2,361 |
| **LIABILITIES** | | |
| Current liabilities: | | |
| Due to municipalities | $ 2,411 | $ 2,359 |
| Other liabilities | 2 | 2 |
| Total liabilities | $ 2,413 | $ 2,361 |

- 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 POSITION – Fiscal Year Ended June 30, 2014**
**(EXPRESSED IN THOUSANDS)**

| | Balance June 30, 2013 | Additions | Deductions | Balance June 30, 2014 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash – Note J | $ 69 | $ 9,049 | $ 9,056 | $ 62 |
| Temporary investments – Note J | 2,292 | 4,545 | 4,486 | 2,351 |
| Total assets | $ 2,361 | $ 13,594 | $ 13,542 | $ 2,413 |
| **LIABILITIES** | | | | |
| Due to municipalities – Note J | $ 2,359 | $ 4,498 | $ 4,446 | $ 2,411 |
| Other liabilities | 2 | 2 | 2 | 2 |
| Total liabilities | $ 2,361 | $ 4,500 | $ 4,448 | $ 2,413 |

- 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 POSITION – Fiscal Year Ended June 30, 2013**
**(EXPRESSED IN THOUSANDS)**

| | Balance June 30, 2012 | Additions | Deductions | Balance June 30, 2013 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash – Note J | $ 116 | $ 8,978 | $ 9,025 | $ 69 |
| Temporary investments – Note J | 2,266 | 4,417 | 4,391 | 2,292 |
| Total assets | $ 2,382 | $ 13,395 | $ 13,416 | $ 2,361 |
| **LIABILITIES** | | | | |
| Due to municipalities – Note J | $ 2,380 | $ 4,556 | $ 4,577 | $ 2,359 |
| Other liabilities | 2 | 2 | 2 | 2 |
| Total liabilities | $ 2,382 | $ 4,558 | $ 4,579 | $ 2,361 |

- 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 Store Fund and Liquor License Fund are 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.

***Cash:*** Cash includes PLCB funds held by the State Treasurer , imprest balances held at financial institutions and change used at state stores.

***Temporary Investments:*** The PLCB participates in the Pennsylvania Treasury Department's Commonwealth Investment Program (CIP) with other Commonwealth agencies. Practically all individual funds which are part of the Commonwealth are participants in the CIP. The Treasury Department accounts for each participating fund's equity (considered "shares") in the CIP 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 CIP is considered an internal investment pool. Temporary investments are reported at 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.

## NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

***Inventories:*** Inventories are stated at weighted average cost. The PLCB participates in a bailment inventory management program in which the PLCB enters into bailment agreements with certain suppliers that require the suppliers to continue to hold title to stock at PLCB warehouse facilities until it is withdrawn from bailment for shipment to PLCB stores. The bailment inventory management program significantly reduced on hand inventory valuation. 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 Position. 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 Pennsylvania 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. Taxes collected for the period July 1, 2013 to June 30, 2014 are as follows:

| | |
|---|---|
| Liquor Tax | $320,911,580 |
| State Sales Tax | 124,880,357 |
| Local Sales Tax | 8,269,803 |
| Total | $454,061,740 |

***Compensated Absences:*** Employees accumulate annual leave, depending on length of credited service, from between 2.7 percent to 10 percent of regular hours paid. Generally, 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.

## NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Employees earn sick leave based on an agreed upon percentage of regular hours paid. Generally, a maximum of 300 days may be carried forward at the end of each calendar year. Most 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 | 11 |

The accumulated annual and sick leave and related payroll benefits payable reported for the fiscal year ended June 30, 2014 and June 30, 2013 (in thousands) was $24,641 and $24,657, 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.

The following summary provides aggregated information reported on June 30, 2014 compensated absences liabilities; additions and reductions during the fiscal year ended June 30, 2014, and reported compensated absences liabilities at June 30, 2013 (amounts in thousands):

| Liability at June 30, 2013 | Additions | Reductions | Liability at June 30, 2014 |
|---|---|---|---|
| $24,657 | $16,836 | $16,852 | $24,641 |

## 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 Department's Commonwealth Investment Program's (CIP) investment pool. Treasury accounts for each participating fund's equity, or shares, in the pool on a daily basis. 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, 2014 and 2013, the fund's year-end. Shares in the CIP investment pool are reported as temporary investments.

