

**STATE OF NEW HAMPSHIRE  
LIQUOR COMMISSION**

**MANAGEMENT LETTER  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**



*To The Fiscal Committee Of The General Court:*

We have audited the financial statements of the New Hampshire State Liquor Commission, a department of the State of New Hampshire, as of and for the fiscal year ended June 30, 2006 and have issued our report thereon dated February 2, 2007.

This management letter, a byproduct of the audit of the New Hampshire State Liquor Commission for the fiscal year ended June 30, 2006, contains an auditor's report on internal control over financial reporting and on compliance and other matters including related audit findings. Unless otherwise indicated, reference to the Liquor Commission or Commission in this letter refers to the New Hampshire State Liquor Commission.

Attached to the letter is an appendix, which provides a summary of the status of observations presented in the prior, fiscal year 1998 audit report of the New Hampshire State Liquor Commission.

Copies of the Fiscal Year 2006 Annual Report of the New Hampshire State Liquor Commission, which includes the audited financial statements, can be obtained from the New Hampshire State Liquor Commission, P.O. Box 503, Storrs Street, Concord, NH 03302-0503.

Office Of Legislative Budget Assistant

February 2, 2007

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**STATE OF NEW HAMPSHIRE  
LIQUOR COMMISSION  
2006 MANAGEMENT LETTER**

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This report can be accessed in its entirety on-line at [www.gencourt.state.nh.us/lba](http://www.gencourt.state.nh.us/lba).

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## **Auditor's Report On Internal Control Over Financial Reporting And On Compliance And Other Matters**

*To The Fiscal Committee Of The General Court:*

We have audited the financial statements of the New Hampshire State Liquor Commission, a department of the State of New Hampshire, as of and for the fiscal year ended June 30, 2006, and have issued our report thereon dated February 2, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Liquor Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the ability of the Liquor Commission to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Observations No. 1 through No. 12 of this report.

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

## Compliance And Other Matters

As part of obtaining reasonable assurance about whether the Liquor Commission's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, rules, 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*. However, we noted certain matters which are described in Observations No. 13 through 16 of this report.

This auditor's report on internal control over financial reporting and on compliance and other matters is intended solely for the information and use of the management of the Liquor Commission and the Fiscal Committee of the General Court and is not intended to be and should not be used by anyone other than these specified parties.

Office Of Legislative Budget Assistant

February 2, 2007



## Reportable Conditions

### **Observation No. 1: Formal Risk Assessment Policies And Procedures Should Be Established**

#### *Observation:*

The Commission does not have formal policies and procedures in place for recognizing and responding to risks potentially affecting its operations.

The Commission does not have formal policies and procedures in place for periodically reviewing its operations for risks that could jeopardize its ability to continue to function as management intends. Currently, when risks are identified such as the risk of disruption of operations caused by computer or electrical failure, the Commission takes steps to respond to those risks, yet there are no formal policies and procedures to continuously review operations for risks. A lack of understanding of risks generally pushes an entity toward a reactive mode when significant risks are realized/occur. A reactive mode may compromise the efficiency and effectiveness of a response due to the lack of prior identification and understanding of the risks and ramifications.

Management's assessment of risks facing the organization is an integral component of internal control. The purpose of an entity's risk assessment is to identify, analyze, and where appropriate, respond to risks and thereby manage risks that could affect the entity's ability to reach its objectives. Effective risk assessment practices should be a core element of management's planning activities. Risk assessment should be an ongoing activity.

An entity faces many risks. Risk can be defined as the threat that an event or action will adversely affect an entity's ability to achieve its objectives. Risk can be classified in many ways. For example:

*External risks* - threats from broad factors external to the entity including changes in the political arena, statutes and rules, competition from other sources, and illegal activity external to but affecting the organization.

*Operational risks* - threats from ineffective or inefficient processes for acquiring and providing goods and services, as well as loss of physical, financial, or information assets.

*Information risks* - threats from the use of poor quality information for operational, financial, or strategic decision-making within the entity and providing misleading information to others.

A continuous review of the Commission's processes and activities using a risk-based mindset would promote effective planning and assist in resource allocation decision-making. Risks identified should be analyzed to determine whether current internal controls mitigate risk to a level desired by management or whether other actions are required in response to the risk.

*Recommendation:*

The Commission should establish risk assessment policies and procedures that formalize its risk assessment process and provide for a regular and continuous risk assessment of its operations. A formal risk assessment process is a necessary tool to assist in the effective management of risks. Identifying risks significant to Commission operations and employing strategies to mitigate those risks should enhance the effectiveness of the Commission's planning and resource allocation processes and its control processes.

*Auditee Response:*

Concur. The Commission will research, write, and implement policies and procedures dealing with Risk Assessment. The projected completion date is July 31, 2007.

**Observation No. 2: Formal Fraud Risk Mitigation Efforts Should Be Developed And Implemented**

*Observation:*

The Commission has not established a formal fraud assessment, prevention, deterrence, and detection program and has not established a fraud reporting policy.

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. Persons outside or inside the organization can perpetrate it for the benefit or to the detriment of the organization. Fraud runs the spectrum from minor employee theft and unproductive behavior to misappropriation of assets, fraudulent financial reporting, and intentional noncompliance with a law or rule leading to an undue benefit.

Management is responsible for assessing the risk of fraud and implementing measures to reduce the risks of fraud to an organization. Fraud assessment, prevention, deterrence, and detection are crucial to the controlled operations of an organization.

