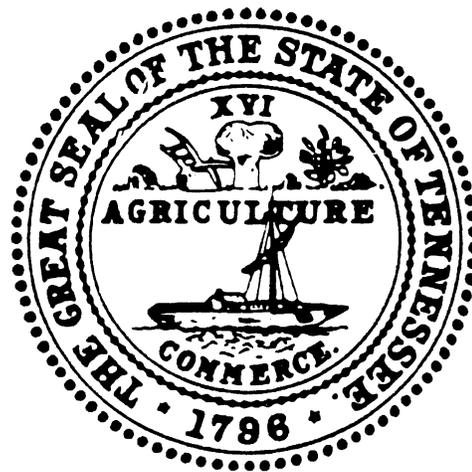


AUDIT REPORT

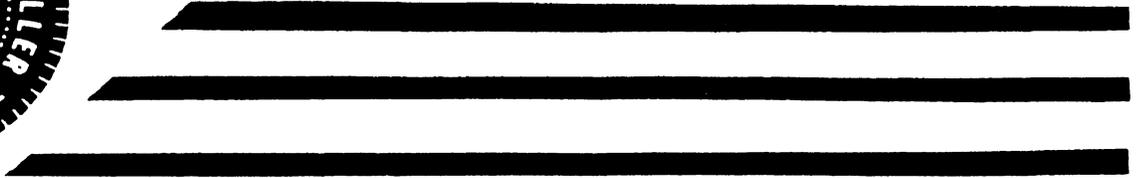
Alcoholic Beverage Commission

July 2007



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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John G. Morgan
Comptroller

July 16, 2007

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Members of the Alcoholic Beverage Commission
and
Ms. Shari Danielle Elks, Executive Director
Alcoholic Beverage Commission
Suite 300, Capital Boulevard Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Alcoholic Beverage Commission for the period July 1, 2001, through January 31, 2007.

The review of internal control and compliance with laws and regulations resulted in certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/to
05/064



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COMPTROLLER OF THE TREASURY
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January 31, 2007

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Alcoholic Beverage Commission for the period July 1, 2001, through January 31, 2007.

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Alcoholic Beverage Commission's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Alcoholic Beverage Commission is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit disclosed certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The Alcoholic Beverage Commission's management has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the Alcoholic Beverage Commission's internal control and instances of noncompliance to the Alcoholic Beverage Commission's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/to

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Alcoholic Beverage Commission
July 2007

AUDIT SCOPE

We have audited the Alcoholic Beverage Commission for the period July 1, 2001, through January 31, 2007. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of revenue, equipment, confiscated inventory, the Alcohol Server Training Program, conflicts of interest, the Financial Integrity Act, Title VI, and the Audit Committee Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

AUDIT FINDINGS

Controls Over Cash Receipts Are Inadequate, Resulting in the Theft of Funds*

The Alcoholic Beverage Commission has not assessed and mitigated fraud risks, resulting in inadequate controls over cash receipting and the theft of funds. Also, the commission cannot ensure that all funds have been collected and properly deposited. The deficiencies include a lack of segregation of duties, a lack of managerial monitoring through reconciliations, and inadequate physical controls over cash (page 5).

The Commission Has Not Assessed and Mitigated Fraud Risks Over Confiscated Inventory

Significant deficiencies in the controls over confiscated inventory were noted through interviews with commission personnel and the review of confiscated inventory procedures and records. The deficiencies include not maintaining a master listing of confiscated inventory, no periodic physical inventory taken by someone independent of the custody or recording of the inventory, and the listing of cases in which cash was confiscated being incomplete and inaccurate (page 11).

The Commission Has Not Assessed and Mitigated Fraud Risks, Resulting in Inadequate Controls Over the Alcohol Server Training Program*

The commission failed to assess the risks of fraud, waste, and abuse in the administration of the Alcohol Server Training Program. As a result, there is not an effective system of internal controls to mitigate those risks. The deficiencies in the internal controls of the Alcohol Server Training Program include written policies and procedures not being adequate, server permits not being issued in numerical sequence, the Tennessee Anytime system allowing users to reprint server permits and modify server data, and access to Tennessee Anytime not being adequately segregated (page 14).

The Commission Has Not Assessed and Mitigated the Risks of Related-Party Transactions

The commission has not developed comprehensive conflict-of-interest policies, and compliance with existing policies is not adequate (page 20).

The Commission Did Not Comply With the Financial Integrity Act

The commission did not prepare and submit the required letters acknowledging responsibility for maintaining internal control that were due by June 30, 2006; June 30, 2004; June 30, 2003; and June 30, 2002. The internal accounting and administrative control

report that was due by December 31, 2003, was received by the Comptroller of the Treasury on March 8, 2004, 68 days late (page 23).

The Commission Failed to Properly Submit Title VI Compliance Reports and Implementation Plans Relating to Compliance With the Civil Rights Act of 1964

The report and plan due on June 30, 2002, were submitted to the Comptroller's Office on October 11, 2002. The report and plan due on June 30, 2003, were submitted on October 1, 2004. There was no evidence in the Comptroller's Office that the report and plan due on June 30, 2004, were ever received. The report and plan due on June 30, 2005, were submitted on May 31, 2006 (page 24).

Management of the Alcoholic Beverage Commission Has Not Completed a Risk Assessment, and the Commission Does Not Have a Functioning Audit Committee, Nor Has the Commission Requested an Exception as Required by State Law

As of, January 31, 2007, no audit committee has been established, no charter has been created, nor have the commission members requested an exception to the audit committee law. Also, management of the Alcoholic Beverage Commission has not completed a risk assessment (page 26).

* Parts of this finding are repeated from the prior audit.

Financial and Compliance Audit Alcoholic Beverage Commission

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Financial and Compliance Audit Alcoholic Beverage Commission

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Alcoholic Beverage Commission. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The commission consists of three members, one from each grand division of the state, appointed by the Governor for terms concurrent with the Governor’s term. The Executive Director of the commission, a licensed attorney, is the chief administrator and is aided by an Assistant Director and a Chief Law Enforcement Officer. The commission also employs special agents who are authorized to enforce the provisions of the applicable criminal statutes, as well as those rules and regulations enacted by the commission. These agents are responsible for regulatory inspections and liquor and/or drug investigations, which may be covert or overt.

The commission’s primary responsibility is to enforce the rules and laws governing the liquor industry in Tennessee. Regulation and enforcement of alcoholic beverages less than five percent alcohol (i.e., beer) are handled by the local jurisdictions and vary significantly from place to place.

The commission is the legislatively assigned administrator of the statewide server training program. The purpose of the program is to make alcoholic beverage industry employees aware of the responsible service, sale, and dispensing of alcoholic beverages. The ultimate goal of the program is to help reduce the number of deaths and injuries caused by intoxicated drivers, reduce the numbers of intoxicated drivers on state highways, and reduce the property damage resulting from alcohol-related accidents. Servers also receive training on identifying underage drinkers and intoxicated individuals. The server training program is financed entirely by fees generated from class registration.

An organization chart of the Alcoholic Beverage Commission is on the following page. The commission is part of the General Fund of the State of Tennessee. The audit covered allotment code 316.03.