## NOTE B – DEPOSITS AND INVESTMENTS (Continued)

The CIP 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, 2014 Basic Financial Statements included in the Commonwealth's Comprehensive Annual Financial Report.

PLCB's total deposit balance of $31,024 thousand and $18,476 thousand at June 30, 2014 and 2013, respectively, was not exposed to either custodial credit risk or foreign currency risk.

As a participant in Treasury's CIP 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 CIP 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 option adjusted duration. 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 option adjusted duration of Treasury's CIP investment pool at June 30, 2014 is approximately 0.083 years.

## 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 law.

***Retirement Benefits:*** Under the plan, for most employees hired prior to January 1, 2011, 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 highest three-year average salary multiplied by years of service. This annual benefit is 2.5 percent for Class AA members.

## NOTE C – PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

Act 2010-120 (Act 120), which preserved all benefits in place for members, mandated a number of benefit reductions for new members effective January 1, 2011. The benefit reduction included a new class of membership that accrues benefits at 2 percent of their final average salary instead of the previous 2.5 percent. The new vesting period changed from five to ten years of credited service, and the option to withdraw lump sum accumulated employee contributions was eliminated. The new normal retirement age is 65 for most employees. Act 120 created a new A-3 class of service and an optional A-4 class for most employees that entered SERS membership for the first time on or after January 1, 2011. The general annual benefit for Class A-3 members is 2 percent of the member's highest three-year average salary times years of service while the Class A-4 benefit accrual rate is 2.5 percent.

***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 at www.sers.state.pa.us. 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. The active plan member contribution rate is 6.25 percent of covered payroll for employees in Class AA; for Class A members, the contribution rate is 5 percent. The general membership contribution rate under Act 120 for A-3 and A-4 members is 6.25 percent and 9.3 percent of salary, respectively. 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.

## NOTE C – PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

During each of the three years ended December 31, the Commonwealth's annual required employer contribution and the related percentage of that amount actually contributed are as follows:

| Year Ended December 31 | Annual Required Contribution (ARC) (in thousands) | Percentage of ARC Contributed |
|---|---|---|
| 2013 | $1,314,925 | 60.2% |
| 2012 | $1,044,632 | 53.9% |
| 2011 | $ 913,778 | 42.8% |

The PLCB's pension contributions (in thousands) for the fiscal years ended June 30, 2014, and June 30, 2013, were $23,199 and $16,233, respectively.

Additional pertinent information regarding SERS, outside the scope of PLCB reporting, is published each year as part of the Commonwealth of Pennsylvania's Basic Financial Statements included in its Comprehensive Annual Financial Report.

***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, 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 it 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. During the fiscal year ended June 30, 2014, the PLCB contributed $305 for each active employee paid and reported as part of biweekly payroll expenses for its employees. For the fiscal year ended June 30, 2014, the PLCB's allocated share of the total REHP annual required contribution (ARC) of $898.33 million (for the Commonwealth's fiscal year ended June 30, 2014) was $36,036 million. The last year that was fully funded for the entire REHP ARC, for all REHP-participating organizations, was for the fiscal year ended June 30, 2008. The unfunded OPEB liability has been recorded for subsequent fiscal years. The prior year unfunded liability of $57.38 million, plus an additional increase of $6.25 million, resulted in a total unfunded liability of $63.63 million as of June 30, 2014.

## NOTE C – PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

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 its Comprehensive Annual Financial Report.

## NOTE D – CAPITAL ASSETS

Changes in capital assets for the fiscal year ended June 30, 2014 are as follows (amounts in thousands):

| | Balance June 30, 2013 | Additions | Retirements | Balance June 30, 2014 |
|---|---|---|---|---|
| Non-depreciable capital assets: | | | | |
| Land………………………….. | $ 323 | $ - | $ - | $ 323 |
| Depreciable capital assets: | | | | |
| Building……………………….. | 19,620 | - | 62 | 19,558 |
| Leasehold improvements……... | 2,912 | - | 434 | 2,478 |
| Machinery and equipment….… | 39,268 | 3,190 | 2,074 | 40,384 |
| Intangibles …………………… | 59,557 | 747 | 9,562 | 50,742 |
| Total capital assets……………. | $ 121,680 | $ 3,937 | $ 12,132 | $ 113,485 |

