Secretary of State Audit Report

Kate Brown, Secretary of State

Gary Blackmer, Director, Audits Division

Oregon Liquor Control Commission: Revenue Cycle Financial Controls

Summary

The objectives of our audit were to determine the effectiveness of Oregon Liquor Control Commission's (OLCC) financial controls related to its revenue cycle (collection and distribution), and determine its compliance with key legal requirements. We reviewed agency controls related to revenue collections, revenue distributions, and inventory. Based upon observation and test procedures performed, we concluded that controls over the collection and distribution of sales and tax revenue and over inventory were applied and effective. In addition, our legal compliance testing identified no instances of noncompliance.

Agency Response

The agency response is attached at the end of the report.

Audit Results

Background

The OLCC was created in 1933 after national prohibition ended. The creation of the OLCC ensured that Oregon would be a *control state* with the exclusive right to sell packaged distilled spirits (liquor). The OLCC disburses distilled spirits from its distribution center to nearly 250 retail liquor stores operated by contracted agents. The distribution center and headquarters are located in the Portland area with regional offices located in Bend, Eugene, Medford, and Salem.

A governing board of five commissioners is responsible for setting policy. Commissioners are appointed by the governor to a four-year term, subject to senate confirmation. The board must represent the five congressional districts and include one individual from the food and beverage industry. For the 2011-2013 biennium the OLCC had an approved budget of $133.7 million, which is funded through Other Funds revenue generated from activities such as the sale of liquor.

The OLCC's mission is to promote the public interest through responsible sales and service of alcoholic beverages. The OLCC uses three programs to achieve its mission: Public Safety Service Program, Distilled Spirits Program, and the Administration and Support Services Program. Through these programs the OLCC regulates all individuals and businesses that manufacture, sell, import, export, or serve alcoholic beverages. It also educates and trains liquor licensees, the public, and other groups; and investigates and takes action when necessary against those who violate Oregon's liquor laws.

Financial Controls Review

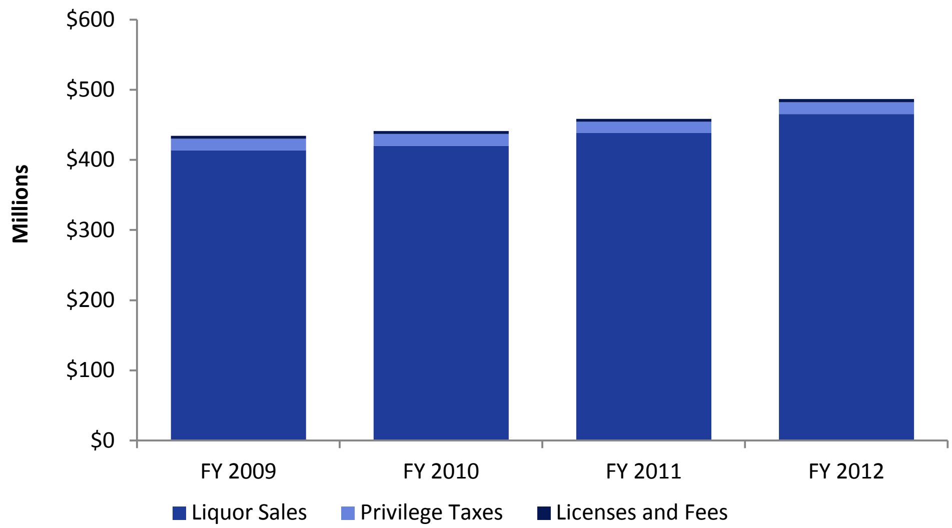
The primary objective of our audit was to determine whether the OLCC had implemented effective financial controls over its revenue cycle; specifically, the collection and distribution of liquor related revenue.

Revenue Collection

The OLCC's revenue is derived from three main sources: distilled spirits (liquor) sales, alcoholic beverage (privilege) taxes, and licenses and fees. Our audit did not include a review of controls related to license and fee revenue.

Despite the economic downturn, total revenues increased 12% over the past four state fiscal years (2009-2012). During this period, liquor sales revenue grew from $413.7 million to $465.4 million. Privilege tax revenue also increased over this time span but at a more modest 3%. Preliminary sales figures indicate this upward trend will continue in fiscal year 2013. As of March 11, 2013, preliminary sales for state fiscal year 2013 totaled nearly $364 million.