- Assessment is critical since risks can only be effectively managed if risks are identified.
- Prevention reduces opportunities. Preventative methods are typically part of the organization's internal control – tone at the top and control procedures.
- Deterrence consists of those actions taken to discourage the perpetration of fraud and limit the exposure if fraud does occur. The principal mechanism for deterring fraud is the establishment of effective controls that persuade employees that frauds will be detected and perpetrators punished. Management has the primary responsibility for establishing and maintaining these controls.
- Detection consists of identifying indicators of fraud sufficient to warrant recommending an investigation. These indicators may arise as a result of controls established by management, tests conducted by internal auditors, and other sources both within and outside the entity.

Management is also responsible for assisting in the deterrence and detection of fraud by examining and evaluating the adequacy and effectiveness of controls, commensurate with the extent of the potential exposure/risk in the various segments of an entity's operations.

The attributes of an effective fraud reporting policy include:

- The policy is in writing,
- The policy describes fraudulent activities and the activities and the actions required when fraud is suspected or detected,
- The policy is communicated to all employees, and
- Management obtains written assurance from each employee that the policy and related reporting mechanism is understood.

The effectiveness of a fraud reporting policy is enhanced when employees have a clear understanding of fraud indicators and what constitutes a fraudulent act. It is important that the reporting procedure is non-threatening for the reporter and provides for the reasonable protection of all parties.

*Recommendation:*

The Commission should establish formal fraud risk mitigation policies to help limit the Commission's exposure to fraud and to promote timely detection.

The Commission should establish a formal fraud assessment, prevention, deterrence, and detection policy to help limit the Commission's exposure to fraud and to promote early detection of fraud that might occur. The Commission should take measures to foster a high degree of control consciousness among its employees and ensure that its employees understand that adhering to controls is a primary concern of management.

The Commission should establish a fraud reporting policy and provide its employees with fraud awareness training. The Commission should take measures to ensure that the policy facilitates and encourages reporting and protects all parties involved.

*Auditee Response:*

Concur. The Commission, when advised of this issue during the audit, immediately initiated the development of a formal policy on fraud prevention. The draft policy is currently being refined by the Commission's attorney. We expect this policy to be submitted to the Commission for approval and implementation by May 31, 2007.

### **Observation No. 3: Comprehensive Administrative Policies And Procedures Should Be Developed For The Bureau Of Enforcement Support Staff**

#### *Observation:*

The Bureau of Enforcement (Enforcement) has not established comprehensive policies and procedures for its administrative operations. There are no formal written policies and procedures in place that outline the duties and administrative responsibilities of Enforcement's support staff employees.

Enforcement is responsible for a variety of functions including: the issuance of on-premise, off-premise, and other licenses and permits; the control of alcoholic beverages shipped directly from vendors to retail customers in the State; and the collection of the beer and wine tax. While Enforcement has a Standard Operating Procedure (SOP) manual covering its liquor investigator activities, there are no similar policies and procedures describing Enforcement's administrative responsibilities related to its licensing, control, and tax collection activities. The lack of comprehensive policies and procedures increases the risk that management's control intentions and plans may not be effectively communicated to employees and effectively placed in operation and that the continuity of Enforcement's administrative activities become reliant upon the performance of key employees and subject to disruption in the event of employee turnover.

During the fiscal year ended June 30, 2006, Enforcement was responsible for the oversight of approximately 5,000 licensees and the collection of \$12.6 million in taxes.

#### *Recommendation:*

All significant aspects of Commission activity, including administrative operations performed by the Bureau of Enforcement support staff, should be supported by formal policies and procedures that incorporate relevant aspects of the Commission's control structure including the components of control environment, risk assessment, control activity, communication, and monitoring.

These policies and procedures should be sufficiently comprehensive to provide useful guidance to employees in performing their duties. While it is recognized that establishing and maintaining current and comprehensive policies and procedures is a time-consuming task, the policies and procedures should be regarded as a critical component of Enforcement's control structure as well as a potential source of increased efficiency in the long-term, as employees become accustomed to performing their duties according to management's plans and objectives.

#### *Auditee Response:*

Concur. The Liquor Commission appointed a new Chief of Enforcement and Licensing in June of 2005. Under the direction of the Liquor Commissioners one of the primary priorities for the newly appointed Chief was to evaluate and re-draft if necessary all policies and procedures for liquor investigators. While liquor investigators have comprehensive procedures governing their activities, the Commission felt a review was in order. The Chief was also instructed to write policies for administrative enforcement staff members. This was also an area identified in the

Chief's evaluation of the administrative enforcement staff. We found the majority of the administrative enforcement staff members activities were covered by written directive and direct supervision. In order to ensure quality control the Commission's Bureau of Enforcement and Licensing began drafting policies for this group of employees as well. The Bureau of Enforcement and Licensing is on track to have this project completed by June 30, 2007.

#### **Observation No. 4: Segregation Of Duties Controls Should Be Implemented Over Processing Of Beer Tax Revenues**

*Observation:*

There is a lack of segregation of duties controls over the Commission's processing of beer tax revenue as there is no review and approval process in place to lessen the risk that errors or frauds that occur in the processing of beer tax revenue are not detected and corrected in the normal course of business.

Two Bureau of Enforcement employees perform essentially all procedures related to the collection of beer tax revenues. These employees are responsible for receiving the monthly returns and supporting schedules from wholesalers and distributors, reviewing the reports and schedules, and issuing payment adjustments when necessary. The processes performed by these employees are complicated by the lack of standardization and automation of the returns submitted by the wholesalers and distributors. Many of the schedules included with the returns are hand written and require the employees to perform manual calculations and review procedures to determine the accuracy and completeness of the return documents. This manual activity decreases the effectiveness of the reviews and increases the risk that errors in the returns are not detected and that other errors may occur and not be detected in the employees' review process. No other Commission employees effectively review the beer tax revenue processing activities of these employees.

