COMMONWEALTH OF PENNSYLVANIA

PENNSYLVANIA LIQUOR CONTROL BOARD
AUDIT REPORT

HARRISBURG, PENNSYLVANIA

STATE STORES FUND
LIQUOR LICENSE FUND

FOR THE FISCAL YEARS ENDED JUNE 30, 2013 AND 2012

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EUGENE DEPASQUALE • AUDITOR GENERAL •

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 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 (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.

BACKGROUND (Continued)

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 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 605 Pennsylvania wine and spirits stores with gross annual sales of over $2.17 billion USD for Fiscal Year 2012-2013. As of June 30, 2013, 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 2012-2013, PLCB employees handled almost 16 million cases of product and sold more than 147 million bottles of wine and spirits.

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 605 stores, which are leased from private landlords, infusing approximately $41 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 $41.4 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 2012-2013, the PLCB transferred nearly $24 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 Fiscal Year 2012-2013.

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EUGENE A. DEPASQUALE
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, 2013 and 2012, and the related Statements of Revenues, Expenses and Changes in Net Position and Statements of Cash Flows for the years then ended; and the PLCB - Liquor License Fund, which comprise of the Statements of Fiduciary Net Position as of June 30, 2013 and 2012, 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, 2013 and 2012, 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, 2013 and 2012, 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 12 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 5, 2013, 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.

Eugene A. DePasquale

December 5, 2013 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.

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.

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. Expenses 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

PLCB Management's Discussion and Analysis (Continued)

Pennsylvania State Police for enforcement of the Liquor Code, the Department of Health 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, 2013 and June 30, 2012; 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, 2013 and June 30, 2012.

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 reflects 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.

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.

PLCB Management's Discussion and Analysis (Continued)

Executive Summary & Highlights

The PLCB ended fiscal year 2012-13 with moderate growth in sales and gross margin. We attained that growth 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 our consumers. We continue to open new rebranded Fine Wine & Good Spirits Premium Collection stores which offer consumers a much warmer, more inviting environment to shop. In all of our new and remodeled Fine Wine & Good Spirits stores, we have utilized end caps to feature sale items and Chairman's Selection® products and we expanded the number of stores carrying Chairman's Selection® products as well. Further, the agency has continued to focus on staff training to improve customer service by providing wine information and recommendations for consumers needing assistance. For instance, we added at least one wine specialist to most of our Premium Collection stores to answer consumer wine pairing questions, provide product knowledge and help to educate other staff members. As a result, the average price per bottle is up and so is the basket size.

Despite Commonwealth negotiated increases in salary and benefit costs, operating expenses were basically flat with the prior year. Sales and margin growth coupled with operating expense controls enabled the agency to deliver the best year in its 79-year history.

- PLCB delivered operating income of $151.9 million which represents a compound annual growth rate of 10.1% since fiscal year 2008-09.
- Operating margin increased to 8.8% versus 7.5% last year.
- Year-end cash and investments decreased $16.6 million to $179.0 million due to the loan payoff, offset by positive cash flow from operations and no increase in the General Fund transfer of $80 million.
- PLCB ended fiscal year 2012-13 with a total of $381.4 million in current assets including $197.8 million in merchandise inventory. Inventory grew from the prior year by $22.2 million which was more than offset by a $26.0 million increase in trade payables.
- Positive operating cash flow growth enabled the PLCB to repay and not renew a $110.0 million working capital loan from the State Treasury.
- After payment of all operating expenses, loans, transfers to the General Fund and transfers for Drug & Alcohol Programs, PLCB's net position improved by $45.8 million during fiscal year 2012-13.

PLCB Management's Discussion and Analysis (Continued)

Revenues and Costs

Sales

Sales and tax revenue in fiscal year 2012-13 totaled $2.172 billion, an increase of $92.7 million or 4.5% over fiscal year 2011-12. Sales growth was driven by a 5.7% increase in wine sales, particularly in the Chairman's Selection® product line and by offering consumers a broader selection of product offerings with a more attractive mix of discounts. PLCB has trained store staff to improve customer service by providing wine information and by assisting consumers with their purchases. Chairman's Selection® program has been a tremendous success for the PLCB. Since 2006, PLCB wine sales have grown at a compounded rate of 6%, almost twice the national growth rate. Spirit sales increased a more modest 3.2% for the fiscal year 2012-13. The sales increase was due mainly to pass through of vendor price increases (PLCB fixed mark-up did not change) as spirit unit sales were up only 0.1%. PLCB advertising approach featured a year round presence with media spots focused on the consumer.