AUDIT SCOPE

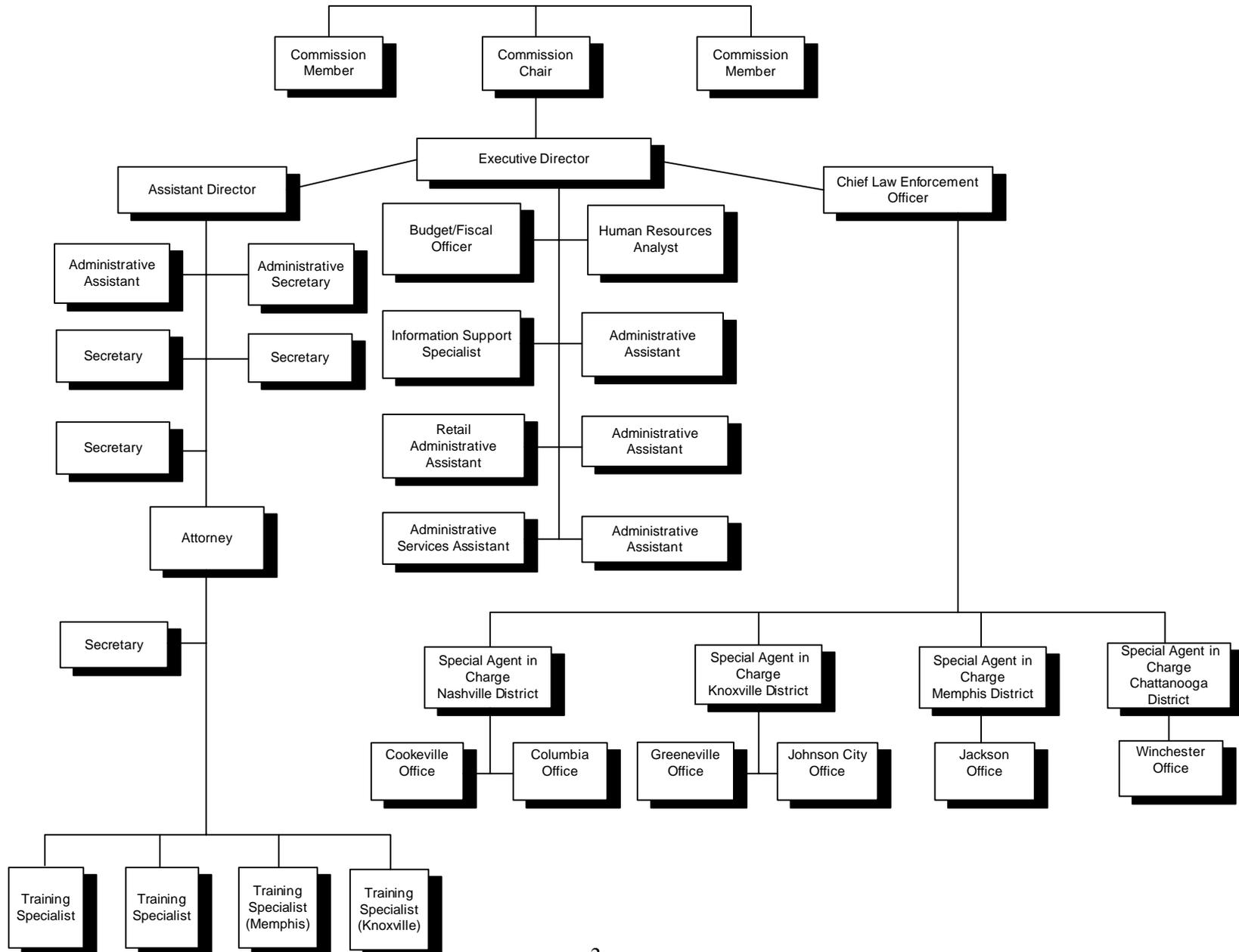
We have audited the Alcoholic Beverage Commission for the period July 1, 2001, through January 31, 2007. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of revenue, equipment, confiscated inventory, the Alcohol Server Training Program, conflicts of interest, the Financial Integrity Act, Title VI, and the Audit Committee Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Alcoholic Beverage Commission filed its report with the Department of Audit on April 8, 2003. A follow-up of all prior audit findings was conducted as part of the current audit.

The prior audit report contained a finding concerning controls over cash receipting needing improvement. This finding has not been resolved and is repeated in the applicable section of this report. The prior report also contained a finding related to the Alcohol Server Training Program. This finding has been partially repeated in the applicable section of this report.

Tennessee Alcoholic Beverage Commission Organization Chart



OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE

Our objectives for reviewing revenue controls and procedures were to determine whether

- policies and procedures regarding revenues were adequate;
- cash collected during the audit period was deposited timely and recorded correctly;
- revenue or fees were charged and recorded at the correct amount;
- physical controls over cash were adequate;
- the Confidential Fund checking account had been authorized by the Department of Finance and Administration;
- commission records were reconciled with Department of Finance and Administration reports; and
- liquor dealers had paid their taxes before their licenses were renewed.

We interviewed key commission personnel, observed the physical controls over cash, and reviewed the policies and procedures manual, the commission's rules and regulations, the log for receipt books, permit cards, liquor by the drink licenses, cash receipt books, license books, liquor dealer files, deposit slips, and mail logs to gain an understanding of the controls over revenue and fees collected by the commission. Because the commission's records were incomplete and inaccurate, we were unable to test cash receipts for timely deposits and correct recording or to determine whether revenue or fees were charged and recorded at the correct amount. We verified that the commission's Confidential Fund was authorized by the Department of Finance and Administration. We reviewed supporting documentation to determine whether commission records were reconciled with reports from the Department of Finance and Administration from July 1, 2002, to March 31, 2005. We tested a nonstatistical sample of liquor dealer files for verification that the dealers' state taxes had been paid prior to license renewal.

Based on interviews, reviews of supporting documentation and the commission's policy and procedures manual, and testwork performed, we determined that policies and procedures regarding cash receipting and the physical controls over cash were inadequate. Due to the lack of segregation of duties, lack of managerial monitoring through reconciliations, and other deficiencies in internal controls, the risk of fraudulent activities cannot be mitigated. The internal control deficiencies and a related theft of funds are detailed in finding 1. In addition to the deficiencies noted in finding 1, there were additional deficiencies noted in our review of the Alcohol Server Training Program which also affect the ability of the commission to verify the accuracy of revenue related to permits. See finding 3.

We determined that the Confidential Fund checking account has been authorized by the Department of Finance and Administration, that the commission's records were reconciled with reports from the Department of Finance and Administration, and that liquor dealers had paid their taxes before their licenses were renewed with minor exceptions.

1. The Alcoholic Beverage Commission has not assessed and mitigated fraud risks, resulting in inadequate controls over cash receipting and the theft of funds, and the commission cannot ensure that all funds have been collected and properly deposited

Finding

The commission collects funds from licenses issued to wineries, distilleries, liquor wholesalers and retailers, non-resident sellers, temporary liquor sales venues, and establishments with on-premise liquor consumption (liquor by the drink). Funds are also collected from server permits, server training program certifications, server trainer certifications, and fines. The commission receives funds for all types of licenses, certificates, permits, and fines in the mail and from walk-in clients. Revenue from server permits and liquor-by-the-drink licenses is primarily received from walk-ins. The rest of the revenue is primarily received by mail. The commission has locations in Chattanooga, Knoxville, Nashville, and Memphis that collect funds and issue permits and licenses.

Based on interviews and reviews of the commission's policy and procedures manual, we determined that policies and procedures regarding cash receipting were inadequate. The commission's written policies and procedures were created in 1993. The cash receipting process has changed drastically with the conversion to a computerized environment and various personnel changes. However, the policies have not been updated to include these changes.

