State of North Carolina

Office of the State Auditor
Beth A. Wood, CPA

Alcoholic Beverage Control Commission

Alcoholic Beverage Control Commission Warehouse Contract

Performance Audit
August 2018

NC OSA
The Taxpayers' Watchdog

EXECUTIVE SUMMARY

PURPOSE

The purpose of this audit was to determine whether the Alcoholic Beverage Control Commission (Commission) procured, administered, and monitored the LB&B Associates, Inc. (LB&B) contract for the warehousing and distribution of spirituous liquor in accordance with state policies and best practices.

BACKGROUND

The Commission has the responsibility to oversee and provide a uniform system of control over the sale, purchase, transportation, manufacture, consumption, and possession of alcoholic beverages in North Carolina.

Historically, the Commission has contracted with a vendor to warehouse and distribute spirituous liquor. LB&B has been contracted to provide these services since 2004.

In state fiscal year 2017, the contract cost for warehousing and distributing spirituous liquor was $8.3 million. The total contract cost from July 2004 through June 2017 was $77.7 million.

KEY FINDINGS

The Commission did not procure, administer, and monitor the LB&B contract for the warehousing and distribution of spirituous liquor in accordance with state policies and best practices.

- Poor contract administration cost the State at least $11.3 million over 13 years
- Unused warehouse space potentially cost the State $2.1 million over 7 years
- No monitoring left the State underpaid by at least $297,537 over two years

KEY RECOMMENDATIONS

- The Commission should procure, monitor, and administer contracts in accordance with state laws and regulations and the contract terms
- The Commission should review and validate the reasons given for all requested contract amendments and price increases prior to authorization
- The Commission should obtain the Division of Purchase & Contract's review and approval when the contract term, including extensions and renewals, will exceed three years
- The Commission should reassess its warehouse space needs and determine if costs can be reduced

The key findings and recommendations in this summary may not be inclusive of all the findings and recommendations in this report.

STATE OF NORTH CAROLINA
Office of the State Auditor

Beth A. Wood, CPA
State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0600
Telephone: (919) 807-7500
Fax: (919) 807-7647
http://www.ncauditor.net

AUDITOR'S TRANSMITTAL

The Honorable Roy Cooper, Governor
Members of the North Carolina General Assembly
Alexander Guy Jr., Chairman, Alcoholic Beverage Control Commission
Erik Hooks, Secretary, Department of Public Safety

Ladies and Gentlemen:

We are pleased to submit this performance report titled *Alcoholic Beverage Control Commission Warehouse Contract*. The objective of this audit was to determine whether the Alcoholic Beverage Control Commission procured, administered, and monitored the LB&B Associates, Inc. contract for the warehousing and distribution of spirituous liquor in accordance with state policies and best practices.

The Alcoholic Beverage Control Commission's Chairman reviewed a draft copy of this report. His written comments are included starting on page 18.

This audit was conducted in accordance with *Article 5A of Chapter 147* of the North Carolina General Statutes.

Respectfully submitted,

Beth A. Wood, CPA
State Auditor

Beth A. Wood, CPA
State Auditor

TABLE OF CONTENTS

PAGE

BACKGROUND 1

OBJECTIVE, SCOPE, AND METHODOLOGY 3

RESULTS AND CONCLUSIONS 4

FINDINGS, RECOMMENDATIONS, AND RESPONSES

POOR CONTRACT ADMINISTRATION COST THE STATE AT LEAST $11.3 MILLION OVER 13 YEARS 5

UNUSED WAREHOUSE SPACE POTENTIALLY COST THE STATE $2.1 MILLION OVER SEVEN YEARS 9

NO MONITORING LEFT THE STATE UNDERPAID BY AT LEAST $297,537 OVER TWO YEARS 12

MATTERS FOR FURTHER CONSIDERATION 15

APPENDIX 16

STATE AUDITOR'S RESPONSE 17

RESPONSE FROM THE ALCOHOLIC BEVERAGE CONTROL COMMISSION 18

ORDERING INFORMATION 21

Article V, Chapter 147 of the North Carolina General Statutes, gives the Auditor broad powers to examine all books, records, files, papers, documents, and financial affairs of every state agency and any organization that receives public funding. The Auditor also has the power to summon people to produce records and to answer questions under oath.

BACKGROUND

North Carolina is one of 17 control states.[1] North Carolina is a "local option"[2] state with 167 local Alcoholic Beverage Control (ABC) boards operating the 428 retail ABC stores that sell spirituous liquor[3] to individual consumers or businesses in the State.[4]

The Alcoholic Beverage Control Commission (Commission)[5] has the responsibility to oversee and provide a uniform system of control over the sale, purchase, transportation, manufacture, consumption, and possession of alcoholic beverages in North Carolina.

Chapter 18B of the North Carolina General Statutes grants and charges the Commission with its responsibilities. Specifically, the Commission is responsible for:

- Administering the ABC laws
- Providing for enforcement of the ABC laws
- Setting prices of spirits sold in ABC stores
- Determining brands of alcoholic beverages sold in the State
- Serving as wholesale distributor of spirituous liquor
- Contracting the State ABC warehousing of spirituous liquor
- Overseeing local ABC boards
- Issuing ABC permits
- Imposing sanctions against businesses holding ABC permits that violate the law
- Promulgating rules

The Commission currently consists of two members, a Chairman and Commissioner.[6] The Chairman and Commissioner report to the Governor and are responsible for setting the policy of the Commission. Between 2004 and 2017, there have been four Chairmen of the Commission. The current Chairman was appointed by Governor Roy Cooper in March 2017.