During fiscal year 2006, the Commission collected \$12.6 million of beer tax revenue. Our review of 36 Wholesale Monthly Returns (nine returns reviewed for each of the months of September and December 2005, and March and June 2006) revealed a total of 12 of the returns (33%) contained errors resulting in a net revenue understatement of \$2,338. Most of the errors noted were limited to the returns of three beer distributors. A further review of 24 Wholesale Monthly Returns for those three distributors for the remainder of fiscal year 2006 revealed 19 of the 24 returns had errors (79%) for an additional revenue understatement of \$3,403.

While the noted errors were not significant to the total beer tax revenue collected by the Commission, the relatively high percentage of returns that contained previously undetected errors is indicative of a process that needs to be improved.

*Recommendation:*

Effective controls, including segregation of duties controls, should be implemented over the Commission's processing of beer tax revenue. The Commission should consider implementing

an automated beer tax reporting process through which wholesalers and distributors could file required reports in a consistent and controlled manner. A well-designed process could include automated accuracy and consistency checks as well as other control features that could lessen the Commission's dependency upon manual and inefficient control procedures performed by Commission employees.

Pending the Commission's implementation of an automated beer tax reporting process, the Commission should include a reasonable review and approval control over the beer tax reporting process. At a minimum, all payment adjustments made by the Commission employees should be reviewed and approved by a supervising employee.

*Auditee Response:*

Concur. The Commission recognizes the critical importance of this unit and has requested additional administrative enforcement staff in its recent budget proposal. The Bureau of Enforcement and Licensing has been instructed to review the possibility of increasing efficiencies in the beer tax reporting and collection processes. The review will address electronic submission of reports from the industry and automated accuracy checks. The evaluation of the current process will include a discussion with the industry and the Commission's Chief Financial Officer. The Bureau of Enforcement and Licensing will provide its recommendations to the Commission by August 31, 2007.

**Observation No. 5: Controls Over Direct Shipment Sales Should Be Improved**

*Observation:*

Commission controls intended to verify the accuracy and completeness of direct shipment permit fees are not being consistently applied.

Pursuant to RSA 178:27, companies are allowed to sell and ship alcoholic beverages directly to New Hampshire consumers. Companies making direct sales and shipments are required to acquire a direct shipper permit from the Commission and to pay the Commission a fee equal to 8% of the retail price on all New Hampshire direct sales. Companies making direct sales to consumers are required to submit a direct shipper report and copies of customer invoices for all sales of alcoholic beverages shipped directly to New Hampshire consumers.

One Bureau of Enforcement employee is responsible for reviewing and verifying the accuracy of the direct shipper reports and the remitted fees. This employee reviews the direct shipper reports and also reviews carrier reports, which identify all alcohol shipments delivered by common carriers to New Hampshire, to ensure the completeness of the direct shipper reports. In addition to proving the accuracy of the direct shipper reports, this comparison also allows the identification of non-permitted companies that direct ship alcohol to New Hampshire customers.

According to the Bureau, due to the growing amount of direct shipper activity and the resources currently applied by the Bureau to review that activity, not all direct shipping activity is

subjected to the Bureau's control processes. During May 2006, approximately 200 of the direct shipper reports were not reviewed timely and no carrier reports were reviewed or compared to direct shipper reports. Direct shipment fees during fiscal year 2006 totaled approximately \$315,000.

*Recommendation:*

The Commission should review its controls over direct shipment sales to ensure that the controls are appropriate for the perceived risks and the Bureau's available resources.

The Commission should not allow the condition to persist where control activities cannot be achieved due to workload. In order for control activities to be effective, trained employees must perform the controls in a consistent manner. In situations where resources are not sufficient to perform detail control procedures on all transactions, it may be appropriate to perform the controls on a sample of the transactions or otherwise reduce the testing performed to better match the control efforts of the available resources to the perceived risks.

*Auditee Response:*

Concur. The direct shippers program has grown at a very rapid pace over the last several years far out exceeding the Commission and General Court's expectations. The Commission certainly recognizes the importance of maintaining appropriate levels of control to ensure maximum revenue and public safety. The Commission has requested additional staffing in the fiscal year 2008 budget proposal to address this issue. We are unable to provide a target date of completion largely because agency staffing levels are beyond the Commission's control.

**Observation No. 6: Accounts Payable Should Be More Closely Monitored**

*Observation:*

The Commission's accounts payable balance at June 30, 2006 increased significantly from the balance recorded at the end of the prior year, potentially signifying a decrease in the efficiency of the Commission's vendor payment processes. The Commission did not have an accounts payable aging report to track the age and balances of accounts payable or other formal control activities to monitor the performance of its disbursement section. Subsequent to the auditors' inquiry, the Commission initiated the development of a reporting process for accounts payable aging.

The Commission's June 30, 2006 accounts payable balance was \$39.5 million, a 25% increase from the end of the prior year. During fiscal year 2006, the average number of days payables remained outstanding increased by seven days. The December 2006 accounts payable balance was \$61.6 million, a 56% increase over the June 30, 2006 balance.

Allowing vendor invoices to remain unpaid increases the potential of vendor dissatisfaction, leading to less favorable pricing and increased difficulty in resolving differences or other problems with products or invoicing.

Per the Commission, several factors contributed to the increase in June 30, 2006 accounts payable including increases in purchases, disputed invoices, and personnel turnover.

While it appears that unusual levels of personnel turnover may have contributed to a delay in the timely payment of vendor invoices, the Commission did not have a formal process in place to monitor, evaluate, and react to the significant increase in the accounts payable balances. This is especially concerning as the Commission had apparently not effectively reacted to the situation as the balance continued to increase through at least December 2006, the most recent period for which reports were available.