Within the PLCB's customer base, retail sales grew 5.1%, while licensee sales increased by 1.4%, as retail sales have grown to 78% of total stock sales. On a volume basis, wine units comprise an increasing proportion of our volume – 51.8% versus 51.5% last year. Gallonage growth versus last year for wine was up 2.3% compared to 0.8% growth for spirits. Debit/credit card purchases represented 58.4% of sales up from 56.0% last year. Average sale per debit and credit card transaction was $30.07 and $53.24, respectively.

Gross Margin

Gross margin increased to 31.2% in 2012-13 from 30.9% last year. The increase is due in part to increases in the volume of vendor promotion allowances, and PLCB buy-ins in advance of vendor price increases. Gross margin also benefitted by a slight sales mix shift in spirits to lower priced products which, because of the bottle charge component of the mark-up formula, carry higher net gross margin than more expensive brands.

Operating Income

PLCB has controlled all aspects of operating expense as demonstrated by the 0.1% increase from last year. For the year ended June 30, 2013, PLCB was able to leverage the sales and margin growth and expense control into a 21.5% increase in operating income - $151.9 million vs. $125.0 million last year. Since 2008-09, PLCB has grown its operating income by a compounded 10.1% without the benefit of retail product mark-up increases.

PLCB Management's Discussion and Analysis (Continued)

PLCB operating expenses including Comptroller expenses increased to $387.5 million versus $387.1 million last year and decreased as a percent of sales to 22.4% of sales from 23.4% in 2011-12. Part of the favorable comparison is attributable to a $2.5 million inventory write-off included in expense last year. Personnel costs which are two-thirds of PLCB operating expenses, decreased slightly due to reduced overtime and to a one-time credit to correct for prior years' overcharges to the agency for part-time employee benefit costs. The correction more than offset benefit increases for pensions as well as higher current and retiree health care costs. Other major operating expenses include $27.2 million of IT-related expenses, up 6.9% from last year and credit card service fees of $21.5 million, up 1.4% due to higher card usage, partially offset by lower rates. Store rent of $40.4 million increased 4.3% from last year reflecting store build-outs associated with store re-branding and refurbishment efforts.

Operating Transfers Out

Pennsylvania State Police received $24.0 million, an increase of $2.2 million or 10.3% from the previous year to fund the operations of its Bureau of Liquor Control Enforcement. Transfer for Drug & Alcohol Programs increased to $2.6 million, $0.5 million or 24.0% more than last year. As directed by the Governor's Budget Office, $80.0 million was transferred to the General Fund and a $110.0 million dollar working capital loan from the State Treasury was paid by PLCB and not renewed. Excluding the loan repayment and after covering all operating expenses, the LCB generated $512.3 million in contribution to the state treasury, $4.4 million in license fees were returned to local municipalities, and $8.1 million in local sales tax was collected and fully remitted to Philadelphia and Allegheny counties.

PLCB Management's Discussion and Analysis (Continued)

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

	Fiscal Year Ended 30-Jun-13	Fiscal Year Ended 30-Jun-12	Fiscal Year Ended 30-Jun-11	Fiscal Year Ended 30-Jun-10	Fiscal Year Ended 30-Jun-09	CAGR *
Sales Net of Taxes	$ 1,731,463	$ 1,657,205	$ 1,571,223	$ 1,511,390	$ 1,491,738	3.8%
Gross Profit	$ 539,416	$ 511,738	$ 490,262	$ 449,986	$ 475,192	3.2%
Gross Margin	31.2%	30.9%	31.2%	29.8%	31.9%	
Operating Expenses	$ 387,535	$ 387,057	$ 386,083	$ 381,801	$ 371,738	1.0%
Operating Income	$ 151,850	$ 124,991	$ 103,757	$ 68,185	$ 103,454	10.1%
Transfers to State Police	$ 23,984	$ 21,738	$ 20,308	$ 20,085	$ 20,178	4.4%
Drug & Alcohol Transfers	$ 2,567	$ 2,070	$ 1,674	$ 1,050	$ 1,781	9.6%
Net Income	**$ 128,366**	**$ 103,494**	**$ 83,704**	**$ 49,870**	**$ 68,852**	**16.9%**
Liquor Tax	$ 311,248	$ 298,144	$ 281,746	$ 271,015	$ 266,332	4.0%
State Sales Tax	$ 121,093	$ 116,033	$ 109,652	$ 105,518	$ 104,759	3.7%
Local Sales Tax	$ 8,143	$ 7,835	$ 7,386	$ 6,567	$ 4,732	14.5%
License Fees Returned **	$ 4,436	$ 4,469	$ 4,522	$ 4,500	$ 4,555	-0.7%
Number of Stores	605	608	610	650	621	
Average Sales per Store	$ 2,862	$ 2,726	$ 2,576	$ 2,325	$ 2,402	
Operating Exp./Net Sales	22.4%	23.4%	24.6%	25.3%	24.9%	
Contributions/Net Sales	31.9%	32.0%	33.8%	34.0%	35.3%	
Return on Assets	35.8%	28.1%	23.8%	16.6%	22.5%	