The Commission employs a Chief Administrator and 50 staff members. The Chief Administrator reports directly to the Chairman and Commissioner and is responsible for all day-to-day operations as well as for the administration and oversight of the warehouse and distribution contract. The current Chief Administrator has been in this role since January 2015, and the prior Chief Administrator held the position since 1995.

Historically, the Commission has contracted with a vendor to warehouse and distribute spirituous liquor. LB&B Associates, Inc. (LB&B) has been contracted to provide these services since 2004.

---

1 A control state prohibits the sale of liquor in private stores, limiting it to government-owned outlets only.
2 A local option gives a city or county the authority to establish ordinances for the sale of malt beverages, unfortified wine, and fortified wine.
3 Spiritous liquor refers to an alcoholic beverage that is produced by a distiller.
4 According to the Commision's 2017 Annual Report.
5 The Commission is an agency administratively located within the North Carolina Department of Public Safety but exercises its powers independently of the Secretary of Public Safety.
6 Commission members are appointed by the Governor to serve at his pleasure.

LB&B is a facilities management, logistics, and training company headquartered in Columbia, Maryland. It employs nearly 1,000 employees across the United States and maintains more than 65 contracts at any one time performing services for the federal government, state government, and private clients.[7] Approximately 70 employees are dedicated to the North Carolina's warehousing and distribution of spirituous liquor contract.

Since the assignment of the warehousing and distribution of spirituous liquor contract to LB&B in 2004, there have been 12 amendments to the contract that have retained LB&B as the State's vendor and made changes to the price and/or contract terms.[8]

In state fiscal year 2017, the contract cost for warehousing and distributing spirituous liquor was $8.3 million.[9] The total contract cost from July 2004 through June 2017 was $77.7 million.[10]

---

[7] According to www.lbbassociates.com.

[8] Amendments were approved and executed under four separate Commission Chairman and two Commission Chief Administrators.

[9] According to contract. Contract payments were verified by auditors.

[10] Figures according to the Contract; this value does not include additional revenues collected by LB&B from boards and distillers for additional services in relation to the Contract. Contract payments between 2004 and 2015 were not verified by auditors.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this audit was to determine whether the Alcoholic Beverage Control Commission (Commission) procured, administered, and monitored the LB&B Associates, Inc. (LB&B) contract for the warehousing and distribution of spirituous liquor (Contract) in accordance with state policies and best practices.

The audit scope included the Commission's procurement and administration of the contract during state fiscal years (SFYs) 2004-2017. The audit scope also included the Commission's monitoring and oversight of the contract, including LB&B's performance under the contract during SFYs 2016 and 2017.

To accomplish the audit objective, auditors interviewed personnel, observed operations, reviewed policies, analyzed records, and examined documentation supporting transactions, as considered necessary. Whenever sampling was used, auditors applied a nonstatistical approach. Therefore, results could not be projected to the population. This approach was determined to adequately support audit conclusions.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

As a basis for evaluating internal control, auditors applied the internal control guidance contained in professional auditing standards. However, our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

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 objectives.

RESULTS AND CONCLUSIONS

The Alcoholic Beverage Control Commission (Commission) did not procure, administer, and monitor the LB&B Associates, Inc. (LB&B) contract for the warehousing and distribution of spirituous liquor in accordance with state policies and best practices.

FINDINGS, RECOMMENDATIONS, AND RESPONSES

1. POOR CONTRACT ADMINISTRATION COST THE STATE AT LEAST $11.3 MILLION OVER 13 YEARS

The Alcoholic Beverage Control Commission (Commission) did not administer the Alcoholic Beverage Control Commission Warehouse contract (Contract) in the best interest of the State.

The Commission (1) exceeded the maximum allowable Contract price by $11.3 million over 13 years, (2) approved $5.5 million in contractor requested price increases without verifying reasonableness and necessity, and (3) exceeded the three-year contract term limit four times without proper review and approval which denied the State the opportunity to reduce costs through negotiation and competitive bidding.

Exceeded Maximum Allowable Contract Price 13 Years in a Row

First, the Commission failed to ensure prudent use of public funds by repeatedly approving Contract price increases that exceeded the maximum allowable amounts stipulated by the Contract.

The Contract states,[11] "Requested increases shall not exceed the changes in the Average Wages of N.C. Employees in Wholesale Trades [ECI] and/or the Consumer Price Index for Motor Fuels [CPI]."[12]

However, the Commission increased the Contract's price by amounts that exceeded the ECI and/or CPI for 13 consecutive years.

[11] Per the 2004 contract.

[12] Consumer Price Index (CPI) was obtained from the U.S. Department of Labor, Bureau of Labor Statistics. The Average Wage of N.C. Employees in Wholesale Trades was obtained from the N.C. Department of Commerce, Labor and Economic Analysis Division. Both indices were calculated based on state fiscal year to align with the contract.