Figure 1: Total Revenues by Fiscal Year, 2009 to 2012



The majority of OLCC's revenue comes from liquor sales made by independent contractors referred to as *liquor agents*. Liquor agents are appointed to operate liquor stores and are compensated based on monthly liquor sales.

Liquor agents are required to deposit proceeds daily and submit weekly sales reports to the OLCC. OLCC staff review the sales reports and supporting records, verify that expected deposits were made, and perform periodic audits to ensure liquor agents are properly safeguarding inventory.

During the audit we selected a random sample of 25 liquor agents for review. We verified that an audit had been completed within the last year and that identified inventory discrepancies were resolved. In addition, we selected five weeks between July 2012 and April 2013 and reviewed sales reports and supporting records for each of the 25 liquor agents in our sample. We verified the reports had been submitted, and agreed to supporting documentation and deposit records. Based upon observation and testing performed, we concluded that controls over the collection of liquor sales revenue were applied and effective.

OLCC also collects a privilege tax imposed on businesses that manufacture or import malt beverages (i.e., beer, cider) and wine. The revenue generated from this tax, 3% of OLCC's total revenues, is significantly less than that generated through liquor sales.

Manufacturers and importers, referred to as licensees, are required to submit privilege tax forms and payments monthly. Small breweries and wineries that produce fewer than 100,000 gallons of malt beverage or wine are exempt from the tax, but are still required to file an annual privilege tax report.

The total tax owed by a licensee is determined by the type and amount of alcohol that is produced or imported. Figure 2 provides the current tax rates.

Figure 2: Privilege Tax Rates

Type of Alcohol	Tax	Unit of Production
Malt Beverage	$2.60	Per barrel (31 gallons)
Wine- containing less than 14% alcohol	$0.67	Per gallon
Wine- containing more than 14% alcohol	$0.77	Per gallon

OLCC staff reviews licensees' monthly tax reports for accuracy and uses supporting records to recalculate the tax due. Although not applicable to all licensees, periodic desk audits performed by OLCC staff also serve as a mechanism for ensuring privilege taxes are accurately calculated and paid.

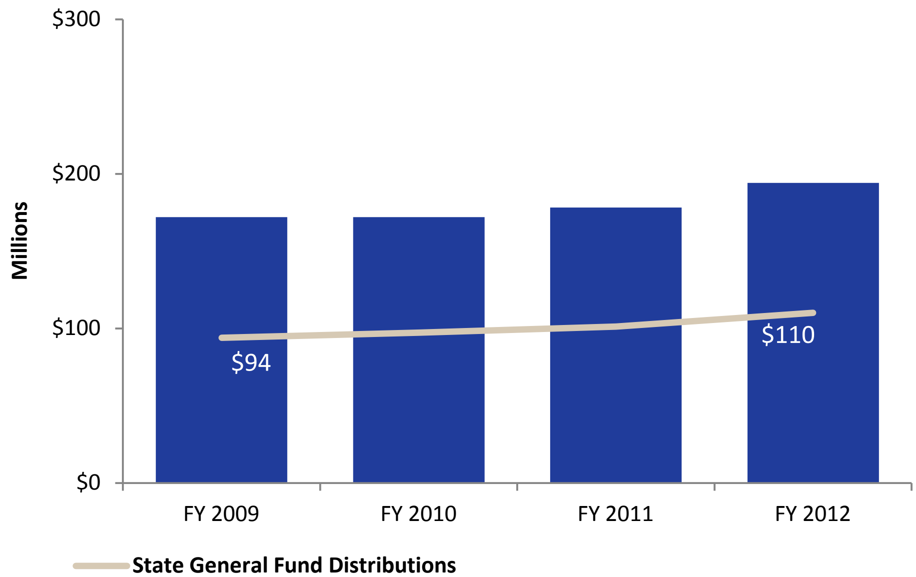
To evaluate OLCC's controls over the privilege tax, we selected a random sample of 60 licensees for review. We verified as applicable that monthly privilege tax reports were received, were adequately supported, and the tax due was calculated correctly. We also reviewed the most recently completed desk audit for licensees in our sample that were subject to audit. In general, we concluded that controls were applied and effective.