Since the prior audit, which covered the period July 1, 1999, through June 30, 2001, the commission has had three cash receipts thefts. Two were thefts of cash in the amounts of \$350 and \$400 from a safe and drawer, respectively. The third was the theft of \$12,075 through the use of dual receipt and license books. Various actions of management related to the misappropriation of funds were inappropriate, including the Executive Director handing out envelopes to employees requesting that the person who took the \$400 return the funds and no questions would be asked. According to the Executive Director, one employee admitted to her that she had taken the money, and the Executive Director decided to give the employee a second chance by placing the employee on five days of administrative leave without pay and allowing the employee to repay the money on an installment basis. This employee was subsequently convicted of theft of the additional \$12,075 from the commission. The employee had only repaid \$100 of the \$400. In addition, the Executive Director did not notify the Comptroller of the Treasury's office upon the discovery of either the \$350 or the \$400 loss. Also, the Executive Director did not promptly notify the Comptroller of the Treasury's office of the \$12,075 loss. The loss was discovered by commission staff on July 13, 2004, but was not reported until August 9, 2004. In February 2005, the employee who had taken the money pled guilty and was

sentenced to three years of probation and ordered to pay restitution of \$12,000 and court costs. As of April 4, 2007, the commission has received \$1,010 from the former employee.

A review of criminal history disclosed that while the former employee was an employee of the commission, she was prosecuted for possession of marijuana in May 2003. She pled no contest to a misdemeanor and was given an 11-month, 29-day suspended sentence and was sentenced to probation. The employee's arrest, conviction, and sentence were known to the Executive Director at the time. It would have been a prudent business practice to remove that employee from any responsibility of handling funds.

After the thefts were discovered, the commission attempted to improve its cash receipting procedures; however, assets are still not being adequately safeguarded, and a lack of segregation of duties still exists.

The prior audit contained a finding stating that controls over cash receipts needed improvement. Management concurred with the prior finding and stated that "the procedure for making cash deposits daily and receipting and entering all revenue received through the mail shall be improved. Accountability shall be enhanced by employing an independent person to review the mail log, deposit slips, and accounting records." Although some changes were made, further improvements are needed.

The following deficiencies were determined through interviews with commission personnel and review of cash receipting procedures and records.

- The Budget/Fiscal Officer has full access to all aspects of the cash receipting process. Her duties include the review of cashiers' daily collections, preparing deposits and taking them to the bank, posting all entries into the accounting records, issuing receipt books, and issuing license books. She also randomly verifies that items in the deposit are listed on the mail log.
- Physical controls over cash are inadequate. The auditors noted that funds were not always placed in a locked safe; sometimes funds were left in desk drawers. As a result, the commission issued a bank bag to each cashier. In addition, when mail is distributed, envelopes containing money are at times left in a mail organizer, which serves as a mail file for each employee. This organizer is open to anyone who enters the administrative offices area.
- We determined that cash collected during the audit period was not always deposited timely for the Nashville location. During our fieldwork, the commission had a training session during the week of May 9, 2005, thru May 13, 2005. Based on discussions with personnel, no deposits were made during that week. After reviewing a nonstatistical selection of deposit slips, the auditor found instances of funds not being deposited daily throughout the audit period.
- Since the theft, the commission established a policy requiring cashiers to make up any shortage noted in a deposit. As these shortages are being covered by employees, they are not being reported to upper management or to the Comptroller of the Treasury as

required by state law. Based on interviews with cashiers in Nashville, there have been at least three instances subsequent to the matters previously reviewed in which shortages were replaced by employees.

- The commission's cash receipt books are preprinted, prenumbered, and multi-copy forms; however, they were not issued in sequence. Before the thefts, access to the cash receipt books was unlimited. A log of receipt books issued was supposed to be maintained; however, our review of the log revealed that it was incomplete and that the sequence of receipts listed was inaccurate. After the theft, access to the cash receipt books was restricted to the Budget/Fiscal Officer, who secures the books in her office. She now has the responsibility of keeping a log of all issued books. However, in order to use up the current stock of receipts, she is still issuing books out of sequence. Therefore, we are unable to ensure that all cash receipts issued by the commission have been retained or documented.
- In addition to the cash receipt books, the commission uses similar preprinted form books to issue licenses for liquor by the drink and retail stores. The license books issued were supposed to be logged in the same book as the receipt books. However, similar to the receipt books, the license books have also been issued out of sequence, and the log appears to be inaccurate and incomplete.
- There are no independent reconciliations of cash receipts. There is no complete reconciliation of the mail log to the final amount deposited; there is only a random verification by the Fiscal/Budget Officer of items in the deposit to items listed on the mail log. There is no reconciliation of certificates issued, licenses issued, server permits issued, or fines assessed to funds collected. Therefore, the commission can not ensure that all funds have been collected and deposited for all licenses and permits issued and fines assessed.

In addition to the deficiencies noted above, there are additional deficiencies noted in our review of the Alcohol Server Training Program which also affect the ability of the commission to verify the accuracy of revenue related to permits. See finding 3.

Based on the deficiencies noted in this finding as well as the other findings in this report, it appears that the Alcoholic Beverage Commission's management has not assessed the risk of fraud, waste, and abuse within its organization's processes. As a result, the commission has failed to develop, implement, and monitor an effective internal control structure for cash receipting. Since the commission's management has been given authoritative control over the affairs of the Alcoholic Beverage Commission, it is their responsibility to assess risks based on a critical review of the organization's processes. In addition, management is responsible for developing, implementing, and monitoring effective internal controls to mitigate those risks.

Recommendation

Top management should ensure that risks related to the cash receipting process are adequately identified and assessed in their documented risk assessment activities.

(Management's risk assessment should be comprehensive in scope and not just limited to matters noted by the auditors.) Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect deficiencies timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt corrective actions should deficiencies occur. At the very least, the following matters should be clearly documented in the internal control policies and procedures developed by management:

- Management should adequately segregate the cash receipting responsibilities of preparing the mail log or cash receipt, issuing a permit or license, preparing the deposit, taking the deposit to the bank, and posting the receipt to the accounting records.
- The Budget/Fiscal Officer should conduct regular and ongoing reconciliations of the bank-validated deposit slips, with the cash receipts, licenses and permits issued, mail log, and the accounting records. The Budget/Fiscal Officer may continue to post transactions to the accounting records and issue receipt and license books; however, she should not perform any other cash receipting functions.
- Management should also ensure deposits are made timely.
- An employee who is not associated with fine assessment or payment should regularly reconcile fines assessed to the final disposition of the fine.
- Access to cash should be restricted to as few employees as possible. Management should ensure that cash is safeguarded at all times.
- Management should ensure that cash receipt and license books, as well as the related receipts and licenses, are issued in sequence.
- All reconciliations should be fully documented. Any unexplained differences noted in the reconciliation should be immediately reported to top management, who should immediately report them as noted below.
- Management should, upon receiving knowledge of abusive or fraudulent actions by employees, promptly review their job responsibilities and take appropriate actions to mitigate risks of misappropriation of funds or assets. A prudent business practice would be to immediately remove the employee from handling funds and to report the matter immediately to the Comptroller of the Treasury's office.

Management's Comment

We concur. A review of the past three audits performed on the Tennessee Alcoholic Beverage Commission (TABC) indicates that cash receipting has been a weakness for the agency for at least the past ten years. After each audit, the TABC implemented changes that the audit report recommended to the extent possible.