*Recommendation:*

The Commission should effectively monitor its accounts payable to ensure that vendors are paid according to normal payment terms. As part of its monitoring efforts, the Commission should establish acceptable parameters for accounts payable balances and have procedures for identifying and addressing circumstances that cause the balances to go outside those parameters. While the establishment of an accounts payable aging can be regarded as a reasonable first step, the Commission will need to establish policies and procedures to address appropriate actions to be taken on the information provided by the aging.

Management should review current disbursement policies and procedures, including accounts payable processing, to determine whether improvements can be made in order to minimize the amount of time it takes to process or dispute accounts payable. By becoming more current in its payment processes, the Commission may be able to negotiate and take advantage of early payment discounts.

*Auditee Response:*

Concur. We have already established an aging report which is being monitored monthly by the Accounts Payable Supervisor and the Chief Financial Officer to ensure appropriate action is taken when balances exceed acceptable parameters.

**Observation No. 7: Effective Payroll Monitoring Controls Should Be Established**

*Observation:*

The Commission has not established an effective control monitoring process over payroll controls. During fiscal year 2006, Commission and State payroll policies and procedures were not consistently adhered to, yet effective corrective action was not taken by the Commission to promote increased compliance with the controls.

1. Commission policy requires all employees to sign the Personnel Attendance And Leave System (PALS) signature sheet to verify that the hours worked and leave taken for the bi-weekly pay period is accurate.



- Enforcement Bureau employees did not sign the PALS signature sheets to verify the accuracy of the time worked and the leave taken for all pay periods during fiscal year 2006. While Commission payroll personnel recognized that the control was not in place in the Enforcement Bureau, apparently there was no effort to enforce compliance with the control.
  - During our review of a sample PALS signature sheet for a May 2006 pay period, we noted that one store employee had erroneously signed the PALS on two lines, on the appropriate line and on another employee's line. Signing the PALS on the two lines obscured the fact that the second employee failed to sign the PALS. The store manager who approved the PALS signature sheet did not notice the error.
2. N.H. Admin Rule Per 1202.01 requires each employee requesting leave to fill out and sign a standard leave application form (leave slip). It further requires employees requesting sick leave to certify the reason for the leave and to sign and date the certification.
- When an Enforcement Bureau employee who works in the field takes leave time, he/she sends an email to the supervisor requesting leave. The supervisor approves the leave by the act of forwarding the email to an administrative secretary who types up the leave slip (form PD-8) for the employee and inputs the leave time taken into PALS. Except for sick leave, employees do not sign leave slips. The supervisor also signs the leave slips before forwarding them to the payroll department. It appears that sending the email to the supervisor serves as the "employee signature on the leave slip (to request leave)". Though this is not in strict compliance with N.H. Admin Rule Per 1202.01, it appears that the use of technology has not been considered by the administrative rule.
  - A store manager requested leave on June 15, 2006 but the responsible store supervisor did not approve the leave slip until August 3, 2006, when the auditor brought the unapproved leave slip to the Commission's attention. Per conversation with payroll employees, as a general occurrence, leave slips for store managers are not approved timely as the slips are held by the Commission as "pending" until the store supervisors comes to headquarters and approve them. The Commission's practice of delayed approval is not in compliance with N.H. Admin Rule Per 1202.02, which requires a leave application to be approved prior to the employee being compensated.
  - A Commission employee did not sign a leave slip for the sick leave taken on a leave slip selected for audit testing. N.H. Admin Rule Per 1202.01(c) requires an employee to state the reason why the employee was unable to attend to official duties for the time indicated, and sign and date the certification. The employee's supervisor approved the leave slip even though the leave slip was not completed in accordance with the above-cited rule.

While it is expected that instances will occur where payroll policies and procedures will not be complied with, an effective system of controls, including monitoring the effectiveness of controls, should reasonably ensure that management's intentions for a controlled payroll process are in place.

*Recommendation:*

The Commission should establish and implement controls to promote compliance with Commission and State payroll policies. When noted, instances of noncompliance should be brought to the attention of an appropriate level of management to establish the reason for noncompliance and to determine whether additional training or other efforts should be undertaken to encourage better compliance.

The Commission should consider whether its current practice of using technology not currently considered by administrative rule is appropriate and, if so, establish policies and procedures to describe and control the application of the technology for these purposes.

*Auditee Response:*

Concur. When the Commission was informed of this finding during the audit, we immediately drafted and implemented a new policy clarifying payroll and leave procedures. This policy addresses the issues raised by the LBA audit team.

**Observation No. 8: Controls Should Be Improved Over Output From Commission Information Systems**

*Observation:*

A program limitation in the Commission's Liquor Inventory Distribution System (LIDS) resulted in errors in processing certain credit adjustments. Credit adjustments may result from product damaged or missing in vendor deliveries, reductions or discounts in vendor prices, etc. Two fiscal year 2006 credit adjustments were affected by the LIDS program limitation resulting in the Commission under-recovering \$60,000 of credits from vendors.

An auditor reconciliation of the Commission's general ledger, LIDS, and State accounting system (NHIFS) information indicated an unknown variance between information reported by the three information systems. Research by the Commission into the difference detected a limitation in LIDS that restricts the brand code amount field on claims invoices to seven digits, including the decimal. As a result, LIDS erroneously reported claims that had a single line item with a brand code amount field more than \$9999.99. These amounts were truncated at seven digits from the right. The invoicing errors were not identified when the invoiced transactions were compared to the affidavits supporting the claims and, as the Commission does not reconcile expenditures per LIDS to expenditures per NHIFS, the Commission did not otherwise detect the error. In addition, the vendors did not note and correct the errors when they processed the credit.