Changes in capital assets accumulated depreciation for the fiscal year ended June 30, 2014 are as follows (amounts in thousands):

| | Balance June 30, 2013 | Additions | Retirements | Balance June 30, 2014 |
|---|---|---|---|---|
| Buildings…………………… | $ 10,807 | $ 895 | $ 62 | $ 11,640 |
| Leasehold improvements…... | 2,387 | 163 | 348 | 2,202 |
| Machinery and equipment…. | 20,030 | 3,708 | 2,073 | 21,665 |
| Intangibles……….…………. | 44,044 | 8,439 | 9,562 | 42,921 |
| Total accumulated depreciation | $ 77,268 | $ 13,205 | $ 12,045 | $ 78,428 |

## NOTE E – DUE TO OTHER FUNDS

At June 30, 2014 and June 30, 2013, a total (in thousands) of $10,432 and $6,793, respectively, was due to other funds. This total was due to various funds.

## NOTE F – LEASE COMMITMENTS

The PLCB, through the Pennsylvania Department of General Services, has operating leases covering all of its Fine Wine and Good Spirits store locations and some equipment. The leases generally provide for an initial term of three to ten years. Most leases have options for renewal. For leases not renewed, but not terminated, the lease will continue as a renewal in 90 day increments into the future. For such leases, only 90 days of future rental commitments are included in the rental commitment schedule below.

Rental expenses (in thousands), for the fiscal year ended June 30, 2014 and June 30, 2013 were $43,522 and $41,767, respectively.

The following is a schedule of future minimum rental commitments for noncancelable operating leases in effect as of June 30, 2014, (expressed in thousands):

| Fiscal Year Ended June | Fine Wine and Good Spirits Store Leases |
|---|---|
| 2015 | $ 36,149 |
| 2016 | 26,157 |
| 2017 | 18,289 |
| 2018 | 13,222 |
| 2019 | 9,311 |
| Total Minimum Lease Payments: | $103,128 |

## NOTE G – 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 transfers were $80 million for each of the fiscal years ended June 30, 2014 and June 30, 2013.

## NOTE H – OPERATING TRANSFER FOR DRUG AND ALCOHOL PROGRAMS

Per Act 1987-14, two percent of the PLCB's profits from the sale of alcohol shall be transferred to the Pennsylvania Department of Drug and Alcohol for drug and alcohol rehabilitation programs. The PLCB establishes a liability for the amount due and transfers the payment in the

## NOTE H – OPERATING TRANSFER FOR DRUG AND ALCOHOL PROGRAMS (Continued)

subsequent fiscal year. The amounts of the liability established to the Department of Drug and Alcohol for the fiscal years ended June 30, 2014 and June 30, 2013 (in thousands) were $2,474 and $2,567, respectively.

## NOTE I – 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 transfers (in thousands) were $24,958 and $23,984 for the fiscal years ended June 30, 2014 and June 30, 2013, respectively.

## NOTE J – STATEMENT OF CHANGES IN FIDUCIARY NET POSITION

The Statement of Changes in Fiduciary Net Position 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 K – SELF-INSURANCE LIABILITIES

The Commonwealth is self-insured for statutory workers' compensation, which includes indemnity and medical benefits (employee disability) 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 $500 million per occurrence. The Commonwealth has established various administrative policies, which are intended to avoid or limit the aforementioned risks. There was no reduction in commercial insurance coverage during the fiscal year ended June 30, 2014. No settlements exceeded commercial insurance coverage during each of the past three fiscal years.

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, annuitant medical/hospital and tort claims are established 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, 2014 and June 30, 2013, respectively, the State Stores Fund reported (in thousands) a $30,565 liability ($4,596 as current and $25,969 as non-current) and $30,918 liability ($4,998 as current and $25,920 as non-current) for employee disability claims.