As a result, the State incurred approximately $11.3 million more in contract costs than required or allowed by Contract terms and conditions:

	Contract Price Adjustments			Allowable Price Increases and Variance (excess)		
SFY	Price	Increase ($)	Increase (%)	Max Allowed (%)	Max Contract Allowed ($)	Variance ($)
2004	$ 3,199,780	N/A	N/A	N/A	N/A	N/A
2005	3,526,412	$ 326,632	10.2%	4.9%	$ 3,357,190	$ 169,222
2006	3,777,979	251,567	7.1%	5.7%	3,549,175	228,804
2007	4,638,240	860,261	22.8%	4.7%	3,715,001	923,239
2008	4,638,240	-	0.0%	2.5%	3,807,702	830,538
2009	5,082,379	444,139[13]	9.6%	2.9%	3,919,360	1,163,019
2010	4,956,769[14]	133,000	2.8%	0.0%	3,919,360	1,037,409
2011	5,066,019	109,250	2.2%	2.3%	4,010,638	1,055,381
2012	7,300,000	2,233,981	44.1%	5.3%	6,456,611	843,389
2013	7,300,000	-	0.0%	3.0%	6,648,232	651,768
2014	7,700,000	400,000	5.5%	0.6%	6,687,978	1,012,022
2015	7,700,000	-	0.0%	0.0%	6,687,978	1,012,022
2016	7,700,000	-	0.0%	0.0%	6,687,978	1,012,022
2017	8,300,000	600,000[15]	7.8%	0.0%	6,987,978	1,312,022
		$ 5,358,830[16]			TOTAL:	$ 11,250,855

The Commission did not explain why it repeatedly approved price increases that exceeded the maximum allowed amounts. But the Commission offered that it had little to no resources dedicated to monitoring the Contract.

However, as a state agency, the Commission is responsible for the prudent use of public funds and for obtaining services at the lowest possible costs. The North Carolina State Procurement Manual states: (*Emphasis Added*)

> "In North Carolina, the central authority over purchasing goods and services for all State departments, institutions and agencies is vested in the Department of Administration, and by delegation, in its Division of Purchase and Contract ('the Division' or 'P&C') through the State Purchasing Officer. Thus, the Division—and by extension, **everyone performing the procurement function across State government—has primary responsibility for the prudent use of public funds.**"
>
> "The purchasing activities of both private enterprise and State government are charged with **acquiring suitable good and services at the lowest possible cost.**"

[13] Included one-time lump sum payment in the amount of $258,610 for an increase in the cost of fuel, increase in Warehouseman's Public Liability coverage, and a 3% cost of living adjustment for labor.

[14] The 2010 contract included an increase in the amount of $133,000. However, the total contract value was reduced in comparison to 2009 due to a one-time lump sum payment received in 2009 (see FN 13 above).

[15] Included one-time lump sum payment in the amount of $250,000 for additional costs associated with an increase in the volume of fuel and volume of cases received, handled, and shipped.

[16] Amount does not include $150,000 of price increases authorized for 2019, 2020, 2021 contract years.

Approved Contract Price Increases without Verifying Reasonableness and Necessity

Second, the Commission failed to ensure prudent use of public funds by not evaluating and verifying the reasonableness and necessity of contractor requested price increases before approving them. Since September 2004, the Commission approved 12 price increases to the Contract totaling more than $5.5 million.[17]

Evaluation and verification would have been prudent because documentation shows that some reasons given for price increases were not accurate or appropriate to support a price increase. For example:

- In 2008, the contractor requested an increase based in part[18] on increased fuel costs during 2008. However, documents show that the contractor's fuel costs actually decreased by $23,197 in 2008.
- In 2016, the contractor requested an increase based in part[19] on increased fuel usage during 2016. However, documents show that the contractor's fuel usage and costs actually decreased by 7,264 gallons and $221,228 respectively in 2016.
- In five separate contract amendments, the contractor requested an increase based in part on an increase in the number of cases of spirituous liquor shipped to local ABC boards. However, according to the Contract, increases or decreases in the volume of cases handled did not obligate the State to adjust the price of the Contract prior to July 1, 2016.[20]

Because the Commission did not evaluate or verify the contractor's reasons for requesting a price increase, the Commission cannot provide reasonable assurance that over $5.5 million in price increases were reasonable or necessary.

The Commission did not perform these tasks because, according to the Commission's Chief Administrator, they believed it was unnecessary to verify the legitimacy of documentation received from the contractor to support increased costs.

However, as noted above, the Commission is responsible for the prudent use of public funds and for obtaining services at the lowest possible costs.

Exceeded State Contract Term Limits Four Times without Proper Approval

Third, the Commission violated state purchasing policy when it executed the Contract for terms of greater than three years without obtaining approval from the Department of Administration, Division of Purchase and Contract (P&C).

The Commission then continued to violate state purchasing policy by executing three contract extensions, each exceeding the three-year term limit, without obtaining P&C's review and approval.

---

[17] See Appendix for full list of Contract amendments and price increases.

[18] (1) Increased cost and volume of fuel, (2) cost of additional insurance coverage, (3) cost of living adjustment for labor, and (4) the increase in number of cases shipped to local ABC boards.

[19] (1) Increased volume of fuel, (2) to allow for additional services from the Raleigh and Clayton warehouses.

[20] Beginning July 1, 2016, LB&B is entitled to a lump sum adjustment to the contract price if the number of cases of spirituous liquor shipped by LB&B is at least 5% higher than the number shipped during the preceding 12-month contract period.