Upon review of the current audit recommendations, the TABC has implemented changes in its procedures attempting to minimize and/or to eliminate the possibility and opportunities of fraud risks. Specifically, the TABC accounts for every license, receipt, etc. issued—whether voided or not—and insures that they are issued in sequence. Such are assigned to personnel, and must be accounted for prior to receiving the next group of licenses, receipt books, etc. Further, the TABC will attempt to segregate duties wherever possible to distinguish the collection of monies and the issuances of licenses, consent orders, etc. Although customer service will remain a priority to the TABC, the segregation of duties will be implemented.

A more concerted effort shall be made to timely deposit the monies received. The TABC does have concerns in situations where license fees/penalties would be required to be deposited prior to the approval of licenses, certifications, and/or settlements. Research is being conducted to look at alternatives.

Although reconciliations currently take place on a regular basis, a more detailed reconciliation of the mail logs, licenses issued, and monies received shall be made.

The audit recommends that the fines received should be reconciled to the final disposition of the fine. That process has been done on an informal procedure in the past; the reconciliation shall be formalized.

It should be noted that the TABC reacted to the employee theft situation in good faith. After advising the Comptroller's Office of the situation and corrections in procedure that had been implemented, the TABC requested any additional suggestions which should be implemented. The TABC understands why additional suggestions were not forthcoming as such could influence future audit reviews. As such, the TABC will request an improvement for an auditor to be added to its staff to assist in internal policies and procedures, but for use in enforcement areas as well.

EQUIPMENT

Our objectives for reviewing equipment controls and procedures were to determine whether

- policies and procedures related to equipment were adequate;
- equipment purchases were properly added to the Property of the State of Tennessee (POST) system;
- the information on the commission's equipment listed in POST was accurate and complete;
- proper procedures were followed for lost or stolen equipment;
- equipment was adequately safeguarded;
- policies and procedures for firearms were adequate; and

- employee access to POST was appropriate.

We interviewed key commission personnel and reviewed supporting documentation to gain an understanding of the commission's controls and procedures over equipment. We traced all equipment items purchased from July 1, 2001, through January 31, 2005, that cost at least \$5,000 to the supporting invoices to determine whether the equipment was properly added to POST. We tested a nonstatistical sample of equipment in POST as of March 9, 2005. These equipment items were physically located, and the description, tag number, serial number, and location were traced to POST. We reviewed supporting documentation to verify that lost or stolen equipment was reported to the Comptroller of the Treasury and removed from POST. We interviewed key commission personnel to gain an understanding of the commission's controls and procedures over firearms. We obtained a current listing of persons with access to POST. We then determined whether persons with access were active employees, had job duties which required this level of access, and had a level of access which created an adequate segregation of duties.

Based on interviews and reviews of supporting documentation, we determined that policies and procedures related to equipment were adequate, and equipment was adequately safeguarded. Based on testwork, we determined that equipment purchases were properly added to POST and that information on the commission's equipment listed in POST was accurate and complete. Also, proper procedures were followed for lost or stolen equipment. Based on interviews and observations, we determined that the commission's policies and procedures for firearms were adequate. Our testwork revealed that access to POST was appropriate.

CONFISCATED INVENTORY

Our objectives for reviewing controls and procedures over confiscated inventory, including cash, were to determine whether

- policies and procedures for confiscated inventory were adequate;
- confiscated inventory was adequately safeguarded;
- inventory recorded represented a complete listing of the commission's confiscations and such items were physically on hand; and
- confiscated cash for cases closed during the audit period was properly removed from inventory and deposited.

We interviewed key commission personnel at the Nashville office and reviewed the commission's policies and procedures manual, inventory logs, evidence logs, Property Receipt/Release Forms, and Inventory Search Forms to gain an understanding of the commission's controls and procedures over confiscated inventory. We attempted to perform procedures to determine the completeness of the confiscated inventory records. We performed an inventory test count of the Nashville office's inventory of drugs, drug paraphernalia, liquor, various liquor paraphernalia (stills), weapons, and gambling paraphernalia. The test counts

consisted of verifying the existence of a sample of items listed on the inventory log created by the Nashville custodian. In addition, the auditor selected items at random from the inventory and verified that the items were properly recorded on the inventory log. We also attempted to test confiscated cash by requesting from the commission a listing of cases with confiscated cash. We then attempted to verify that the cash evidence for those cases was maintained in the commission's safety deposit boxes. In addition, we counted the cash for each case in the safety deposit boxes and verified that it matched the Property Receipt/Release Forms attached. We also attempted to test cash from cases closed during the audit period to determine whether funds were properly removed from inventory and deposited.

Based on interviews and reviews of supporting documentation, we determined that policies and procedures regarding confiscated inventory were inadequate. We were unable to determine the accuracy and completeness of the commission's records related to the confiscated inventory, due to the lack of managerial monitoring through reconciliations. We determined the confiscated inventory recorded by the Nashville custodian was on hand in the Nashville storage facility. However, we could not determine if these records represented all seizures that should have been placed in the custody of the Nashville storage facility custodian, because there are no independent confiscated inventory records kept by the commission. The confiscated inventory at the Nashville storage facility appears to be adequately safeguarded. The disposal of confiscated inventory and the final disposition of closed cash cases were not tested, because there is no independent reconciliation of the confiscated inventory records with the confiscated inventory on hand. The internal control deficiencies noted above are detailed in finding 2.

2. The Alcoholic Beverage Commission has not assessed and mitigated fraud risks over confiscated inventory

Finding

The commission's confiscated inventory comes from seizures performed by the commission's law enforcement agents. The confiscated inventory, which can be from either a regulatory or criminal case, consists of drugs, drug paraphernalia, liquor, various liquor paraphernalia (stills), weapons, gambling paraphernalia, and cash. During a case, if the agent performs a seizure or search, he is required to complete an Inventory Search Form. Then, when the inventory is placed in the care of the inventory custodians at each major post of duty or transferred from one person to another, a Property Receipt/Release Form is completed. Finally, when inventory is disposed of through sale, destruction, or return, an Evidence Disposition Report is completed. There are two custodians for cash as the funds are kept in two bank safety deposit boxes, which require two signatures to enter. The Chief Law Enforcement Officer and the Budget/Fiscal Officer are the custodians. The following deficiencies were noted through interviews with commission personnel and the review of confiscated inventory procedures and records:

- The commission's policies and procedures over confiscated inventory have not been updated or signed as reviewed since 1993. In addition, the policy manual discusses

the storage of evidence at local sheriffs' offices, police departments, or county clerks' offices; however, this practice is no longer allowed.

- The commission does not maintain a master listing of confiscated inventory. Each custodian maintains copies of the Property Receipt/Release Forms and/or listings of confiscated inventory placed in his custody. The central office receives copies of the Inventory Search Forms and Property Receipt/Release Forms; however, no master listing of inventory is prepared by the central office. Therefore, the commission maintains no independent record of what confiscated inventory should be on hand.
- Although the commission's policies include provisions for a periodic physical inventory, there was no documentation that an inventory was taken by someone independent of the custody or recording of the inventory.
- There is no master listing of items removed from inventory and their final disposition. Therefore, commission management cannot make an assessment that all inventory items were disposed of properly.
- The listing of cases in which cash was confiscated was incomplete and inaccurate. The listing did not include all cash in the commission's safety deposit boxes. In addition, there was one case on the commission's listing for which the applicable case file indicated that the case did not contain a cash seizure.
- There is no independent reconciliation of cash received to cash recorded. Therefore, we were unable to determine that all funds confiscated were recorded in the commission's confiscated cash records and placed in the safety deposit boxes. We were also unable to verify that the closed case listing was complete and accurate.