Revenue Distribution

Revenue generated through the sale and tax of alcoholic beverages is used to support state, county, and city general funds, the Oregon Wine Board, and alcohol and drug abuse prevention, intervention and treatment services. These distributions are mandated by Oregon law. Sales and tax revenue is also used to compensate liquor agents for retailing services and to pay OLCC's administrative expenses.

Figure 3 shows that annual distributions of sales and tax revenue have grown from about $172 million in fiscal year 2009 to $194.1 million in 2012. During this period, revenue distributions to the state's general fund increased 17% from $93.9 million to $110.2 million.

Figure 3: Total Annual Revenue Distributions by Fiscal Year, 2009 to 2012



OLCC distributes sales and tax revenue monthly. Prior to distribution, staff reconciles OLCC's subsidiary sales systems to its general ledger. Management reviews the reconciliations and certifies to the Department of Administrative Services the amount of revenue available for distribution. Distribution vouchers are subsequently prepared, authorized, and input into the state's accounting system.

To examine OLCC's controls over revenue distributions, we selected three months between July 2012 and March 2013 and verified that general ledger account balances reconciled to the respective subsidiary systems, were adequately supported, and were reviewed by management. We also determined that distribution vouchers were reviewed by management and correctly recorded in the state's accounting system.

During the budgeting process the OLCC creates a forecast of expected sales for the biennium. At the same time the Oregon Legislature establishes an *authorized average payout* rate, currently 8.88%, which is multiplied by the forecasted sales to determine the maximum amount of compensation that can be paid to liquor agents for retail services during the biennium. Actual compensation for an individual agent, however, is based on a commission approved compensation formula. The formula incorporates both a fixed base allowance plus a variable sales commission.

Using information from weekly sales reports, OLCC staff calculates each liquor agent's monthly compensation. Management reviews the calculations and authorizes the payment. During the audit, we found that monthly liquor agent compensation was accurately calculated. We also found that compensation was accurately entered into the state's accounting system.

In addition, we obtained liquor sales revenue from the state's accounting system for the past three state fiscal years (2010-2012). We multiplied the sales revenue by the authorized average payout rate to estimate the maximum compensation paid for each fiscal year. We compared our estimate to actual compensation paid to all liquor agents and found the amounts to be within an acceptable level of each other.

Based upon observation and test procedures performed, we concluded that controls over the distribution of sales and tax revenue were applied and effective.

Inventory

Inventory control is a key component of OLCC's operations and directly impacts the amount of revenue that is collected and distributed. Therefore, our gaining an understanding of the inventory process was determined to be important.

The OLCC uses an inventory bailment system. Under a bailment system the liquor manufacturer retains ownership of the inventory and is responsible for making sure that adequate inventory levels are maintained at the distribution center. Inventory is removed from bailment as needed to fill liquor agent orders, triggering the transfer of ownership to OLCC.

Although the OLCC does not own most of the inventory at the distribution center, it is responsible for its safeguarding once received at the warehouse. To facilitate this effort, OLCC employs a number of physical controls such as key card access to the warehouse and cameras stationed at strategic locations. OLCC management has also implemented a number of information technology systems (i.e., MBS, RIMS) that track daily shipments and receipts of inventory. Additional controls, such as liquor agent audits and a year-end inventory count, are used to ensure an accurate record of inventory is kept. These controls are also intended to ensure the inventory is properly recorded on OLCC's financial statements.

We conducted test procedures designed to verify that OLCC was accurately recording its inventory. These procedures included a review of the audits for 25 randomly selected liquor agents and verification that any noted discrepancies were resolved. We also reviewed a sample of monthly records OLCC uses to track inventory distributed to liquor agent stores. During our review we verified that information recorded was supported by daily and monthly inventory system reports. In addition, we observed the year-end inventory process. Based upon observation and testing performed, we concluded that controls over inventory were applied and effective.