The terms of the original contract and extensions were:

- October 2003 – July 2007
- July 2006 – June 2011
- July 2011 – June 2016
- July 2016 – June 2021[21]

The Commission's failure to obtain proper review and approval prevented P&C from ensuring that the contract and extensions were in the best interest of the State. It also denied the State the opportunity to reduce costs through negotiation and a competitive bidding process.

According to the Commission, it did not obtain P&C's review and approval because it believed that it was exempt from North Carolina procurement rules.

However, neither *NC General Statutes Chapter 143 Article 3* (Purchases and Contracts) nor *Chapter 18B Article 2* (State Administration) specifically exempts the Commission from state procurement rules.

Consequently, as a state agency, the Commission is required to follow the policy contained in the *North Carolina Procurement Manual* which states:

> "The contract term, or length, **shall not be for more than three years, including all extensions and renewals**, without the prior approval of the SPO/SCIO or his designee, based on a determination that the longer period is advantageous to the State." (*Emphasis Added*)

RECOMMENDATIONS

The Commission should procure, monitor, and administer the Contract in accordance with state laws and regulations and contract terms.

The Commission should review and validate the supporting reasons given for all requested contract amendments and price increases prior to authorization.

The Commission should obtain review and approval from the Division of Purchase & Contract when a contract's term, including extensions and renewals, will exceed three years.

AGENCY RESPONSE

See page 18 for the Commission's response to this finding.

[21] For the July 2016 contract, the Commission also failed to obtain the Attorney General's review as required by *North Carolina General Statute 114-8.3(a).*

2. UNUSED WAREHOUSE SPACE POTENTIALLY COST THE STATE $2.1 MILLION OVER SEVEN YEARS

The Alcoholic Beverage Control Commission (Commission) failed to ensure prudent use of public funds when it authorized the lease of a Clayton warehouse. A large amount of the warehouse space was unused and potentially resulted in $300,000 a year of unnecessary cost over seven years. The Commission did not verify its need for a warehouse of this size, although state policy and best practices required the Commission to perform its responsibilities prudently and economically.

Warehouse Space Largely Unused

In 2011, the Commission authorized LB&B Associates, Inc. (LB&B) to lease an additional 200,000 square-foot warehouse in Clayton[22] as a five-year short term solution to the Commission's need for additional warehouse space.

Adding this warehouse to the Alcoholic Beverage Control Commission Warehouse contract (Contract) doubled the amount of warehouse space available[23] and has increased the cost of the contract by approximately $2.54 million a year on average.[24]

However, the warehouse space is largely unused.

According to LB&B's 2017 inventory space allocation report, only 23% of the Clayton warehouse space is allocated for regularly listed spirituous liquor.[25]

Additionally, auditors toured the Clayton warehouse on three separate occasions[26] and observed large amounts of unused space in the warehouse. The unused space was evident even during the auditors' visit during LB&B's admittedly busiest time, the holiday season.[27]

The following photos were taken between 12/7/2017 and 12/12/2017 and show how much of the warehouse space was unused during the busy holiday season.

[22] Previously, the warehousing and distribution was handled from a single 200,000 square foot state-owned warehouse located in Raleigh. The Clayton warehouse exists in addition to the Raleigh warehouse.
[23] From 200,000 square feet to 400,000 square feet.
[24] The contract price increased by $2.3 million in the first two years and by $2.7 million in subsequent years.
[25] LB&B did not retain space allocation reports for 2011–2016.
[26] Dates inlude November and December 2017.
[27] Includes the months of October, November, and December.

Potentially Resulted In $300,000 of Unnecessary Annual Costs

The fact that the Clayton warehouse had this much space available raises the question of whether it was significantly larger than necessary.

As noted above, LB&B reports indicated that only 23% (46,000 square feet) of the Clayton warehouse space was allocated for regularly listed spirituous liquor.

Consequently, a 92,000 square-foot warehouse may have been sufficient.

In 2011, 92,000 square-feet of warehouse space could have been leased in the surrounding area for approximately $272,860 to $337,260 less per year than the Clayton warehouse.[28]

With approximately $300,000 a year in unused space, the Clayton warehouse lease potentially resulted in $2.1 million of unnecessary costs over the last seven years.

Caused By Commission Not Verifying Reasonableness of Its Short Term Solution

The Commission did not document that it evaluated and verified the reasonableness and necessity of leasing an additional 200,000 square foot warehouse as a short term solution to its need for additional space before amending the Contract.

On April 14, 2011, the Commission discussed its need for additional warehouse space. The meeting minutes stated:

> "**In 2007, the Commission recognized this need** and hired a consultant who provided different options for expansion. Unfortunately, the Commission was unable to move forward on any of the options **and the past two years started experiencing the problems** of managing a growing business in a warehouse without enough space to handle demand." (*Emphasis Added*)

The minutes also note the problems that the Commission associated with the lack of space:

> "To keep up with growth, steps have been taken to discontinue product and reduced allocated space on items. **This has resulted in less selection and out of stocks** and created issues at the retail level affecting the ABC Boards ability to maximize

[28] Based on Triangle Business Journal SFY 2011 warehouse lease information and the SFY 2011 Clayton warehouse lease payments totaling $613,260.