* 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, 2013**	**June 30, 2012**
Current assets:		
Cash	$ 18,407	$ 32,025
Temporary investments	160,552	163,539
Accounts and claims receivable, net	1,013	17,755
Due from other funds	48	31
Merchandise inventories	197,827	175,659
Operating supplies	799	937
Prepaid expenses	2,782	2,452
Total current assets	$ 381,428	$ 392,398
Noncurrent assets-Note D:		
Non-depreciable capital assets:		
Land	$ 323	$ 323
Depreciable capital assets:		
Building	19,620	19,738
Leasehold improvements	2,912	3,096
Machinery and equipment	39,268	39,706
Intangibles	59,557	54,456
Less: accumulated depreciation	(77,268)	(64,194)
Net depreciable capital assets	$ 44,089	$ 52,802
Total noncurrent capital assets	$ 44,412	$ 53,125
Total assets	$ 425,840	$ 445,523
LIABILITIES		
Current liabilities:		
Trade accounts payable	$ 239,798	$ 213,774
Miscellaneous accounts payable	18,808	11,647
Accrued expenses	19,170	20,203
Due to other funds – Note E	6,793	6,590
Due to pension trust funds	1,303	949
Due to other governments	717	558
Advances from the General Fund-Note F	-	110,000
Total current liabilities	$ 286,589	$ 363,721
Noncurrent liabilities:		
OPEB – Note C	57,379	46,147
Self-Insurance – Note M	25,920	25,723
Compensated absences	19,972	19,751
Total noncurrent liabilities	$ 103,271	$ 91,621
Total liabilities	$ 389,860	$ 455,342
NET POSITION		
Net investment in capital assets	$ 44,412	$ 53,125
Deficit	(8,432)	(62,944)
Total net position	$ 35,980	$ (9,819)

- 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, 2013	Fiscal Year Ended June 30, 2012
Sales net of taxes	$1,731,463	$1,657,205
Less: Cost of goods sold	1,192,047	1,145,467
Gross profit from sales	$ 539,416	$ 511,738
Less: Operating expenses:		
Purchasing, storage and transportation	16,287	17,126
Stores' operations and supervision	286,346	284,103
Central administrative support	68,596	69,366
Comptroller operations	4,889	5,318
Commonwealth-provided services	11,417	11,144
Total	$ 387,535	$ 387,057
Operating profit from state stores	$ 151,881	$ 124,681
Other operating revenues (expenses):		
Enforcement fines	1,346	1,492
License fees	11,902	11,529
Miscellaneous income	2,348	2,801
Administrative law judge	(2,122)	(2,086)
Legal	(2,723)	(2,948)
Licensing and investigations	(10,782)	(10,478)
Total	$ (31)	$ 310
Total operating income	$ 151,850	$ 124,991
Nonoperating revenues (expenses):		
Interest income/loss	503	249
Other	(3)	(8)
Total	$ 500	$ 241
Income before operating transfers	$ 152,350	$ 125,232
Operating transfers out:		
PSP enforcement – Note J	23,984	21,738
Income after enforcement/before other transfers	$ 128,366	$ 103,494
Other operating transfers:		
Transfers out:		
General Fund – Note H	(80,000)	(80,000)
Drug and alcohol programs – Note I	(2,567)	(2,070)
Total	$ (82,567)	$ (82,070)
Change in net position	$ 45,799	$ 21,424
Net position – beginning	$ (9,819)	$ (31,243)
Total net position – ending	$ 35,980	$ (9,819)