*Recommendation:*

The Commission should review its major systems and develop and implement procedures to ensure that the output produced by the systems is accurate, complete, and reliable. These procedures should include formal reconciliations of the information reported by the systems.

The Commission should review its controls over the invoicing process, including credit adjustments, to determine whether controls currently in place are operating as intended and whether the personnel performing the controls are properly informed of and trained in their control responsibilities. The Commission should develop and implement adequate monitoring activities to ensure controls are operating as intended.

*Auditee Response:*

Concur. This specific audit observation found a fault in a claims invoice where the amount field was too small to handle the value of the claim. While the LBA auditors were still in residence here, we took corrective action to recover credits from vendors and corrected the database software programming to prevent this problem from occurring again.

**Observation No. 9: Controls Should Be Established/Strengthened Over The Processing And Recording Of Purchase Discount Transactions**

*Observation:*

The Commission's current controls do not ensure that purchase discounts are processed accurately.

A post-off is a monthly special purchase allowance (SPA) or discount offered by vendors and brokers. When a *vendor* offers an SPA, purchases made by the Commission are net of the vendor SPA. When a *broker* offers an SPA, the Commission pays the vendor the full price for the product and invoices the broker for the SPA amount.

Depletion allowances are discounts offered by brokers for products sold by the Commission out of on-hand inventory. Depletions are offered by brokers to reduce bailment and store inventory and are based on the amount of the vendor's product the Commission sells to retail customers/licenseses during the period covered by the depletion allowance, generally a month.

The Commission purchased approximately \$300 million of inventory during fiscal year 2006. Post-off and depletion allowances for the same period totaled approximately \$25.8 million.

During our testing of discounts from SPAs, we noted several relatively minor errors in the Commission's processing of the transactions that indicate that additional controls should be implemented to lessen the risk associated with the transactions.

For example:

1. A vendor and a broker were incorrectly billed for SPAs on the same item,
2. In two instances noted, brokers were not billed for SPAs, and
3. In one instance, a broker was inaccurately billed for an SPA.

While the errors noted were not significant to the Commission's total purchases of product, there were no apparent control procedures at the Commission to detect and correct the type of errors noted.

*Recommendation:*

The Commission should establish/strengthen controls over the processing and recording of special purchase allowances. Where possible, automated edit checks and reporting should be used to review for and disclose apparent or possible errors in these transactions.

*Auditee Response:*

Concur. The Commission is currently implementing electronic controls to ensure accuracy in billing and collecting all depletion allowances and other related billings to brokers for discount offers. These controls will be fully implemented by May 31, 2007.

**Observation No. 10: Security Over Credit Card Data Should Be Improved**

*Observation:*

The Commission does not appear to be in compliance with Payment Card Industry Data Security Standard (PCIDSS) Requirement 9.6 *Restricted Physical Access To Cardholder Data*. Paper debit/credit card receipts are within easy access of all store employees and the necessary procedures have not been implemented to ensure that this confidential information does not get into the hands of unauthorized individuals.

PCIDSS Requirement 9.6, requires the merchant to "Physically secure all paper and electronic media (e.g., ... paper receipts, paper reports...) that contain cardholder information. The physical access to cardholder data must be appropriately restricted to prevent the misuse of the data." Unauthorized release or misuse of cardholder data can result in significant costs to merchants who may need to notify and take additional steps to protect cardholders in the event of an unauthorized disclosure of cardholder information.

During fiscal year 2006, the Commission stores did not maintain the paper credit/debit card transaction receipts, which contain cardholder information including cardholder name, number, and expiration date, in a secured manner.

*Recommendation:*

The Commission should take immediate steps to secure all data containing cardholder information. All data containing cardholder information should be stored in a secure place that allows access to authorized personnel only.

The Commission should continue its review of technological solutions that could make the storage of paper data unnecessary. If the Commission moves to an electronic solution to store

credit card transactions and cardholder information, the Commission will need to adequately address the associated risk exposure inherent in the storage and access to electronic data as well.

*Auditee Response:*

Concur. A contract was just approved by Governor and Council to replace point of sale equipment at all our retail stores. This equipment includes electronic signature capture for credit cards. This equipment will be installed in all our retail stores within the next 4-5 months. This will result in a significant improvement in security regarding cardholder information. In the meantime, the Commission is preparing a plan to remove all paper receipts from our retail stores. Those older than two years will be brought back to our headquarters in Concord where they will be stored securely and destroyed when appropriate. Those not yet two years old will be consolidated at selected retail stores where they will be stored securely. This will be completed by May 31, 2007.

**Observation No. 11: Store Lease Documents Should Be Clarified**

*Observation:*

The Commission's standard store facility lease agreement contains language that is inconsistent with statute and the Commission's lease review and approval process. During fiscal year 2006, the Commission operated 75 liquor stores; eleven stores operated in facilities owned by the Commission and 64 stores operated in leased facilities.

RSA 177:1 authorizes the Commission to lease stores, warehouses, and other merchandising facilities as are necessary to run its liquor store operations. It further states, "Any lease or contract made pursuant to this section shall be approved by the attorney general and, in the case of a contract, by the governor and council as well as the attorney general, before becoming effective."

Pursuant to RSA 177:1, the Commission submits lease agreements for store facilities to the Attorney General for approval but does not submit the lease agreements to Governor and Council.

For three out of a sample of four lease agreements tested, we noted the Commission utilized the State's *Standard Lease Agreement* form which includes the phrase that the lease is conditioned "...upon its approval by the Governor and Executive Council of the State of New Hampshire..." even though that condition is not applicable to the lease of store facilities and the approval is neither sought nor obtained.