> profits by purchase low and selling high when items are increasing in price. It also has led to lost sales at retail." (*Emphasis Added*)

As a short term solution, the minutes note that the Commission approved a recommendation:

> "for the current warehouse contractor, LB&B Associates to put together **a short term proposal** to lease an additional 200,000 square feet of space at a nearby location **for five years until a long term solution can be found.**" (*Emphasis Added*)

However, there was no analysis or verification that this was the most efficient short term solution. Specifically, the Commission did not document verification of the following:

1. That an additional 200,000 square feet of warehouse space was the minimum amount necessary based on trends and expected growth over the five-year short term

   Seven years later, only about 23% of the warehouse space is allocated for regularly listed items.

2. That the lack of space was the main reason for being out of stock and under filling orders

   Seven years later, significant under filling of orders still occurs. In fact, 52% of orders were under filled in state fiscal year (SFY) 2017 and 39% were under filled in SFY 2016 despite the additional warehouse space.

Additionally, the Commission did not obtain the Department of Administration, Purchase & Contract Division's (P&C) review and approval, which prevented P&C from ensuring that the short term solution was reasonable and prudent.

State Policy and Best Practices Require Prudent Use of Public Funds

As a state agency, the Commission is responsible for the prudent use of public funds and for performing its responsibilities economically.

The North Carolina State Procurement Manual states: (*Emphasis Added*)

> "In North Carolina, the central authority over purchasing goods and services for all State departments, institutions and agencies is vested in the Department of Administration, and by delegation, in its Division of Purchase and Contract ('the Division' or 'P&C') through the State Purchasing Officer. Thus, the Division—and by extension, **everyone performing the procurement function across State government—has primary responsibility for the prudent use of public funds.**"
>
> "The purchasing activities of both private enterprise and State government are charged with **acquiring suitable good and services at the lowest possible** cost."

Additionally, best practices identified by the Government Accountability Office (GAO) states:

> "**Management and officials entrusted with public resources are responsible for carrying out public functions** and providing service to the public effectively, efficiently, **economically**, ethically, and equitably within the context of the statutory boundaries of the specific government program." (*Emphasis Added*)

RECOMMENDATIONS

The Commission should review and validate the reasons given for all requested contract amendments prior to authorization.

The Commission should reassess its warehouse space needs and determine if costs can be reduced. The Commission should maintain documentation of its analysis, conclusions, and decisions.

AGENCY RESPONSE

See page 18 for the Commission's response to this finding.

3. NO MONITORING LEFT THE STATE UNDERPAID BY AT LEAST $297,537 OVER TWO YEARS

The Alcoholic Beverage Control Commission (Commission) did not monitor compliance with the Alcoholic Beverage Control Commission Warehouse contract (Contract). As a result, underpayments of $297,537 to the State and $12,183 to distillers went undetected.[29] The Commission did not believe that it was responsible for monitoring. However, state policy and best practices require adequate contract monitoring.

Commission Did Not Monitor Compliance with Contract

The Commission did not adequately monitor LB&B Associates, Inc. (LB&B) compliance with the contract for warehousing and distribution of spirituous liquor in North Carolina.

According to the Commission's Chief Administrator, the Commission performed some monitoring such as receiving monthly aging reports for accounts past due and inventory stock status reports from LB&B.

However, the Commission did not provide evidence that the reports were reviewed or that any action was taken as a result of any reviews.

Furthermore, the Commission did not have:

- A formal process in place to track fees or a complete set of supporting documents such as collection or disbursement statements

[29] Amounts of underpayments to the State based on analysis of available data from LB&B's Macola and Peachtree billing systems. Amounts of underpayments to distillers based on analysis of available data from LB&B's payout reports and inventory reconciliation for losses reports. The Commission was unable to produce original documentation in the timeframe necessary to complete this audit.

- Documentation to reconcile LB&B physical inventory with inventory records and to show how dollar value adjustments[30] and inventory shrinkage fees[31] were determined
- Reports from LB&B of billings made to local ABC boards and distillers
- LB&B financial statements specific to its North Carolina operations to show annual warehousing and distribution costs for comparison to the State contract price

Resulted in Undetected Underpayments to the State and to Distillers

Failure to adequately monitor could allow contract noncompliance and errors to go undetected.

For example, the Commission failed to detect that the State did not receive its share of incidental services fees[32] and special services fees.[33] The Commission also failed to detect that LB&B underpaid distillers for inventory shrinkage.

Specifically, auditors reviewed two years of fees and found the following undetected errors:

- State was underpaid $138,395 (30%) in state fiscal year (SFY) 2017 and $37,142 (12%) in SFY 2016 for incidental services fees[34]
- State was underpaid $69,350 (63%) in SFY 2017 and $52,650 (51%) in SFY 2016 for special services fees[35]
- Distillers were underpaid $12,183 (20%) in SFY 2017 for inventory shrinkage[36]

Any similar errors that may have occurred in previous years would have gone undetected due to lack of monitoring.

Caused by Commission's Belief That It Is Not Responsible for Monitoring

When asked about monitoring and oversight of the Contract, the Commission's Chief Administrator stated that the Commission did not need to monitor LB&B's activities because any errors made by LB&B would be noticed, addressed, and corrected by a local ABC board or distiller's interaction with LB&B.

---

[30] Dollar value adjustments refers to any adjustment made to the dollar value of inventory. For example, due to an inaccurate count of inventory.

[31] Inventory shrinkage fees refer to the cost of inventory that can't be accounted for due to theft or other loss.