- 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, 2013	Fiscal Year Ended June 30, 2012
Cash flows from operating activities:		
Receipts from customers	$ 1,763,802	$ 1,656,434
Payments to suppliers	(1,557,645)	(1,457,648)
Net cash provided by (used for) operating activities	$ 206,157	$ 198,786
Cash flows from noncapital financing activities:		
Operating transfers out	(106,550)	(103,808)
Net borrowings under advances from other funds	(110,000)	-
Net cash used for noncapital financing activities	$ (216,550)	$ (103,808)
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(6,715)	(7,879)
Net cash used for capital and related financing activities	$ (6,715)	$ (7,879)
Cash flows from investing activities:		
Purchase of investments	(1,381,078)	(1,234,738)
Proceeds from sale and maturities of investments	1,384,065	1,163,584
Investment income	503	249
Net cash used in investing activities	$ 3,490	$ (70,905)
Net increase in cash	$ (13,618)	$ 16,194
Cash – beginning of year	32,025	15,831
Cash – end of year	$ 18,407	$ 32,025
Reconciliation of operating income (loss) to net cash provided by (used for) operating activities:		
Operating income	$ 151,850	$ 124,991
Depreciation	15,424	14,927
Change in assets and liabilities:		
Accounts receivable	16,742	(16,587)
Inventory	(22,030)	89,264
Due from other funds	(17)	(6)
Other operating net assets	(330)	(116)
Accounts payable and accrued liabilities	32,152	(22,949)
Due to other funds	203	(1,611)
Due to pension trust funds	354	367
Due to other governments	159	(43)
Other post-employment benefit obligations	11,232	10,123
Self-insurance liabilities	197	(361)
Compensated absences	221	787
Total adjustments	$ 54,307	$ 73,795
Net cash provided by (used for) operating activities	$ 206,157	$ 198,786

- 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, 2013	June 30, 2012
ASSETS		
Current assets:		
Cash – Note L	$ 69	$ 116
Temporary investments – Note L	2,292	2,266
Total assets	$ 2,361	$ 2,382
LIABILITIES		
Current liabilities:		
Due to municipalities – Note L	$ 2,359	$ 2,380
Other liabilities	2	2
Total liabilities	$ 2,361	$ 2,382

- 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, 2011	Additions	Deductions	Balance June 30, 2012
ASSETS				
Cash – Note L	$ 116	$ 8,978	$ 9,025	$ 69
Temporary investments – Note L	2,266	4,417	4,391	2,292
Total assets	$ 2,382	$ 13,395	$ 13,416	$ 2,361
LIABILITIES				
Due to municipalities – Note L	$ 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. -

PENNSYLVANIA LIQUOR CONTROL BOARD
LIQUOR LICENSE FUND
STATEMENT OF CHANGES IN FIDUCIARY NET POSITION – Fiscal Year Ended June 30, 2012
(EXPRESSED IN THOUSANDS)

	Balance June 30, 2011	Additions	Deductions	Balance June 30, 2012
ASSETS				
Cash – Note L	$ 82	$ 9,188	$ 9,154	$ 116
Temporary investments – Note L	2,571	4,283	4,588	2,266
Total assets	$ 2,653	$ 13,471	$ 13,742	$ 2,382
LIABILITIES				
Due to municipalities – Note L	$ 2,651	$ 4,600	$ 4,871	$ 2,380
Other liabilities	2	2	2	2
Total liabilities	$ 2,653	$ 4,602	$ 4,873	$ 2,382

- 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 U.S. 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 at the Treasury Department, imprest balances held at financial institutions and change used at state stores.

Temporary Investments: The PLCB participates in the 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.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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: Inventories are stated at weighted average cost. In January 2012, the PLCB implemented a bailment inventory management program. PLCB began entering 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. 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 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, 2012 to June 30, 2013 are as follows:

Liquor Tax	$311,247,792
State Sales Tax	121,092,901
Local Sales Tax	8,142,691
Total	$440,483,384

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Compensated Absences: Employees earn 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.