Recommendation

Management should ensure that risks related to confiscated inventory are adequately identified and assessed in their documented risk assessment activities. (Management's risk assessment should be comprehensive in scope and not just limited to matters noted by the auditors.) Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect deficiencies timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt corrective actions should deficiencies occur. At the very least, the following matters should be clearly documented in the internal control policies and procedures developed by management:

- The policies and procedures manual should be updated to reflect the current internal control policies and procedures.
- An independent master listing of the confiscated inventory and cash should be maintained, including the final disposition of inventory and cash.
- A periodic physical inventory should be performed and documented to ensure that inventory records represent a complete and accurate listing of the confiscated items

and that items that should be on hand are on hand. The physical inventory should be performed by someone independent of the custody or recording of the inventory using the independent master listing.

- Any unexplained differences noted in the physical inventory should be immediately reported to top management and investigated.

Management's Comment

We concur. In the 1996/1997 audit, an audit finding was that “controls over confiscated inventory were inadequate.” The TABC implemented the recommendations made in that audit report. Although confiscated inventory items were reviewed, subsequent audits did not reflect any findings related to this area. However, the 2001-2004 audit reflected a finding that “the Alcoholic Beverage Commission has not assessed and mitigated fraud risks over confiscated inventory.”

The findings of the most recent audit indicate that a master listing of confiscated inventory does not exist. We concur. However, please note that at each office where confiscated inventory is stored, a master listing for that location exists. Seizure forms and property receipt/release forms are forwarded to the Nashville headquarters so that at any given time, Nashville headquarters may ascertain what property is held at any location—although a “master list” has not been compiled. Such “master list” shall be created, maintained, and reconciled.

Although the audit implies that reconciliations of the confiscated inventory and cash to the actual inventory and cash on hand had not been performed, such reconciliations had been performed either by the Chief Law Enforcement Officer, Fiscal Officer, and/or Special Agents-in-Charge. However, such reconciliations had not been documented. The finding indicates that someone independent of these individuals perform such audit. The TABC will find someone independent of law enforcement to perform such an inventory. Any differences found based upon this independent reconciliation shall be investigated. It is anticipated that the new Edison program implemented by the state shall assist in this matter.

The policy and procedures manual in all areas will be updated. The update is in progress.

ALCOHOL SERVER TRAINING PROGRAM

Our objectives for reviewing the Alcohol Server Training Program were to determine whether

- policies and procedures for the program were adequate;
- the rules for issuing server permits were complied with; and
- the correct server permit and training program certification fees had been charged and collected.

We interviewed key commission personnel and reviewed the policies and procedures manual, rules of the commission, server permit applications, daily reports from Tennessee Anytime, and other supporting documentation to gain an understanding of the commission's procedures and controls over the Alcohol Server Training Program. We also observed the commission's process of issuing server permits. We attempted to test a sample of server permits issued and trainers certified during the audit period to determine compliance with commission rules and if fees were properly collected.

Based on interviews and reviews of the commission's policy and procedures manual, we determined that policies and procedures regarding the Alcohol Server Training Program were inadequate. We were unable to assess the accuracy and completeness of the commission's records related to the server permit program; therefore, we were unable to sample and test server permits or trainers certified. In addition, due to the lack of segregation of duties, lack of managerial monitoring through reconciliation, and other deficiencies in internal controls, the risk of fraudulent activities cannot be mitigated. The internal control deficiencies are detailed in finding 3. As the issuance of permits is integrated into the cash receipting process, the weaknesses noted in this section will affect the accuracy and completeness of the permit revenue discussed in the Revenue section above and finding 1.

3. The Alcoholic Beverage Commission has not assessed and mitigated fraud risks, resulting in controls over the Alcohol Server Training Program being inadequate

Finding

The primary responsibility of the Alcoholic Beverage Commission is to enforce the rules and laws governing the liquor industry in Tennessee. In 1995, the General Assembly passed legislation creating a statewide server-training program and assigned the commission as the administrator. The purpose of the program is to make alcoholic beverage industry employees aware of the need for responsible service, sale, and dispensing of alcoholic beverages.

The commission issues server permits for establishments with on-premise liquor consumption. The permit requires servers to receive training in the serving, selling, and dispensing of alcoholic beverages. The commission certifies various groups to present a server training program. In addition, the commission certifies trainers under each certified program.

In December 2001, in an attempt to make server permits easier to obtain, the commission contracted with Tennessee Anytime, a division of NIC Inc., to provide an online permit system. The Web access portion of the system for the commission's clients has not been activated. However, commission personnel use the system to issue permits at all four major posts of duty: Chattanooga, Knoxville, Memphis, and Nashville.

Based on interviews with key commission personnel in Nashville, reviews of the server permit process and related supporting documentation, and a review of the Tennessee Anytime system, the commission failed to assess the risks of fraud, waste, and abuse in the administration

of the Alcohol Server Training Program. As a result, there is not an effective system of internal controls to mitigate those risks. The following deficiencies in the internal controls of the Alcohol Server Training Program were noted:

- We determined that written policies and procedures regarding the Alcohol Server Training Program were not adequate. The manual has not been updated since 1993, and the rules of the commission have not been updated since 1999. Tennessee Anytime, which was implemented in December 2001, is not mentioned in either set of policies.
- We were unable to test a sample of server permits, since we could not ensure that the population we were testing was complete. We attempted to select a sample from all server permits in the Tennessee Anytime permit system. However, server permits are not issued in numerical sequence. We found that numerous permit numbers were skipped by the computer. For example, on one day during the audit period, we noted that 57 permit numbers were skipped. These numbers were among the 142 permits that appear to have been issued that day. We also attempted to obtain the database of server permits from Tennessee Anytime. However, we were informed by personnel from Tennessee Anytime and commission personnel that the database had been dumped into a file and given to the commission. Commission personnel stated that they were reviewing the database dump information in order to identify duplicate entries and delete them from the system. Based on discussions with personnel from Tennessee Anytime, no records have been deleted. However, based on discussions with commission personnel, records have been deleted by Tennessee Anytime. Therefore, we were unable to determine that the database was complete. As a result, any testing from the database would not be an accurate reflection of the transactions that had occurred.
- We determined that the Tennessee Anytime system allows users to reprint server permits and modify server data. Therefore, multiple permits can be issued with the same permit number but with different names. In addition, multiple permit numbers or multiple copies of a permit can be issued to the same person.
- Access to Tennessee Anytime is not adequately segregated by the commission. There have been 39 identification codes established in the system. These identification codes allow the person assigned the code unlimited access to the system, including the ability to issue a server permit. The access codes assigned include five former employees and one employee with two identification codes.
- The auditors have not been able to obtain adequate documentation for the Tennessee Anytime server permit system. There is no user or system manual at the commission's offices.
- Based on a review of application reports from the commission, the system allows two records with the same social security number. The system also allows the social security number to include letters and have a length other than nine digits.