By including inapplicable condition language in the lease agreement, the Commission may inappropriately provide undue assurance on the level of State reviews and approvals provided to the lease agreements and also may cause undue confusion as to the authority of a lease that contains this language yet has not met the approval requirements stated in the lease document.

According to the Commission, leaving the inapplicable condition language in the lease agreement was an oversight.

*Recommendation:*

The Commission should review and revise as appropriate the documents it uses to lease store and other related facilities to ensure that the lease agreement language is appropriate for the Commission's purpose and is consistent with the Commission's lease practices.

The Commission should review its policies and procedures for establishing, reviewing, and approving lease documents to ensure that controls are in place to make reasonably certain that the lease agreements are effectively reviewed and approved.

*Auditee Response:*

Concur. The Commission's attorney is currently reviewing these leases to ensure language is appropriate and consistent with the Commission's lease practices. This review will be completed by April 30, 2007.

**Observation No. 12: Continued Appropriateness Of Standard Mark-Up Percentages Should Be Reviewed**

*Observation:*

The Commission's most current *Product Classification and Price Mark-up %* pamphlet has an effective date of July 1999 and was last published in February 2001. It is unclear whether the Commission's base mark-up percentages have been reviewed for continued appropriateness since that time.

The Commission's mark-up percentages are used to establish base retail prices for products based on pre-determined profit margin percentages above vendor costs. The mark-up percentages are set for each category of product sold by the Commission. Retail prices set using the mark-up percentages are subject to discounts, sales, and other price adjustments made by the Commission.

The Commission was unable to provide documentation of how the percentages in the July 1999 pamphlet were set or documentation to support that the percentages had been reviewed for continued appropriateness since 1999. The percentages in the 1999 pamphlet continued to be used during fiscal year 2006.

*Recommendation:*

The Commission should establish policies and procedures to provide for a regular review and analysis of product mark-up percentages. The policies and procedures should ensure that the mark-up percentages used are adequately documented and regularly reviewed for continued appropriateness.

*Auditee Response:*

Concur. The Commission will create and implement policies and procedures regarding the review and analysis of mark-up percentages by May 31, 2007.

## State Compliance

### **Observation No. 13: Policies And Procedures Should Be Established Describing The Commission's Inspection Program For License Renewals**

#### *Observation:*

The Commission's compliance with a statutory requirement for frequent inspections of licensees is unclear, as the Commission could not provide criteria for determining the required frequency of inspections.

Per RSA 179:57, "[t]he commission shall cause frequent inspections to be made of all the premises with respect to which any license has been issued under the provisions of this title."

The Bureau of Enforcement was unable to provide documentation of licensee inspections for nine out of 11 (82%) licensees selected for audit testing. A report on a subsequent inspection was provided for one test item however the Bureau could not provide documentation of an inspection occurring during the period requested for the audit test. Licensee inspections are intended to ensure licensee compliance with statutes and rules intended to control the sale of alcoholic beverages and to protect public safety.

When asked how it determines when to perform a licensee inspection, the Commission responded that it generally reacts to complaints or other notice of potential concerns with a licensee's operation. While the Bureau of Enforcement does have Standard Operating Procedures for its liquor inspectors, the Commission could not describe that it had policies and procedures to promote its compliance with the statute's requirement for frequent inspections of licensees.

#### *Recommendation:*

The Commission should establish policies and procedures that more clearly describe its inspection program. If the Commission has concerns as to whether its inspection program meets the criteria in statute of frequent inspections, the Commission should revise its program to better meet the statutory requirement or request additional clarification or revision of the law to allow for its compliance.

#### *Auditee Response:*

Concur. The Commission has complied with RSA 179:57 in that compliance checks, incident report and premises checks are all concerned with inspection checks. Under this definition, the Bureau provided documentation on six out of the eleven licensees surveyed. We will more clearly define inspections in policy. However, it is important to note that under the direction of the newly appointed Enforcement & Licensing Chief in June of 2005, the Enforcement Bureau began recording all premises checks in an electronic format. Prior checks were recorded on the investigator's weekly duty report. All premises are checked, however not every licensee is checked with the same frequency during any established period of time. Under the direction of



the field supervisors, liquor investigators are required to check each licensee. Frequency is driven largely by the number of complaints from local communities as well as the general public. We certainly recognize the inherent risk factors associated with the sale and service of alcohol beverages. Licensees operating in a manner that threatens the welfare, safety or health of a community are certainly checked more often to ensure compliance with all appropriate laws and rules.

#### **Observation No. 14: Current Exemption From Bailment Fees Granted To Vendor Should Be Reviewed**

*Observation:*

The Commission's implementation of N.H. Admin Rule Liq 401.02, *Bailment Warehouse Fees* is a misapplication of the rule.

Per N.H. Admin Rule Liq 401.02 (a), "Bailment warehouse fees shall be paid by vendors unless exempted by statute or rule." Part of the exemption in Liq 401.02 (c) states, "no fee shall be charged on liquor and wine **products manufactured in NH** [emphasis added] by any vendor who:

- (1) Is licensed as a liquor manufacturer pursuant to RSA 178:6, a rectifier pursuant to RSA 178:7, or a wine manufacturer pursuant to RSA 178:8;
  - (2) Maintains a federally bonded liquor warehouse in the state; and
  - (3) Maintains an inventory equal to 30 days average sales for each brand code registered with the commission."
- During fiscal year 2006, the Commission waived \$230,395 of bailment fees for one New Hampshire rectifier who had product in bailment at the Commission's Concord warehouse. The Commission waived \$120,505 in bailment fees on product manufactured out of state and bottled in New Hampshire and waived \$109,890 in fees on product manufactured and bottled out of state. According to the rule, bailment fees should be waived for product manufactured in New Hampshire. There is no similar provision in the rule for products manufactured out of state.
  - It is unclear that the exemption to bailment fees in this rule is intended to allow New Hampshire manufacturers to maintain product in Commission-controlled bailment, yet not be charged for the warehouse services. Providing these services without charging for them, in essence, provides New Hampshire manufacturers a subsidy that is detrimental to the Commission's net profits. It could be argued that the rule envisions that the 30-day supply would be maintained in the manufacturer's in-state bonded warehouse and thereby not be subject to the bailment fees.