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, 2013 and June 30, 2012 (in thousands) was $24,657 and $24,383, 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, 2013 compensated absences liabilities; additions and reductions during the fiscal year ended June 30, 2013, and reported compensated absences liabilities at June 30, 2012 (amounts in thousands):

June 30, 2012 Liability	Additions	Reductions	June 30, 2013 Liability
$24,383	$16,214	$15,940	$24,657

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 PLCB 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

NOTE B – DEPOSITS AND INVESTMENTS (Continued)

year, based on the timing of cash receipts and disbursements. PLCB has reported the fair value of its shares as of June 30, 2013 and 2012, the fund's year-end. Shares in the CIP investment pool are reported as temporary investments.

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. Treasury's pooled deposits and investments are included in the disclosures in the Commonwealth of Pennsylvania's June 30, 2013 Comprehensive Annual Financial Report.

PLCB's total deposit balance of $18,476 thousand and $32,141 thousand at June 30, 2013 and 2012, 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, 2013 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 laws.

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

NOTE C – PENSION AND OTHER POSTEMPLOYMENT BENEFITS (Continued)

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.

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 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
2012	$1,044,632	53.9%
2011	$ 913,778	42.8%
2010	$ 866,822	31.4%

The PLCB's contributions (in thousands) for the fiscal years ended June 30, 2013 and June 30, 2012, were $16,233 and $10,998, 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 the 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, 2013, the PLCB contributed $265 for each active employee paid and reported as part of biweekly payroll expenses for its employees. For the fiscal year ended June 30, 2013, the PLCB's allocated share of the total REHP annual required contribution (ARC) of $869.14 million (for the Commonwealth's fiscal year ended June 30, 2013) was $34,863 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 $46.15 million, plus an additional increase of $11.23 million, resulted in a total unfunded liability of $57.38 million as of June 30, 2013.

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 June 30, 2013 Comprehensive Annual Financial Report.

NOTE D – CAPITAL ASSETS

Changes in capital assets for the fiscal year ended June 30, 2013 are as follows (amounts in thousands):

	Balance June 30, 2012	Additions	Retirements	Balance June 30, 2013
Non-depreciable capital assets:				
Land…………………………..	$ 323	$ -	$ -	$ 323
Depreciable capital assets:				
Building………………………..	19,738	(118)	-	19,620
Leasehold improvements……...	3,096	46	230	2,912
Machinery and equipment…..…	39,706	1,688	2,126	39,268
Intangibles ……………………	54,456	5,101	-	59,557
Total capital assets…………….	$ 117,319	$ 6,717	$ 2,356	$ 121,680

The PLCB has capitalized $5,101 (in thousands) of its Enterprise Resource Planning Project costs for the fiscal year ended June 30, 2013.

Changes in capital assets accumulated depreciation for the fiscal year ended June 30, 2013 are as follows (amounts in thousands):

	Balance June 30, 2012	Additions	Retirements	Balance June 30, 2013
Buildings……………………	$ 9,931	$ 876	$ -	$ 10,807
Leasehold improvements…...	2,437	180	230	2,387
Machinery and equipment….	18,346	3,807	2,123	20,030
Intangibles……….………….	33,480	10,564	-	44,044
Total accumulated depreciation	$ 64,194	$ 15,427	$ 2,353	$ 77,268

Depreciation and amortization expenses related to capital assets for the fiscal year ended June 30, 2013 amounted to $15,427 thousand.

NOTE E – DUE TO OTHER FUNDS

At June 30, 2013 and June 30, 2012, a total (in thousands) of $6,793 and $6,590, respectively, was due to other funds. This total was due to various funds.

NOTE F – ADVANCES FROM THE GENERAL FUND

The PLCB loan from the General Fund in the amount of $110,000 (in thousands) for working capital purposes, which was classified at June 30, 2012 as an advance from the General Fund was paid back in February 2013.

NOTE G – LEASE COMMITMENTS

The PLCB, through the 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, 2013 and June 30, 2012 were $41,767 and $40,103, respectively.

The following is a schedule of future minimum rental commitments for noncancelable operating leases in effect as of June 30, 2013, (expressed in thousands):

Fiscal Year Ended June	Fine Wine and Good Spirits Store Leases
2014	$32,912
2015	24,834
2016	16,743
2017	9,648
2018	5,370
Total Minimum Lease Payments:	$89,507

NOTE H – OPERATING TRANSFERS TO THE 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 $80,000 and $80,000 (in thousands) for the fiscal years ended June 30, 2013 and June 30, 2012, respectively.