- Controls over cash receipting are not adequate. At the end of each day, a listing of funds received is prepared and reconciled to the physical assets by the employee collecting the funds. The listing shows the name or establishment and the amount collected by cash or by check. It also has a total of all funds collected. Finally, the listing is signed by the cashier acknowledging that all funds have been reconciled. After this reconciliation is prepared, the funds and reconciliation are placed in a locked bank bag; the bag is given to or picked up by the Personnel Analyst and locked in the commission's safe overnight. The next morning, the locked bank bags are taken out of the safe by the Personnel Analyst and handed back to the employee who collected the funds. Tennessee Anytime then sends to the Budget/Fiscal Officer a daily report listing permits issued per the system and the related amount of funds that should have been collected. The Budget/Fiscal Officer sorts the report into a printable format and distributes copies of the report to the applicable employee. After the employee matches the funds on the report to the funds collected, the funds in the bank bag are then taken to the Budget/Fiscal Officer for deposit. This process results in several deficiencies, such as inadequate segregation of duties and inadequate safeguarding of physical assets, which are outlined in finding 1. In addition to those deficiencies, there is no independent reconciliation of amounts collected and deposited to server permits issued.

In addition to the deficiencies noted above, as the issuance of permits is integrated into the cash receipting process, the weaknesses noted in finding 1 will also affect the accuracy and completeness of the permit revenue and controls related to the Alcohol Server Training Program.

Appropriately, the commission members have vested the commission's management with responsibility over the day-to-day operational affairs of the Alcoholic Beverage Commission. In all cases, it is management's responsibility to establish an environment in which commission assets are protected against fraud, waste, and abuse and financial and nonfinancial information of the commission is complete and accurate.

To that end, and as reaffirmed in Appendix B of the letter sent to the chairman of the commission in November 2005, it is management's responsibility to assess risks based on a critical review of the entity's processes. In addition, management is responsible for developing, implementing, and monitoring effective internal controls to mitigate those risks. As demonstrated by the deficiencies in this finding and the others throughout the report, the commission's management has failed to identify risks associated with the Alcohol Server Training Program. In addition, management failed to develop, implement, or monitor an effective internal control structure.

Recommendation

Management should ensure that risks related to the Alcohol Server Training Program are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal

controls to prevent and detect deficiencies timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt corrective actions should deficiencies occur.

Management should develop written policies and procedures that outline a system of internal controls that ensures all funds received through the Alcohol Server Training Program can be accurately and completely recorded and reported. Management should either develop an external system of controls for deficiencies in the Tennessee Anytime system or contract to have the deficiencies corrected. System corrections should include, at a minimum:

- Documentation of all transactions when a permit number is assigned by the system. This could be accomplished in several ways, including redesign of the system so that the permit number is assigned at the time of printing, not when a transaction is started. Another possible option is the use of pre-numbered forms that are completed by the computer system.
- Documentation of all permits printed either as a first-time permit, renewal, and/or reprint or the removal of the reprint option. Other options include allowing a reprint only by a supervisor and using pre-numbered forms.
- The establishment and performance of edit checks on the database records and upon entry by commission personnel. These should include the system's only allowing nine-digit, numeric social security numbers and restricting duplicate records such as social security numbers and driver license numbers. Management and the system administrator should review the edit checks on all other fields to determine adequacy. Any override or change in the edits should be prohibited. Any such actions, if they occur, should be fully investigated by top management, including appropriate administrative action against individuals responsible for such actions. Top management should report any such situations promptly to the commission members. The commission members should review the actions of top management in investigating the matter and taking appropriate corrective action. All of these steps should be fully documented. If the situation involves possible fraud, top management and/or the commission members should immediately notify the Comptroller's Office as required by Section 8-19-501, *Tennessee Code Annotated*.
- A system of multilevel user access. The system should provide for read-only access, permit-issuance access, server training history access, and managerial or supervisor access. Management should limit the number of employees with unlimited access to the permit system.

Management should also develop or obtain from the system vendor a user manual and system documentation manual. Management should maintain documentation for all system changes and modifications, including direct modifications of the database. The Budget/Fiscal Officer should conduct a complete reconciliation of the bank-validated deposit slips, the cash receipts, permits issued, the Tennessee Anytime permit system reports, and the accounting records.

Management's Comments

Tennessee Alcoholic Beverage Commission

We concur. The TABC appreciates the issues found in the report, and was unaware that they existed. Since the creation of this software program, the TABC has had continuous issues with Tennessee Anytime, the creator of the computer program.

Because the TABC did not have a computer programmer on its payroll, employees—including management—did not have sufficient knowledge of computers and computer programming to specifically advise Tennessee Anytime that certain items must be built into the program. The TABC advised Tennessee Anytime of the purpose of the software, the requirements of the software, and how the software should work. The TABC reiterated its concerns over security and audit capabilities. The TABC relied on Tennessee Anytime—as the sole vendor available on state contract—to insure that the TABC concerns were implemented. Obviously, based upon the findings of the Comptroller's audit, such was not the case.

The TABC has consistently and constantly expressed its dissatisfaction with Tennessee Anytime. In fact, the TABC has refused to go forward with its original plans to issue server permits from the Internet because of Tennessee Anytime's inadequacies—even before the issuance of this audit. When the TABC received jurisdiction over a new training program at the end of the 2006 legislative session, the TABC went to the Office for Information Resources (OIR) only and has refused to allow the involvement of Tennessee Anytime in any of the programming for the new software.

A finding associated with server training is that too many employees have access to the issuance of the server permits. This practice was implemented to insure and to assist in customer service. Permits are issued from four offices; in three of the four offices only two support staff are employed. Additional employees (i.e., agent personnel) have been required in the past to access the program and issue permits when an employee is absent and/or at lunch. Otherwise, the public service is hindered. The TABC will develop a system of multilevel user access.

The TABC is investigating the possibility of a new server permit computer program—one which will not only correct the various findings in this audit report, but one that will also allow for the possibility of pictures for identification purposes to be used on server permits. The TABC will request that OIR aid in the development of this program if funding is available. Otherwise, the TABC will work with OIR and Tennessee Anytime to correct the various problems referenced in the report.

Department of Finance and Administration, Office for Information Resources (OIR)

The management response is limited to specific references to the online permit system developed by Tennessee Anytime for the Alcoholic Beverage Commission. OIR is not in a position to comment on the commission's assessment and subsequent mitigation of its fraud risks.

The major purpose of the system in support of the Alcohol Server Training Program was to provide the public the capability to apply for temporary (60-day) server permits and schedule the required training to obtain a three-year permit through the Web. An administrative component was developed for commission internal use. As noted in the audit, the Web access portion was not activated. Instead, both components of the system were implemented with commission employees as the only users.

OIR has had limited involvement in the development and maintenance of this application throughout its lifecycle. Responsibility for the establishment and maintenance of a contract with the state's portal vendor was OIR's primary responsibility. The specifications of the application, however, were negotiated between the Tennessee Alcoholic Beverage Commission and Tennessee Anytime and documented in a written agreement.

Tennessee Anytime examined the source code to determine whether an error in the application was responsible for permit numbers being skipped. They indicated that they were not able to detect any issue with the code. The application was developed to automatically generate a Permit ID number sequentially. If a permit process is terminated before completion, then that particular Permit ID is deemed unique and not reused. The application simply moves to the next sequential Permit ID number with the next request. Therefore, Tennessee Anytime believes that the Permit ID numbers in question simply were discarded and never used.

OIR concurs that the system allows users to reprint server permits and modify server data and is not adequately segregated by the commission. While OIR concurs with the finding's recommendations, the solution is best accomplished through the development of a new server system. Any new system, however, will **only** be successful if clear and comprehensive requirements are developed by the Alcoholic Beverage Commission and thorough testing is done by the commission prior to implementation. OIR would expect to review a project proposal and cost benefit analysis prepared and submitted by the agency.