Legal Compliance Review

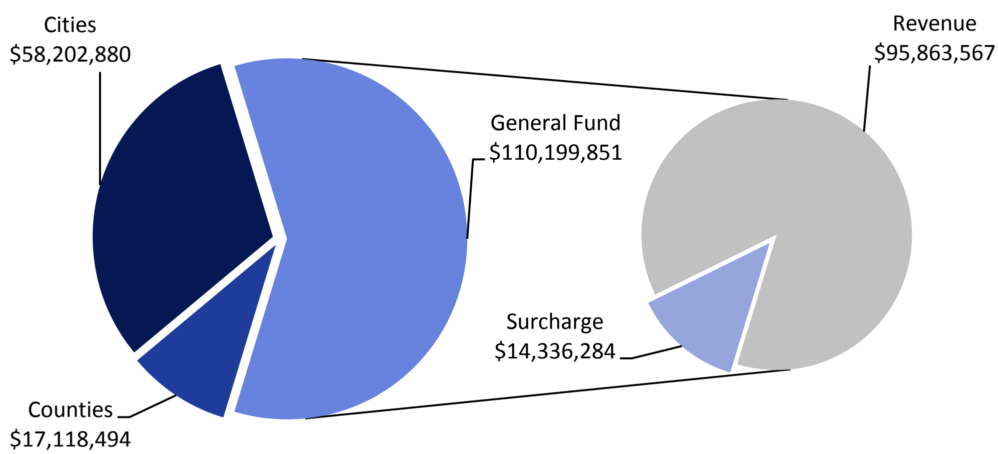
We reviewed laws and regulations to identify legal requirements that may be key within the context of our audit objectives. Legal requirements regarding the distribution of OLCC revenue, specifically privilege tax and excess revenues were determined to be key to the audit.

Excess Revenue Distribution

After privilege taxes have been distributed, liquor agents compensated, and its administrative costs paid, the OLCC is required to distribute the remaining revenue to the state (56%), county (10%), and city (34%) General Funds.

We obtained transfer and distribution data from the state's accounting system for each of the past three fiscal years (2010-2012) and identified the data specific to the state General Fund, county, and city transfers/distributions. We verified compliance by totaling the related transfers and calculating the percentage of each specific type of transfer. To illustrate, revenue distributions to the state, county and city general funds for 2012 totaled $171.2 million[1]. As shown in figure 4, distributions to cities and counties equaled about $58.2 million (34%) and $17.1 million (10%), respectively. Similarly, transfers of nearly $95.9 million (56%) were made to the state General Fund.

Figure 4: Excess Revenue Distribution, Fiscal Year 2012



[1] Total revenue distributions in fiscal year 2012 equal about $185.5 million. However, that amount includes excess bottle surcharge revenue distributions of $14.3 million that also get transferred to the state General Fund. Excess bottle surcharge revenue is not subject to the distribution requirements being tested and has therefore been excluded for testing purposes.

The results of the legal compliance tests described previously disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Privilege Tax Distribution

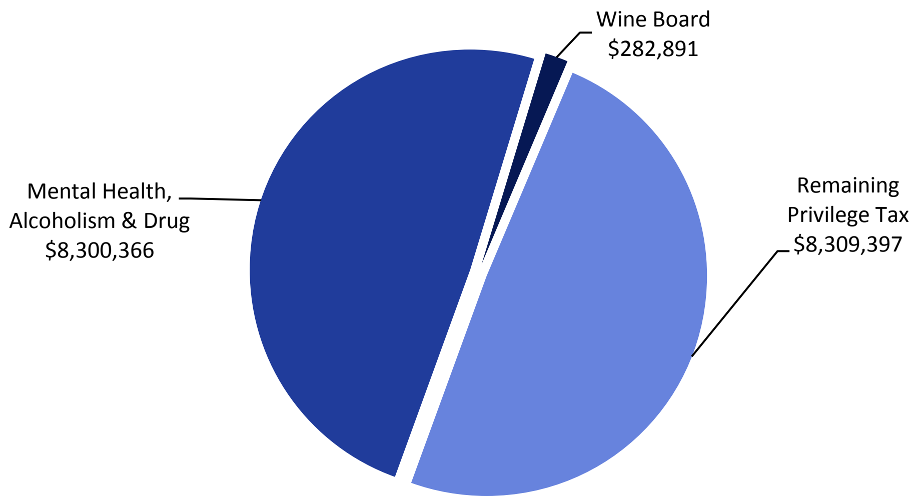
Oregon law requires that 50% of privilege tax revenues be allocated for mental health, alcohol and drug abuse prevention, intervention and treatment services. In addition, the Oregon Wine Advisory Board (Wine Board) receives two cents for every gallon of wine sold. The remaining privilege tax revenues can be used to pay contracted liquor agents and to finance OLCC operations.