[32] Incidental services are services provided by LB&B, charged to distillers, and collected directly by LB&B. They include re-palleting, holding of delisted items, recoding merchandise and destroying deteriorated products. According to the contract, incidental services are split 50/50 between the State and LB&B.

[33] Special services include additional services provided by LB&B for the benefit of the distiller. Such services include billing, data link communications, shipment summary, and handling of merchandise on slip sheets in lieu of wooden pallets. These additional services are provided for a fee to distillers, and they are in addition to regular merchandise handling such as receipt and storage of inventory. According to the contract, special services are payable 100% to the State.

[34] LB&B collected $923,322 (SFY17) and $600,424 (SFY16) in incidental services fees that are 50% payable to the State. But the State only received $323,266 (SFY17) and $263,070 (SFY16).

[35] LB&B collected $221,510 (SFY17) and $206,610 (SFY16) in special services fees that are 100% payable to the State. But the State only received $152,160 (SFY17) and $153,960 (SFY16).

[36] LB&B paid $49,923 but should have paid $62,106.

However, local ABC boards and distillers do not have the ability to monitor LB&B's compliance with the state contract. Local ABC boards and distillers do not receive LB&B reports or have access to LB&B systems, except for information related to orders.

State Policy and Best Practices Require Contract Monitoring

Furthermore, as a state agency, the Commission is responsible for monitoring its contracts and complying with guidance issued by the Department of Administration, Purchase and Contract Division (P&C).

P&C's *Contract and Administration Monitoring Guide* states:

> "Each agency is independently responsible for implementing and documenting sound business contract monitoring procedures in this guide, in accordance with applicable state laws, regulations, policies and procedures."
>
> "The integrity of the public purchasing system demands that goods and services be furnished, received, invoiced and paid as specified in the contract."
>
> "Tracking the performance of the contractor is the principal function of proper contract monitoring and administration. The purpose is to ensure that the contractor is performing all duties in accordance with the contract and for the agency to be aware of and address any problems or issues promptly."

Best practices also require contract monitoring. According to the National State Auditors Association's Best Practices for Contracting Services:

> "Contract monitoring is an essential part of the contracting process. **Without a sound monitoring process, the contracting agency does not have adequate assurance it receives what it contracts for.** To properly monitor the contract, the agency should assign a contract manager with the authority, resources and time to monitor the project." (*Emphasis Added*)

RECOMMENDATIONS:

The Commission should assign someone to monitor the contract in accordance with state laws and regulations and the contract terms.

AGENCY RESPONSE

See page 18 for the Commission's response to this finding.

MATTERS FOR CONSIDERATION

During the course of an audit, Office of the State Auditor staff may uncover potential issues that are outside of the audit objective. Although the issues may not have been part of the planned objective, the issues need to be presented to those charged with governance of the organization under audit. Below is such an issue.

Commission Did Not Assist in Obtaining Contractor Documentation

The Alcoholic Beverage Control Commission (Commission) provided the Office of the State Auditor (OSA) with limited assistance in obtaining documentation necessary to perform audit procedures from LB&B Associates, Inc. (LB&B).

As administrator of the Alcoholic Beverage Control Commission Warehouse contract (Contract), the Commission is responsible for monitoring the performance of LB&B in accordance with the terms and conditions of the Contract. This would include, requesting and inspecting documentation from LB&B on a regular basis.

Upon notification that OSA was considering a subpoena to obtain records from LB&B, the Commission's Chief Administrator stated that the issue was between OSA and LB&B.

It should be noted that documentation requested by auditors were those that the Commission should be requesting from LB&B as part of their ongoing oversight and monitoring responsibilities.

Ultimately, OSA was able to obtain the majority of records and documentation requested by working with LB&B directly and a subpoena was unnecessary.