CONFLICTS OF INTEREST

The objectives of our review of conflict-of-interest policies and procedures were to determine whether

- the commission has established a comprehensive, written conflict-of-interest policy for commission members and employees, and
- signed conflict-of-interest disclosure statements had been completed.

We interviewed key commission personnel and reviewed the conflict-of-interest policy to gain an understanding of the policies and procedures regarding conflicts of interest. All personnel records were tested for signed conflict-of-interest disclosure statements. We determined that the conflict-of-interest policy was inadequate and that the required conflict-of-interest disclosure statements were not always completed, as discussed in finding 4.

4. The commission has not assessed and mitigated the risks of related-party transactions

Finding

The commission has not developed comprehensive conflict-of-interest policies, and compliance with existing policies is not adequate. As a result, the commission has not mitigated the risk of fraud, waste, or abuse of state resources from related-party transactions. The commission's current policy on conflict of interest is derived from Section 57-1-108, *Tennessee Code Annotated*, which states,

(a) No person shall be eligible to be appointed as a member of the commission, and no person shall be employed in any capacity by the commission, if such person shall have any interest, financial or otherwise, either direct or indirect, in any distillery, wholesale dealer or retail dealer licensed as such in the state of Tennessee. No family member, including spouse, child or children, father or mother, niece or nephew by blood or marriage, son-in-law or daughter-in-law, shall be employed by any distillery, wholesale dealer or retail dealer, nor shall any family member hold or have issued to them any alcoholic beverage license in the state of Tennessee.

(b) No such person shall have interest of any kind in any building, fixtures, or in the premises occupied by any person, firm or corporation licensed under the provisions of this chapter.

(c) No such person shall own any stock, nor shall have any interest of any kind, direct or indirect, pecuniary or otherwise, by a loan, mortgage, gift, seeking a loan, or guaranteeing the payment of any loan, in any distillery, wholesale dealer or retail dealer licensed under the provisions of this chapter.

The commission's policy 1-1-10 requires all employees to complete a conflict-of-interest disclosure statement every four years and have it notarized. However, commission management has not ensured compliance with this policy. Our review indicated that 31 of the 60 employees (52%) had not completed a disclosure statement in the last four years. Four of the 60 employees (7%) had completed statements, but they were not dated or notarized. One commission member's statement was not dated or notarized.

Only requiring the statement to be completed every four years is not adequate. In addition, the commission's conflict-of-interest policy and disclosure statement are not adequate. Although the statement addresses commission members, the policy only mentions employees. Also, the policy and statement quote part (a) of the statute mentioned above but do not include parts (b) and (c). Neither the policy nor the statement addresses other potential conflicts of interest discussed in Section 12-4-101, *Tennessee Code Annotated*:

(a)(1) It is unlawful for any officer, committee member, director, or other person whose duty it is to vote for, let out, overlook, or in any manner to superintend any

work or any contract in which any municipal corporation, county, state, development district, utility district, human resource agency, or other political subdivision created by statute shall or may be interested, to be directly interested in any such contract.

(b) It is unlawful for any officer, committee member, director, or other person whose duty it is to vote for, let out, overlook, or in any manner to superintend any work or any contract in which any municipal corporation, county, state, development district, utility district, human resource agency, or other political subdivision created by statute shall or may be interested, to be indirectly interested in any such contract unless the officer publicly acknowledges such officer's interest.

Conflict-of-interest disclosures are designed to ensure that the public's interest is protected and that employees who make key decisions about investigations and business operations are independent from the other involved parties. Annual written disclosures help to ensure that commission members and employees are acting on the state's behalf and that they are recusing themselves from decision-making as needed. By failing to establish and enforce such a critical part of effective internal controls, top management is not creating the proper control environment.

Recommendation

Commission management should ensure that risks such as those noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should strengthen internal control by developing comprehensive conflict-of-interest policies. The policies should require commission members and employees to sign and update, as necessary, an annual disclosure statement. Management should also identify specific staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur. All controls and control activities, including monitoring, should be adequately documented.

Management's Comment

We concur. Although all employees have signed conflict-of-interest disclosure statements and they are on file, such statements had not been updated on an annual basis. Disclosure statements will be modified and strengthened and will be given to each employee—including commission members—to be signed on an annual basis. Staff will be assigned to monitor and insure compliance with all requirements and take prompt action should exceptions occur.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the commission's June 30, 2006; June 30, 2005; June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and the December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated*;
- documentation to support the commission's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated*; and
- corrective actions have been implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the commission's procedures. We requested the June 30, 2006; June 30, 2005; June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and the December 31, 2003, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We also reviewed the supporting documentation for the commission's evaluation of its internal accounting and administrative control. To determine if corrective action plans had been implemented, we interviewed management and reviewed corrective action for the weaknesses identified in the report.

We determined that the Financial Integrity Act responsibility letters had not always been submitted, the internal accounting and administrative control report was not submitted on time, support for the internal accounting and administrative control report was properly maintained, and procedures used to prepare the report complied with *Tennessee Code Annotated*. Corrective actions on the weaknesses have not been fully implemented. See finding 5.

5. The commission did not comply with the Financial Integrity Act

Finding

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration (F&A) and the Comptroller of the Treasury by June 30, 1999, and each year thereafter. In addition, the head of each executive agency is also required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

The commission did not prepare and submit the required letters acknowledging responsibility for maintaining internal control to the Commissioner of F&A or the Comptroller that were due by June 30, 2006; June 30, 2004; June 30, 2003; and June 30, 2002. The commission submitted the letter due by June 30, 2005, timely. The internal accounting and administrative control report that was due by December 31, 2003, was received by the Comptroller on March 8, 2004, 68 days late.

The internal accounting and administrative control report included two material weaknesses dealing with cash receipting procedures and the server permit data management system. Although the commission has attempted to implement corrective actions for the cash receipting material weakness identified in the report, internal controls over cash receipting continue to be inadequate, as discussed in finding 1. The commission reported as its other material weakness inadequate data management in the implementation of an online system for issuing server permits. As the commission is dependent on an outside vendor, various redesigns of the system are not being implemented timely. In addition to the data management weakness identified by the commission, this audit also identified weaknesses in the server permit system, as discussed in finding 3.

Recommendation

The Executive Director should take responsibility for developing, implementing, and monitoring effective internal controls by complying with all requirements of the Financial Integrity Act, including submitting the required letters and reports to the Commissioner of F&A and the Comptroller of the Treasury by the submission deadlines. The Executive Director should also continue to correct weaknesses identified through the Financial Integrity Act process.

Management's Comment

We concur. Employees previously responsible for insuring these documents were created and submitted have retired, and no notice was received requesting such documentation from any

source. The letters required by T.C.A. 9-18-104 have now been submitted and will continue to be submitted on a timely basis.