The following summary provides aggregated information on June 30, 2013 reported self-insurance liabilities; incurred claims and payments during the fiscal year ended June 30, 2014 and reported self-insurance liabilities at June 30, 2014 (amounts in thousands):

| | June 30, 2013 Liability | Incurred Claims | Payments | June 30, 2014 Liability |
|---|---|---|---|---|
| Employee Disability | $30,918 | $6,070 | $6,423 | $30,565 |

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EUGENE A. DEPASQUALE
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***

Independent Auditor's Report

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

The Honorable Joseph E. Brion
Chairman
Pennsylvania Liquor Control Board
Harrisburg, PA 17124

We have audited, 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, the accompanying Statements of Net Position, Statements of Revenues, Expenses and Changes in Net Position, and Statements of Cash Flows for the State Stores Fund, and the Statements of Fiduciary Net Position and Statements of Changes in Fiduciary Net Position for the Liquor License Fund of the Pennsylvania Liquor Control Board (PLCB) as of and for the years ended June 30, 2014 and 2013, and the related notes to the financial statements and have issued our report thereon dated December 8, 2014.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered PLCB's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of PLCB's internal control.

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 and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that is there is a reasonable possibility that a material misstatement of the PLCB's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weakness or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, described in the accompanying Finding Section as Finding No. 1 and Finding No. 2, that we consider to be significant deficiencies.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the PLCB's financial statements are free from 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 Response to the Findings**

PLCB's response to the findings identified in our audit is described in the accompanying Finding Section. PLCB's response was not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on it.

**Purpose of This Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of PLCB's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering PLCB's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Eugene A. DePasquale

December 8, 2014

Eugene A. DePasquale
Auditor General

**Finding No. 1 – 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 fiscal year ended June 30, 2014, disclosed the following internal control deficiencies that need to be addressed by PLCB management:

1. Management partially remediated a prior year weakness by reducing the number of users, including contractors, with administrator and/or privileged access (i.e., the ability to add, change or delete user IDs, edit data directly, or make configuration changes) in the Information Business Management System (IBMS). However, management indicated that access for additional users still needed to be revoked from the Point of Service (POS) module of IBMS as of June 30, 2014.

**Agency Response:** Agree

2. Management partially remediated a prior year weakness whereby PLCB management had not formally released a policy to comply with Information Technology Policy, ITP-APP012, "Systems Development Life Cycle (SDLC) Policy", to establish requirements for planning, designing, developing, testing, approving, and implementing new applications and upgrades to existing applications, including vendor-developed software. In June of 2014, PLCB management developed a draft SDLC policy.

**Agency Response:** Agree. However the policy was completed in August 2014.

3. Robocom Inventory Management System (RIMS), warehouse inventory management software, was producing inaccurate Quarterly Cycle Count Reports during the audit period.

**Agency Response:** Agree. However, Robo Com remediated the issue as of October 2014.

4. The Office of Administration and Office of Budget issued Management Directive 205.43, “Quality Assurance for Business Productivity Tools” in November 2013 remediating a prior year weakness regarding the lack of an end user computing policy.

**Agency Response:** Agree. Has been remediated.

**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. Also, a well defined SDLC policy ensures that new applications and upgrades to existing applications are developed in accordance with stated requirements, work effectively and accurately, are cost-effective, and are maintainable.

**Cause:** PLCB has developed new policies and procedures for assigning access rights and user roles to PLCB systems based on the principle of least privilege needed to perform authorized tasks, which enforces segregation of duties and restricts access to key system functions. However, an error in processing the removal of several administrative accounts occurred which reverted inactive accounts back to an active state.

PLCB took steps to develop a written SDLC policy in order to comply with the Office of Administration's ITP-APP012, issued May 1, 2013. The draft policy, dated June 3, 2014, was not finalized as of the end of the audit period.

The Quarterly Cycle Count Reports were inaccurate apparently due to the lack of a SDLC, including a lack of necessary testing and program change controls when the reports were migrated to production four years ago. Management did not test the accuracy of the reports before using them to identify inventory to count in the warehouses. The report errors were not identified until internal audit reviewed the reports in the current audit period. An earlier development and implementation of SDLC policy may have prevented the use of the inaccurate Quarterly Cycle Count Reports.