APPENDIX

Contract Price Increases and Lump Sum Payments

FY	Contract Date	Eff. Date	New Flat Fee	Contract Increase	One-Time Lump Sum Payment	Total Contract Fee	Contractor's Reason(s) For Contract Increase (Adjustment)				Extended	Extension Dates	Extension Notes
							Reason 1	Reason 2	Reason 3	Reason 4			
2004	4/1/2004	4/1/2004	$ 3,199,780	$ -	$ -	$ 3,199,780					N/A	October 2003 - July 2007	
2005	9/17/2004	7/1/2004	$ 3,526,412	$ 326,632	$ -	$ 3,526,412			"Based upon the indices required" per contract		No		
2006	11/9/2005	7/12/2005	$ 3,632,059	$ 105,647		$ 3,632,059	Fuel				No		
2006	1/20/2006	7/12/2005	$ 3,777,979	$ 145,920		$ 3,777,979		Cases	Operational costs associated with cases shipped		No		
2007	7/13/2006	7/1/2006	$ 4,638,240	$ 860,261	$ -	$ 4,638,240	Fuel	Cases	Allow 50/50 split of incidental fees	Allow 50/50 split of incidental fees	**Yes**	July 2006 - June 2011	With 2 rolling 1-year extensions through June 30, 2013
2008	7/1/2007	7/1/2007	$ 4,638,240	$ -	$ -	$ 4,638,240			Increase the split load fee from $0.20/case to $0.50/case		No		
2009	8/15/2008	7/1/2008	$ 4,823,769	$ 185,529	$ 258,610	$ 5,082,379	Fuel	Cases	Operational Costs	Insurance Coverage,3% Cost of Living Adjustment	No		
2009	3/1/2009	3/1/2009	$ 4,823,769	$ -	$ -	$ 5,082,379			Increase the split load fee from $0.50/case to $1.00/case		No		
2010	6/17/2010	7/1/2009	$ 4,956,769	$ 133,000	$ -	$ 4,956,769	Fuel	Cases			No		
2011	7/15/2010	7/1/2010	$ 5,066,019	$ 109,250	$ -	$ 5,066,019	Fuel	Cases			No		
2012	4/29/2011	7/1/2011	$ 7,300,000	$ -	$ -	$ 7,300,000					**Yes**	July 2011 - June 2016	
2012	4/14/2011	7/1/2011	$ 7,300,000	$ 2,233,981		$ 7,300,000			Operational Costs	Clayton Warehouse	**Yes**	July 2016 - June 2021	
2013			$ 7,300,000	$ -	$ -	$ 7,300,000					N/A		
2014			$ 7,700,000	$ 400,000	$ -	$ 7,700,000					N/A		
2015			$ 7,700,000	$ -	$ -	$ 7,700,000					N/A		
2016			$ 7,700,000	$ -	$ -	$ 7,700,000					N/A		
2017	1/11/2012	7/1/2016	$ 7,750,000	$ 50,000	$ -	$ 7,750,000	These increases were replaced by increases authorized in the November 2016 contract amendment. Therefore, they are not included in the total increase of $5,508,830.						
2018			$ 7,750,000	$ -	$ -	$ 7,750,000							
2019			$ 7,800,000	$ 50,000	$ -	$ 7,800,000							
2020			$ 7,850,000	$ 50,000	$ -	$ 7,850,000							
2021			$ 7,900,000	$ 50,000	$ -	$ 7,900,000							
2017	11/22/2016	7/13/2016	$ 8,050,000	$ 350,000	$ 250,000	$ 8,300,000	Fuel	Cases			No		
2018			$ 8,050,000	$ -	$ -	$ 8,050,000					N/A		
2019			$ 8,100,000	$ 50,000	$ -	$ 8,100,000					N/A		
2020			$ 8,150,000	$ 50,000	$ -	$ 8,150,000					N/A		
2021			$ 8,200,000	$ 50,000	$ -	$ 8,200,000					N/A		
			Total Increase	**$ 5,508,830**									

STATE AUDITOR'S RESPONSE

The Office of the State Auditor (OSA) is required to provide additional explanation when an agency's response could potentially cloud an issue, mislead the reader, or inappropriately minimize the importance of the auditor findings.

Generally Accepted Government Auditing Standards state,

> "When the audited entity's comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditor's recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement."

Poor Contract Administration Cost the State At Least $11.3 million Over 13 Years

The Commission's response stated "It is our understanding that negotiations and amendments were reviewed by the NC Attorney General's Office…"

This response could mislead the reader to believe that the NC Attorney General's Office review provided validation for:

- Exceeding the maximum allowable Contract price by $11.3 million over 13 years
- Approving $5.5 million in contractor requested price increases without verifying reasonableness and necessity
- Exceeding the three-year contract term limit four times without proper review and approval

Consequently, the reader could also misunderstand the extent of the review performed by the Attorney General's Office.

The NC Attorney General's Office **did not** review the Commission's contracts to ensure that price increases were warranted or supported. As required by statute,[1] contracts and amendments submitted to the NC Attorney General's Office were reviewed only to ensure that the proposed contracts/amendments are in **proper legal form**, **contain all clauses required by law**, **are legally enforceable**, and **accomplish their intended purposes**.

Additionally, in 2014, a law was enacted that requires the Secretary of the Department of Administration (DOA) to notify the NC Attorney General's Office of pending contracts for contractual services exceeding a cost of $5 million.[2] Upon notification, the NC Attorney General's Office is required to assign a representative to assist in the negotiation for the award of the contract. The review should **assist in obtaining the most favorable contract for the State** and to **evaluate all proposals available from prospective contractors for that purpose.**

The Commission only executed one contract amendment after 2014, which was a November 2016 contract amendment that approved price increases through 2021. However, the Commission did not provide evidence that the amendment was reviewed by the NC Attorney General's Office for the required assistance, review, and evaluation.

The Commission contends that their contracting activities are exempt from the DOA's oversight. OSA does not agree with the Commission's interpretation of the law. But regardless of interpretation, the statute specifically requires **any** contract exceeding the cost of $5 million to be reviewed and evaluated by the NC Attorney General's Office. This includes contract proposals by any agencies that are exempt from DOA oversight.

---

[1] North Carolina General Statute 114-8.3.(a).
[2] North Carolina General Statute 143-49(3a).

Response From Alcoholic Beverage Control Commission

State of North Carolina
ALCOHOLIC BEVERAGE CONTROL COMMISSION

A. D. "ZANDER" GUY, JR.
CHAIRMAN

AGNES C. STEVENS
ADMINISTRATOR

4307 MAIL SERVICE CENTER
RALEIGH, NC 27699-4307

(919) 779-0700
FAX (919) 661-5927

COMMISSION MEMBERS:
MICHAEL C. HERRING
WEST JEFFERSON
NORMAN A. MITCHELL, SR.
CHARLOTTE

July 26, 2018

The Honorable Beth A. Wood, State Auditor
Office of the State Auditor
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0600

Dear Auditor Wood:

Thank you for the opportunity to respond to your recent audit. As you know, I was appointed Chairman of the North Carolina Alcoholic Beverage Control Commission in 2017. In this role, I am committed to the oversight of operations to ensure efficiencies and best use of state resources. The majority, if not all of your review period, was before my tenure as chair. However, I take this audit seriously and plan to implement changes accordingly. This is the ABC Commission's final and updated response to the recently concluded Performance Audit.