NOTE I – 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 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, 2013 and June 30, 2012 (in thousands) was $2,567 and $2,070, 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 transfers (in thousands) were $23,984 and $21,738 for the fiscal years ended June 30, 2013 and June 30, 2012, 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 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.

NOTE L – STATEMENT OF CHANGES IN FIDUCIARY NET POSITION (Continued)

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, which includes indemnity and medical payments (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. There was no reduction in commercial insurance coverage during the fiscal year ended June 30, 2013. 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 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, 2013 and June 30, 2012, respectively, the State Stores Fund reported a $30,918 thousand liability ($4,998 thousand as current and $25,920 thousand as non-current) and $30,517 thousand liability ($4,794 thousand as current and $25,723 thousand as non-current) for employee disability claims.

The following summary provides aggregated information on June 30, 2012 reported self-insurance liabilities; incurred claims and payments during the fiscal year ended June 30, 2013 and reported self-insurance liabilities at June 30, 2013 (amounts in thousands):

	June 30, 2012 Liability	Incurred Claims	Payments	June 30, 2013 Liability
Employee Disability	$30,517	$4,618	$4,217	$30,918

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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, 2013 and 2012, and the related notes to the financial statements and have issued our report thereon dated December 5, 2013.

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, Finding No. 2, and Finding No. 3, 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 5, 2013 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)

<u>Condition</u>: Our review of general computer controls at PLCB during the 2012-2013 fiscal years disclosed the following internal control deficiencies that need to be addressed by PLCB management:

<u>Information Business Management System (IBMS) – formerly known as Oracle</u>

1. Management remediated a prior year weakness whereby changes to IBMS were deployed using group user IDs that did not identify personnel performing tasks. Additionally, the password for these accounts could not be changed, and user activity was not tracked or logged. Corrective action was implemented in February 2013.

2. Management partially remediated a prior year weakness by reducing the number of users, including contractors, with privileged access in IBMS (i.e., the ability to add, change or delete user IDs, edit data directly, or make configuration changes); however, management indicated that privileged access for additional users still needed to be revoked as of June 30, 2013. Management indicated that policy for granting access to PLCB systems needs to be developed to define which groups should have privileged access and for what purpose. Further, although management indicated they have the ability to monitor the actions of privileged users, there are no formal policies or procedures in place for this purpose.

   <u>Agency Response</u>:

   a. On May 30, 2013, at the end of the Warranty period for the IBMS upgrade project, the change request was sent to DPH requesting privileged access be revoked for the additional users and contractors. DPH completed the changed request. Corrective action was implemented in June 2013.
   b. Policy was created to grant access to PLCB systems. It defines which groups should have privileged access and for what purpose. Corrective action was implemented in June 2013.
   c. Policy for monitoring actions of priviledged users will be developed.

3. Management remediated a prior year finding whereby individuals accessing the IBMS Retail Management System (RMS) could not change their own passwords. Corrective action was implemented in February 2013.

Warehouse Management System

4. User access violations in the warehouse management system are not monitored.

   Agency Response: True, this is a third-party proprietary system that does not log this information.

Multiple Environments

5. Although PLCB follows Department of General Services' policies for acquisition of new systems, there is no systems development life cycle established to outline requirements for planning, designing, developing, testing, approving, and implementing new applications and upgrades to existing applications, including vendor-developed software.

   Agency Response: OA's ITB requiring this was published on May 1, 2013. Policy will be developed and completed by fiscal year end 2014.

6. Management partially remediated a prior year weakness whereby user accounts for the IBMS and the warehouse management applications were not required to comply with Information Technology Bulletin (ITB)-SEC007, "Minimum Standards for User IDs and Passwords". Management implemented password complexity requirements for IBMS as part of the Oracle upgrade in February 2013. Also, management sought a waiver from the policy for the warehouse management system; the waiver was granted by the Office of Administration after the audit period in August 2013.

   Agency Response:

   a. Corrective action for password complexity requirements for IBMS was implemented in February 2013.
   b. Corrective action for password complexity requirements for the warehouse management systems was addressed with a waiver reviewed, analyzed and granted by the Office of Administration in August 2013.