Subsequent to June 30, 2006, the Commission received legal advice that warehouse fees should not be exempted for product manufactured and bottled out of state. No clear actionable advice was received relative to product bottled in state.

*Recommendation:*

The Commission should review its application of N.H. Admin Rule Liq 401.02 to determine if its current practices are as intended by the rule and whether any subsidy provided to New Hampshire firms by the Commission's waiving of the bailment fee is necessary for the efficient and effective operation of the Commission. The Commission should consider its obligation to optimize the profitability of its operations in determining whether to exempt firms from required fees.

*Auditee Response:*

Concur. On February 21, 2007 the Commission reviewed the information provided in this audit observation and the Commission's application of N.H. Admin Rule Liq 401.02 as it related to the waiving of the bailment fee for products manufactured, supplied and/or bottled by out-of-state manufacturers. Following considerable discussion, the Commission voted 2-1 to eliminate the bailment warehouse fee exemption on products manufactured, supplied, and/or bottled by out-of-state manufacturers effective May 1, 2007. The Commission reaffirmed the retention of the bailment warehouse fee exemption on products manufactured, supplied, and/or bottled by an out-of-state distillery in its New Hampshire facility.

Response to Audit Observation by Commissioner John W. Byrne

I concur with the audit observation that the Commission "...should review its application of N.H. Admin Rule Liq 401.02 to determine if its current practices are as intended by the rule and whether any subsidy provided to New Hampshire firms by the Commission's waiving of the bailment fee is necessary for the efficient and effective operation of the Commission." It is my belief that any such review will determine that the current practices of the Commission are necessary and provide fiscally responsible management in waiving bailment fees from in-state liquor and wine manufacturers and rectifiers. It was the intent of the Commission and the Legislature to write this rule to allow the Commission to waive bailment fees for in-state liquor manufacturers and rectifiers.

In the LBA 1998 Financial Audit of the Commission, auditors made a similar finding in Observation #3 Preferential Treatment Of Local Liquor Manufacturer. The response of the Commission to that finding was that a majority of the Commission, Commissioner Luce and I, agreed in principle to formulate rules and to allow for the exemption of bailment for in-state liquor manufacturers. Commissioner Maiola abstained from consideration of this item. The Commission then proposed N.H. Admin Rule Liq 401 during the 2000 legislative session and it was adopted by the Legislative Rules Committee. The Commission wrote the rule with the intent to specifically exempt an existing New Hampshire manufacturer and any new liquor or wine manufacturer, or rectifier that met the requirements of the rule from bailment fees. The Commission testified to the legislative committee that this rule could attract other manufacturers to the state.

Since this previous audit the N.H. manufacturer, cited in 2000 as the reason to promulgate the rule, has been purchased by a regional supplier. The new company did state to members of the

Commission that it considered consolidating its operations at its primary facility in Maine, but instead has kept the in-state facility operational. The company said the bailment rule was one reason for that decision. In addition, there are three newly licensed wine and/or liquor suppliers in N.H. that have qualified under Liq Rule 401 for bailment relief. Thus the bailment rule has resulted in jobs and competitively priced products available to the Commission which was the intent of the Commission in writing this rule.

In her response to the 1998 finding Commissioner Luce stated, "I'm opposed to charging bailment to the only New Hampshire liquor manufacturer....If we did mandate the in-house manufacturer to pay for the use of one of the bailment warehouses, the additional costs would most likely be borne not by the manufacturer, but by our customers. This would erode the Commission's low price niche....The best way for this situation to be handled would be to write the in-state manufacturer's exception to the rules promulgated for our bailment system."

During the past several years the Commission has seen a dramatic consolidation in the supplier and wholesale/broker tiers of the industry. This consolidation has had the effect of reducing the number of companies in each tier who offer products for sale to the Commission. In fact, today one wholesaler/broker represents over 65% of the products from suppliers offered to the Commission for sale in the state. This represents a dramatic change since 1995, when no wholesaler/broker represented more than 20% of all products. This consolidation brings added pressure on the Commission in providing competitively priced products. Commissioner Luce was prescient in her observation about the competitive advantage of an in-state manufacturer. Allowing an in-state manufacturer or rectifier a competitive edge on bailment fees gives the Commission competitively priced products that it can leverage in pricing considerations with other suppliers. While competitors will argue that this is an unfair advantage for the in-state manufacturer, we must keep in mind that local taxes and payroll are an ancillary benefit for the state and an added cost to the in-state manufacturer.

There has been some discussion that the Commission's interpretation of the in-state bailment rule would allow out of state suppliers to set up shell companies to be licensed for the purpose of eluding bailment fees. The licensing requirements of the state and federal government would necessitate any supplier applying for a liquor manufacturer, rectifier, or wine manufacturer's license to invest a large amount of capital. The bailment exemption cannot be exercised without such a license. If, in fact, suppliers do invest in this manner, the state would benefit greatly from added local property taxes and jobs. Not to mention the supplier's product being readily available in the state for the Commission to purchase, since there is a requirement to maintain a 30-day supply of product in inventory at the licensed facility. This would give the state an ability to avoid being out of stock on these products during high volume sales periods.