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30 each year. However, the Alcoholic Beverage Commission did not properly file its compliance reports and implementation plans, as discussed in finding 6.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

6. The commission failed to properly submit Title VI compliance reports and implementation plans relating to compliance with the Civil Rights Act of 1964

Finding

The Alcoholic Beverage Commission did not properly submit the fiscal year 2002, 2003, 2004, and 2005 Title VI compliance reports and implementation plans as required by Section 4-21-901, *Tennessee Code Annotated*. This section requires those state agencies subject to the requirements of Title VI of the Civil Rights Act of 1964 (42 U.S.C. Section 2000d et seq.) to develop and submit Title VI compliance reports and implementation plans to the Comptroller of the Treasury by June 30 of each fiscal year. The report and plan due on June 30, 2002, were submitted to the Comptroller's Office on October 11, 2002. The report and plan due on June 30, 2003, were submitted on October 1, 2004. There was no evidence in the Comptroller's Office that the report and plan due on June 30, 2004, were ever received. The report and plan due on June 30, 2005, were submitted on May 31, 2006. The commission submitted the report and plan due on June 30, 2006, timely on May 31, 2006.

Recommendation

Commission management should ensure that risks such as those noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal

controls over compliance requirements to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur. The Executive Director should submit annual Title VI compliance reports and implementation plans by June 30 of each year as prescribed by *Tennessee Code Annotated*.

Management's Comment

We concur. The 2004 Title VI report was filed late. The finding indicates that the three Title VI reports were filed late. However, a request was made approximately on or about September 30, 2004, for the submission of the 2002 and 2003 Title VI reports. This request indicated that the reports had not been submitted. The TABC immediately re-submitted on October 1, 2004. A review of the various reports indicates that mistakes may have been made related to the reference dates for the report's cover page. The TABC will insure that the correct dates are referenced for the reports and that they are timely filed.

AUDIT COMMITTEE ACT

On May 19, 2005, the Tennessee General Assembly enacted legislation known as the "State of Tennessee Audit Committee Act of 2005." This legislation requires the creation of audit committees for those entities that have governing boards, councils, commissions, or equivalent bodies that can hire and terminate employees and/or are responsible for the preparation of financial statements. Entities, pursuant to the act, are required to appoint the audit committee and develop an audit committee charter in accordance with the legislation. The ongoing responsibilities of an audit committee include, but are not limited to:

1. overseeing the financial reporting and related disclosures especially when financial statements are issued;
2. evaluating management's assessment of risk and the agency's system of internal controls;
3. formally reiterating, on a regular basis, to the board, agency management, and staff their responsibility for preventing, detecting, and reporting fraud, waste, and abuse;
4. serving as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information it may receive pertinent to audit or investigative matters;
5. informing the Comptroller of the Treasury of the results of assessment and controls to reduce the risk of fraud; and
6. promptly notifying the Comptroller of the Treasury of any indications of fraud.

As of January 31, 2007, no audit committee has been established, nor has a charter been created. In addition, management of the commission has not performed and documented a risk assessment. See finding 7.

7. Management of the Alcoholic Beverage Commission has not completed a risk assessment, and the commission does not have a functioning audit committee, nor has the commission requested an exception as required by state law

Finding

Management of the Alcoholic Beverage Commission has not completed a risk assessment, and the commission members do not have a functioning audit committee as required by the “State of Tennessee Audit Committee Act of 2005,” Section 4-35-101 et seq., *Tennessee Code Annotated*. The requirements of the State of Tennessee Audit Committee Act of 2005 include the creation of an audit committee as a standing committee of a state governing board, council, commission, or equivalent body and the adoption of an audit committee charter addressing the committee’s purpose, powers, duties, and mission. The law does allow exceptions in certain situations when approved by the Comptroller of the Treasury. The Act also prescribes certain responsibilities of the audit committee which include:

- a. overseeing the financial reporting and related disclosures, especially when financial statements are issued;
- b. evaluating management’s assessments of the body’s system of internal controls;
- c. formally reiterating, on a regular basis, to the governing board and management their responsibility for preventing, detecting, and reporting fraud, waste, and abuse;
- d. serving as a facilitator of any audits or investigations of the entity, including advising auditors and investigators of any information it may receive pertinent to audit or investigative matters;
- e. informing the Comptroller of the Treasury of the results of risk assessments and controls to reduce the risk of fraud;
- f. promptly notifying the Comptroller of the Treasury of any indications of fraud; and
- g. establishing a process by which employees, taxpayers, or other citizens may confidentially report suspected illegal, improper, wasteful, or fraudulent activity.

Furthermore, the Act required the Comptroller of the Treasury to establish guidelines for the creation of an audit committee charter. Those guidelines require the creation or review by the audit committee of a code of conduct and conflict-of-interest policy for the entity. By letter dated November 23, 2005, the Comptroller of the Treasury reminded entities apparently subject to the audit committee act to either establish an audit committee or seek an exception to the law.

As of January 31, 2007, no audit committee has been established, no charter has been created, nor have the commission members requested an exception to the audit committee law. As a result, commission members are operating in violation of state law.

As previously stated, one of the audit committee's responsibilities is to evaluate management's assessment of internal controls. This responsibility is of paramount importance, as is the responsibility of management to perform this assessment. However, as of January 31, 2007, management of the commission has not performed and documented a risk assessment.

All organizations, regardless of their size or nature, are vulnerable to fraud, waste, and abuse. And so, in all organizations—not just those subject to the Audit Committee Act, management is required by basic tenets of internal control to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what fraud could be perpetrated in the absence of adequate controls. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Consideration should be given to the fact that risks of fraud do not just originate at the beginning or end of an entity's fiscal year. Since the operating environment is dynamic, management's assessment should be an ongoing part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. This too should be an ongoing process.

Recommendation

Management should conduct regular periodic risk assessments. Each assessment should be well documented, complete, and clear. The process should involve the active participation of staff; however, management is ultimately responsible for the results of the assessment.

The risk assessment should include consideration of the risks of fraud, waste, and abuse related to the commission. Management should begin with prior audit findings, ensuring that corrective actions recommended by the auditors have been fully implemented. Management should also think about the general types of problems that can occur, such as conflicts of interest in the procurement processes and theft of funds. The relative materiality of the risks should be considered as well. The results of the risk assessment should be used by management to design appropriate internal controls to mitigate the identified risks. As such, the risks should be prioritized, so that management can focus their initial attention on the greatest risks.

The members of the Alcoholic Beverage Commission should establish an audit committee, or the commission should request an exception from the Comptroller of the Treasury because there are only three commission members. If the commission members do not seek an exception, the audit committee should meet and create a charter based on guidelines from the Comptroller of the Treasury. If an exception is granted, the commission should adopt policies

and procedures that enable it to fulfill the duties and responsibilities of an audit committee as outlined in the “State of Tennessee Audit Committee Act of 2005,” and the guidelines established by the Comptroller of the Treasury. Once the charter or policies are completed, they should be submitted to the Comptroller for review and approval.

The audit committee, or commission members acting as the committee, should review, evaluate, and approve management’s risk assessment and internal controls. In doing so, the commission should take whatever steps necessary, including meeting with management, to obtain a sufficient understanding of the assessment. The commission should independently determine that the risk assessment is adequate and appropriate. Members of the commission should formally sign off on the documentation, acknowledging their approval of the assessment. In addition, they should document both their discussion with management and their comments about the risk assessment.

During the next audit, the auditors will review the risk assessment documentation prepared by management and approved by the commission members. The results of this review will be part of the basis of the auditors’ conclusions about the control environment of the commission.

Management’s Comment

We concur. Risk assessment is being reviewed, and the possibility of an audit committee is being reviewed. An audit committee will either be developed, or an exception will be requested. The TABC would request from the Comptroller’s Office any notice of training classes related to preventing, detecting, and reporting fraud, waste, and abuse so that management and appropriate TABC personnel may attend.

OBSERVATIONS AND COMMENTS

MANAGEMENT’S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors’ risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.