7. There is no formal methodology or written policies regarding end-user computing.

   Agency Response:

   a. Policy will be developed pursuant to policy guidance from the Office of Administration. Anticipated completion date end of fiscal year 2014.

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: An upgrade to the IBMS application occurred in February 2013. As part of the upgrade, single sign-on functionality was implemented for all Oracle modules. This functionality allows users to change their own passwords and restricts the use of group user IDs by requiring users to authenticate through the network using a unique user ID.

PLCB is working to develop new policies and procedures for assigning access rights and user roles to PLCB systems according to job responsibilities, which will enforce segregation of duties and restrict access to key system functions.

In response to the lack of monitoring of user access violations in the warehouse management system, PLCB stated that the warehouse management system is third party proprietary off-the-shelf-software, and the vendor owns the code. Significant custom coding would be needed to correct this issue. PLCB plans to remediate the issue through the warehouse consolidation, which will include a new warehouse management system.

PLCB is working to create a well-defined systems development life cycle framework in order to comply with ITB-APP012, "Systems Development Lifecycle Policy," issued May 1, 2013. This Commonwealth policy requires agencies to establish a methodology for proper evaluation, development, installation, validation, integration, implementation and life cycle management in the delivery of information system solutions to support agency business needs.

PLCB continues to wait for policy guidance from the Office of Administration for end-user computing.

Effect: If general computer control areas are not improved, agency operations may not be conducted in accordance with PLCB management's intent.

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.

Agency Response: Agree. Actions to resolve are noted.

Auditors' Conclusion: Based on the agency's response, 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, 2013 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 totaling $1.88 million were no longer in use, as of June 30, 2013 PLCB had retired one of these assets totaling approximately $323 thousand in September 2013.

The other fully depreciated asset was for costs related to the Oracle ERP implementation. On the capital asset ledger this asset cost was identified as an ERP server. Our analysis of the capital assets ledger identified multiple other ERP server assets that were placed in service around the same time period. Since the description of the assets was not specific enough, we had PLCB evaluate other ERP related assets to determine if they should be retired. PLCB identified a total of six assets, including our test item, totaling $6.9 million that should have been retired as of June 30, 2013. Therefore, it appears that there are weaknesses in PLCB's tracking of assets to ensure that assets no longer in use and fully depreciated are removed from the capital assets ledger.

As a result of our testing, we determined capital assets and accumulated depreciation in PLCB's Statement of Net Position were overstated by $7.2 million. An auditor adjustment was proposed to decrease capital assets and the related accumulated depreciation by $7.2 million, resulting in no net effect on total net position.

Criteria: Effective internal controls are necessary to ensure that amounts reported in PLCB's financial statements are accurately reported. Adequate procedures, to include periodic physical inventories, must be in place to ensure that recorded assets exist and remain in use. Fully depreciated assets should remain in the capital asset ledger only when still in use and providing value to the agency.

Cause: During our audit period, PLCB did not have a policy in place to perform periodic physical inventory counts of capital assets reported in the capital asset ledger that would identify assets no longer in use. However, according to PLCB management, PLCB plans to utilize the capital asset inventories performed as part of reviews at the stores conducted by the Commonwealth's internal auditors beginning January 2014. These independent reviews will be designed to ensure capital assets located at the stores exist and are in use. However, inventories conducted only at the stores will not cover all assets recorded in the capital asset ledger.

Effect: Failure to identify capital assets no longer in use resulted in capital assets and accumulated depreciation balances to be overstated in PLCB's fiscal year ended June 30, 2013 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, 2013 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 capital asset physical inventories at stores and other locations. Also, PLCB should monitor ERP implementation asset costs approaching the end of their service life to ensure all capital assets are in use and accurately reported.

Agency Response: As a result of the audit finding, PLCB Finance with the assistance from the Office of Comptroller Operations agrees to periodically review the capital asset ledger and retire assets that are fully depreciated and no longer in use, including assets capitalized with ERP implementation. Target date for completion is March 31, 2014.

Auditors' Conclusion: PLCB management agrees with this finding and corrective action will be reviewed in the subsequent audit.