The audit finding says that the state waived approximately \$230,000 in bailment fees during the last fiscal year. While the auditors cite figures for bailment fees not collected by the Commission, there is no analysis of the economic benefit accrued to the state and local community from implementation of this rule as interpreted by the Commission. The Commission's bifurcated warehouse system and the costs associated with it have never been adequately reviewed by the state auditors or the legislature. The state-owned warehouse handles less than 25% of the product purchased and sold by the Commission and is inefficient and costly

to the state. It is important to put these bailment numbers in perspective. During the same time period, the Commission purchased over \$293 million in product and grossed over \$120 million to the General Fund. To charge bailment to in-state licensees at the state owned warehouse would be penny wise and pound foolish.

If the Fiscal Committee and legislature believe that the Liq Rule 401 does not provide the Commission with the ability to manage as it is now doing, then the Commission should go to the Legislative Rules committee to rewrite the rule to allow this to happen.

### **Observation No. 15: Formal Written Store Plan For The Retail Stores Should Be Developed**

#### *Observation:*

The Commission has not developed and maintained a formal written store plan for its retail stores.

RSA 177:3 requires the Commission to “develop and maintain a formal written store plan for its retail liquor stores. This plan shall establish goals and policies related to the number, size, and staffing patterns of state operated retail liquor stores to ensure the efficient and effective operation of the state store system.” The plan is required to include: 1) the operational definitions of a marginal store, identification of such stores, and specific plans to consolidate or otherwise improve the profitability of such stores; 2) the optimum size, location, and staffing pattern of stores to maximize their profitability, including a plan to increase the use of part-time employees and a formula for determining appropriate rental payments for leased stores; and 3) plans for the expansion of the existing store system where such expansion is justified.

This observation was also noted during our fiscal year 1998 audit of the Liquor Commission. The Commission responded that it would have the required plan in place by October 31, 1999. According to the Commission, due to an oversight, a formal plan was never developed. At the June 8, 2006 Commission meeting, the Commissioners directed the Marketing and Sales Bureau to address the provisions of RSA 177:3

#### *Recommendation:*

The Commission should continue in its efforts to adopt a formal written store plan in compliance with RSA 177:3. Once adopted, the Commission should monitor compliance with the plan and periodically review and revise the plan as appropriate to help reach the Commission’s goals of optimizing profits while maintaining controls and providing service to their customers in the most efficient and effective manner.

#### *Auditee Response:*

Concur. The Commission will complete its update of our store operations plan by May 31, 2007.

## **Observation No. 16: Expired Rules Should Be Readopted If Still Considered Operational**

### *Observation:*

Certain Commission administrative rules have expired and have not been readopted.

1. N.H. Admin Rules Liq 903 through Liq 906, addressing billing and pricing orders, late and non-payment, bankruptcy, and disputed charges, expired in 2004 but appear to continue to be operational.

The Commission provides all licensees with an option to pay for liquor purchases within an approved 15-day credit window. The above noted expired administrative rules outlined procedures related to collecting on credit sales to licensees and are still cited as criteria in Commission letters and dunning notices.

2. N.H. Admin Rules Liq 1000, related to tobacco, including parts 1001 through 1004 expired on January 1, 2006 and have not been readopted. Rules related to tobacco are required by RSA 126-K:10.

### *Recommendation:*

The Commission should review the administrative rules covering the operation of the Commission to ensure that timely action is taken to keep necessary rules current.

The Commission should review with legal counsel as to whether it is appropriate to cite expired administrative rules in correspondence with licensees.

If the Commission determines that statutorily required rules are no longer needed for Commission operations, the Commission should seek to have the statutory requirements for the rules amended or repealed.

### *Auditee Response:*

Concur. The Commission will establish an internal administrative rules review committee. The committee will consist of a Commissioner, the Commission's legal counsel and Chief of Enforcement and Licensing. They will review rules scheduled for expiration one year prior to the rule expiring. This committee shall make recommendations to the Commission whether to amend or repeal an administrative rule. The committee as well as appropriate policies and procedures will be completed by May 31, 2007.

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## APPENDIX

### Current Status Of Prior Audit Findings

The following is a summary of the status, as of February 2, 2007, of the observations contained in the audit report of the New Hampshire State Liquor Commission for the fiscal year ended June 30, 1998. A copy of the prior audit report can be obtained from the Office of Legislative Budget Assistant, Audit Division, 107 North Main Street, State House, Room 102, Concord, NH 03301-4906.

	<u>Status</u>
<i>Internal Control Comments</i>	
<i>Reportable Conditions</i>	
1. Fixed Asset Accounting Issues	● ● ●
2. Controls Over Cash And Bank Accounts	● ● ●
<i>State Compliance Comments</i>	
3. Preferential Treatment Of Local Liquor Manufacturer ( <i>See Current Observation No. 14</i> )	● ○ ○
4. Noncompliance With Certain State Statutes ( <i>See Current Observation No. 15</i> )	● ○ ○
<i>Management Issues Comments</i>	
5. Reorganization Of The Financial Management Section	● ● ●
6. Preparation Of Liquor Fund Financial Statements	● ● ●
7. Masterpiece General Ledger Software	● ● ●
8. Year 2000 Compliance	● ● ●

<u>Status Key</u>		<u>Count</u>
Fully Resolved	● ● ●	6
Substantially Resolved	● ● ○	0
Partially Resolved	● ○ ○	2
Unresolved	○ ○ ○	<u>0</u>
		8

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