Throughout the year long-performance audit process, I have worked with the Commission's previous administrator and staff to implement areas of improvements the auditors identified. It is important that we implement changes when they are identified.

Audit Findings

- Poor contract administration costs the state $11.3 million over 13 years

The Commission accepts the Auditor's findings.

The current warehouse contract was executed in 2004, after the previous contractor went bankrupt in 2003 and has been extended several times up through our current date. The last extension was done prior to my appointment. It is our understanding that negotiations and amendments were reviewed by the NC Attorney General's Office, presented in public meetings and approved over multiple separate ABC Commission administrations.

Since my appointment, I have tasked the Commission staff to review all aspects of operations, including contract management of this and other contracts. We have reviewed the current contract and will put measures in place to strictly administer it. Additionally, we are moving forward with putting the warehouse management contract out for public bid in 2020 to be effective when the current contract expires in 2021. We are also putting procedures in place to review current

LOCATION 400 EAST TRYON ROAD, RALEIGH, NC 27610
AN EQUAL OPPORTUNITY / AFFIRMATIVE ACTION EMPLOYER
http://abc.nc.gov

deliverables as well as systems to make decisions on whether any requested adjustments are justifiable and in the state's best interest. I have also recently named Agnes Stevens as the new Administrator. She and I will be responsible for oversight of the Commission's operations in the current administration.

As Chair, I understand that it is our duty as a Commission and staff to oversee and manage this contract and all other contracts. Although previous Chairs and Commissions have executed this contract, we will take full responsibility to ensure the terms are completely met and the state is getting the services in a timely and efficient manner.

- Unused warehouse space cost the state $2.1 million over 7 years.

The Commission accepts the Auditor's findings.

It is our understanding in 2010, the state's single 200,000 square foot warehouse was at full capacity, limiting the amount of product manufacturers could ship to the state and limiting the selection available to NC consumers. Therefore, the Commission Chair, at that time, approved an additional warehouse. Since the additional warehouse came in use in 2010, there are almost twice as many products stored there. Additional space is also used for specialty and holiday items. While additional warehouse space was needed, it is unclear whether a facility this large was needed eight years ago. We will continue to review the needs and search for opportunities for efficiencies.

- No monitoring left the state underpaid by at least $297,537 over two years

The Commission accepts the Auditor's findings.

I have instructed the new Commission administrator, along with legal counsel, to review every aspect of current and future contracts. Fees, including out-of-stock, incidental and all other services fees are to be taken seriously. The fees not only help to reduce costs, but also act as a deterrent to ensure the terms of the contract are met.

Over the past year, since the beginning of this performance audit, the Commission has already instituted additional controls over the warehouse contract, including conducting random spot checks of the warehouse facility, inspections of its inventory and operations, and conducting ride-alongs with select deliveries to ABC Boards across the state.

Conclusion
The performance audit process has provided a helpful review for the NC ABC Commission. It is very appropriate for me to implement all the necessary changes to ensure efficiency in our ABC operations for North Carolina.

In addition to actions previously mentioned, I have instructed:

- the Commission administrator and staff to review and monitor this contract and all others and to immediately report any breach, deficiencies or concerns directly to me.
- and fully engaged the ABC Commission Audit Division to also assist with the monitoring of this contract and ask this division to report any deficiencies to the administrator immediately.
- and alerted the full Commission to these changes.

- the Commission administrator and staff to do a complete and thorough review of services needed by an outside contractor.
- that the Commission will openly bid for the services needed before the expiration of this contract, to ensure the state is getting the most up-to-date, efficient services possible. We will work with the appropriate state experts and lawyers to ensure we properly procure the best company and contract to meet our needs in North Carolina.
- staff and the Commission to manage and supervise this and all contracts strictly and appropriately.
- that the Commission will conduct an internal review within the next 12 to 18 months, to ensure we are continuing these practices.

Thank you for the opportunity to respond. While I am not responsible for the actions that occurred before my tenure, as the current chair I will take responsibility for the future oversight and management of this organization. I am committed to making the ABC Commission the best it can be for our state.

A.D. Zander Guy, Chairman, North Carolina Alcoholic Beverage Commission

ORDERING INFORMATION

COPIES OF THIS REPORT MAY BE OBTAINED BY CONTACTING:

Office of the State Auditor
State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0600

Telephone: 919-807-7500
Facsimile: 919-807-7647
Internet: http://www.ncauditor.net

To report alleged incidents of fraud, waste or abuse in state government contact the Office of the State Auditor Fraud Hotline: **1-800-730-8477**
or download our free app.

https://play.google.com/store/apps/details?id=net.ncauditor.ncauditor

https://itunes.apple.com/us/app/nc-state-auditor-hotline/id567315745

For additional information contact:
Brad Young
Director of External Affairs
919-807-7513

NC OSA
The Taxpayers' Watchdog

This audit required 4,257 hours of auditor effort at an approximate cost of $438,471.