Finding No. 3 – Internal Control Weaknesses Exist in the Reconciliation of Inventory

Condition: PLCB Oracle system integrates inventory transactions between the Retail Merchandising System (RMS) and E-Business Suite (EBS) from which the financial statements are generated. All inventory transactions at the distribution centers are recorded in the Legacy Warehouse Management System (RIMS) and inventory transactions at the stores are recorded in Store Inventory Management (SIM). RIMS and SIM flow through RMS which interfaces to EBS. RMS includes detailed transaction data and EBS shows summarized data at the department level.

To ensure that the detailed information in RIMS and SIM flows properly into RMS, PLCB developed weekly automated system reconciliations of these systems. The RIMS to RMS reconciliation generates the Weekly Warehouse Inventory Discrepancy Report (REP108) and the SIM to RMS reconciliation generates the Weekly Store Inventory Discrepancy Report (REP148). These discrepancy reports document stock on hand inventory discrepancies between the two systems during the weekly period.

Although our testing of the RIMS to RMS reconciliations noted no audit exceptions, audit exceptions were noted in the SIM to RMS reconciliations. We selected two stores from each of the 5 weekly REP148 reports selected from our audit period for a total sample of 10 stores. Of our sample of 10 stores, 9 contained variances that were not fully investigated or resolved until October or November 2013 after auditor inquiry. Four of the stores had discrepancies that were first identified on reports dated more than twelve months previous. As a result of our testing, we determined that SIM to RMS discrepancies reported on the REP148 reports are not being investigated or resolved in a timely matter. Although discrepancies noted in REP148 reports tested were not significant, an internal weakness exists that could result in future misstatements.

Criteria: Effective internal controls over inventory are necessary to ensure that inventory balances reported in PLCB's financial statements are accurately reported. Adequate procedures, to include timely resolution of discrepancies noted in reconciliations, must be in place to ensure that inventory is properly recorded.

Cause: Multiple issues related to the Oracle system upgrade in February 2013 and human errors caused the discrepancies between SIM and RMS. PLCB utilizes the Retail Integration Bus (RIB) which transmits messages between SIM and RMS of inventory transactions that need to be processed. Since the system upgrade, numerous RIB message failures occurred between the two systems which was the primary reason for the discrepancies. In addition, improper handling and recording of inventory transactions between the stores and with the distribution centers caused the discrepancies. Due to these issues, the number of discrepancies reported on the REP148 significantly increased. Manual review of the significant discrepancies became unmanageable which caused the delay in investigating and resolving differences on the REP148. Also, the PLCB does not have sufficient staff assigned to investigate the differences identified on the REP148.

Effect: Failure to investigate and resolve inventory differences between SIM and RMS could result in the inventory balance being misstated in PLCB's fiscal year ended June 30, 2013 Statement of Net Position. Weaknesses in internal control procedures over inventory can cause misstatements in the financial statements to occur and go undetected in future periods.

Recommendation: We recommend that PLCB timely investigate and resolve discrepancies noted in the inventory reconciliations between SIM and RMS to ensure store inventory is properly reported. PLCB should designate sufficient staff to analyze and resolve REP148 differences. Also, we recommend that PLCB continue to monitor RIB message failures and correct errors timely to ensure SIM and RMS are functioning as intended.

Agency Response: PLCB acknowledges the breadth and complexity of the issues related to inventory reconciliation as noted below in our basic agreement with the finding. By way of background, we do monitor REP148 showing RMS to SIM discrepancies on a weekly basis. We also have developed daily processes within Supply Chain and the Office of Information Technology Services for monitoring REP148. Further, since the Oracle upgrade was completed, the PLCB has corrected, mitigated, and continues to work on the issues to stabilize the discrepancies between RMS and SIM. We have provided documentation previously to you regarding the extent of our service requests issued to Oracle for assistance with the RIB message failures. We fully agree that timely reconciliation of inventory system discrepancies are an important element in safeguarding PLCB inventory. We have initiated a search for a dedicated, experienced senior inventory control analyst to guide and expedite continuing efforts to resolve discrepancies. We expect the position to be filled by January 31, 2014.

Auditors' Conclusion: We acknowledge that PLCB does have monitoring procedures to identify REP148 discrepancies and appears to be taking steps to improve their efforts to resolve these discrepancies. Corrective action will be reviewed in the subsequent audit.

COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD
JUNE 30, 2013
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