**Effect:** If general computer control areas are not improved, agency operations may not be conducted in accordance with PLCB management's intent. Unnecessary privileged access to PLCB systems may enable individuals to perform actions not consistent with their job responsibilities, create segregation of duties issues, and increase the likelihood of accidents, errors, or unauthorized use. Due to the errors in the Quarterly Cycle Count Reports, not all warehouse inventory was subjected to physical counts, and additional procedures were required by internal audit to verify the inventory that had not been counted during the regular cycles.

Collectively, we consider the above exceptions to be a significant deficiency under generally accepted auditing standards. The auditing standards define a significant deficiency as a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

**Recommendation:** We recommend that PLCB management review the general computer control deficiencies noted above and take the necessary actions to resolve them.

**Auditors' Conclusion:** Based on the agency responses, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

## Finding No. 2 – Internal Control Weaknesses Over Financial Reporting for Capital Assets (A Similar Condition Was Noted in Prior Year Finding No. 2)

**Condition:** PLCB utilizes the capital asset ledger to record all capital assets and related depreciation. Based on our testing of PLCB's capital asset ledger, we found that PLCB did not properly account for capital assets reported in the fiscal year ended June 30, 2014 Statement of Net Position.

We selected a sample of fully and not fully depreciated capital assets from PLCB's capital asset ledger to verify that assets were still in use by PLCB. Of our sample of 25 assets, we found that two fully depreciated assets were for costs related to the Oracle ERP implementation and recorded as intangible assets. Our analysis of the capital assets ledger identified multiple other ERP assets that were placed in service around the same time period. As a result, we had PLCB evaluate other ERP related assets to determine if they should be retired. PLCB identified a total of 27 assets, including our two test items, totaling $24.6 million that should have been retired as of June 30, 2014. However, PLCB did not retire these assets until October 31, 2014. Therefore, it appears that there are weaknesses in PLCB's tracking of assets to ensure that ERP implementation assets that have reached the end of their service life and are fully depreciated are removed from the capital assets ledger.

**Criteria:** Effective internal controls are necessary to ensure that amounts reported in PLCB's financial statements are accurately reported. Adequate procedures, to include periodic reviews of assets, must be in place to ensure that intangible assets that have reached the end of their service life and fully depreciated are properly retired and removed from the capital asset ledger.

**Cause:** During our audit period, PLCB did not have a policy in place to perform periodic monitoring of ERP implementation asset costs approaching the end of the service life to ensure all capital assets are in use and accurately reported. According to PLCB and Comptroller Operations management, in order to correct this weakness going forward, Comptroller Operations plans to run a monthly report listing fully depreciated assets and will forward this report to PLCB management for validation and approval to retire the assets.

**Effect:** Failure to identify and retire capital assets related to ERP implementation that are fully depreciated resulted in capital assets and accumulated depreciation balances to be overstated by $24.6 million in PLCB's fiscal year ended June 30, 2014 Statement of Net Position. An auditor adjustment was proposed to correct capital assets and accumulated depreciation balances but was not posted by PLCB in the fiscal year ended June 30, 2014 financial statements. Without the implementation of adequate control procedures misstatements in the financial statements will occur and go undetected in future periods.

**Recommendation:** We recommend that PLCB develop a policy and perform periodic monitoring of ERP implementation asset costs approaching the end of their service life to ensure all capital assets are in use and accurately reported.

**Agency Response:** The agency did have a policy in place during the audit period to periodically review fixed assets for fully depreciated status. It simply had not been completed. It took longer than anticipated to survey 600+ stores and wrap up the initial review of fixed assets.

**Auditors' Conclusion:** We acknowledge that PLCB did have policy in place during the audit period for general review of fixed assets including review of assets at the warehouses and stores; however, we did not find policy regarding a periodic review of ERP intangible assets that have reached the end of their service life and are fully depreciated to remove them from the capital assets ledger. PLCB and Comptroller management stated that in order to correct this weakness going forward, Comptroller Operations plans to run a monthly report listing fully depreciated assets and will forward this report to PLCB management for validation and approval to retire the assets. We recommend that this plan be put into policy and implemented to ensure all capital assets, including intangible assets, are correctly reported.

**COMMONWEALTH OF PENNSYLVANIA**
**PENNSYLVANIA LIQUOR CONTROL BOARD**
**JUNE 30, 2014**
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