We obtained malt beverage and wine production statistics from OLCC's website for the most recently completed four fiscal years (2009-2012). The statistics present the approximate number of barrels of malt beverages and the gallons of wine reported as taxable for each month for all privilege tax license types.

To determine whether 50% of the privilege tax revenue was distributed to mental health, alcohol and drug abuse prevention, intervention and treatment services, we developed an estimate of privilege tax revenue based on the number of barrels of malt beverage and the number of gallons of wine produced multiplied by the associated tax rate. We compared our estimate to recorded distributions and determined the two amounts were within a reasonable range of each other.

Privilege Tax revenue distributions for the most recently completed fiscal year are illustrated in figure 5.

Figure 5: Privilege Tax Revenue Distributions, Fiscal Year 2012



We examined OLCC's compliance with distributions to the Wine Board by multiplying the number of gallons of wine produced during the most recent five fiscal years by two cents. We compared our calculation to recorded distributions and determined the two amounts were within a reasonable range of each other.

We determined the results of the legal compliance tests described previously disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Objectives, Scope and Methodology

The objectives of our audit were to 1) determine the effectiveness of OLCC's financial controls related to its revenue cycle (collection and distribution), and 2) determine its compliance with key legal requirements.

Our audit procedures focused on financial controls in place during fiscal year 2013. However, for background and financial analysis purposes we obtained financial data from the state's accounting system for state fiscal years 2009 through 2013 (as of March 11, 2013) and we determined the data used in our analysis was sufficiently reliable for our audit purposes.

To accomplish our audit objectives, we performed analytical procedures, made inquiries of department personnel, observed processes, and reviewed supporting documentation.

We selected random samples of OLCC's liquor agents and licensees that were active during fiscal year 2013 and reviewed their records submitted to the OLCC. We reviewed appropriate records for testing purposes, which included agent audit reports, weekly sales reports, deposit slips, accounting system input documents, vouchers, and monthly financial work paper files.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Oregon
John A. Kitzhaber, MD, Governor

Liquor Control Commission
9079 SE McLoughlin Blvd
Portland, OR 97222-7355
(503) 872-5000
(800) 452-6522

June 19, 2013

Gary Blackmer, Director
Oregon Audits Division
Secretary of State
Public Service Building, Ste 500
Salem, Oregon 97301

Dear Director Blackmer:

This month your division's audit team, headed by Deputy Director Mary Wenger, completed its review of the Oregon Liquor Control Commission's (OLCC) revenue cycle's financial controls. The Commission has reviewed the audit letter and acknowledges that the audit found internal controls were "applied and effective". Additionally, we note that legal compliance testing found no instances on non-compliance.

Our agency values the independent role of the audit in ensuring stewardship of state assets. We appreciated the audit team's professionalism in conducting the evaluation. Your audit report reassures us that OLCC is indeed fulfilling its responsibilities in revenue cycle controls.

Sincerely,

Merle Lindsey
Interim Executive Director
OLCC

About the Secretary of State Audits Division

The Oregon Constitution provides that the Secretary of State shall be, by virtue of her office, Auditor of Public Accounts. The Audits Division exists to carry out this duty. The division reports to the elected Secretary of State and is independent of the Executive, Legislative, and Judicial branches of Oregon government. The division audits all state officers, agencies, boards, and commissions and oversees audits and financial reporting for local governments.

Audit Team

Mary Wenger, CPA (Deputy Director)

V. Dale Bond, CPA, CISA, CFE (Audit Manager)

Alan Bell, MBA, CFE (Principal Auditor)

Christian Kelly, MBA (Staff Auditor)

Joseph Flager (Staff Auditor)

This report, a public record, is intended to promote the best possible management of public resources. Copies may be obtained from:

internet: http://www.sos.state.or.us/audits/index.html

phone: 503-986-2255

mail: Oregon Audits Division
255 Capitol Street NE, Suite 500
Salem, OR 97310

The courtesies and cooperation extended by officials and employees of the Oregon Liquor Control Commission during the course of this audit were commendable and sincerely appreciated.