

OFFICE OF THE STATE INSPECTOR GENERAL

**Report to
Jeffrey Painter, Chairman
VIRGINIA DEPARTMENT OF
ALCOHOLIC BEVERAGE CONTROL**

June 2017



**Michael C. Westfall, CPA
Acting State Inspector General
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Jeffrey Painter, Chairman
Virginia Department of Alcoholic Beverage Control
2901 Hermitage Road
Richmond, VA 23220

Dear Mr. Painter:

The Office of the State Inspector General (OSIG) is empowered, under [§ 2.2-309 \[A\]\(10\)](#) of the *Code of Virginia (Code)*, to conduct performance reviews of state agencies to ensure that state funds are spent as intended and to evaluate the efficiency and effectiveness of programs in accomplishing their purposes. The Department of Alcoholic Beverage Control (ABC) review covers the period of July 1, 2015 through November 2016 processes.

OSIG's review focused on ABC's Procurement & Support Services' (PaSS) efforts toward transitioning to an Authority and preparing for its exemption from the Virginia Public Procurement Act.

PaSS was selected for review based on a 2013 statewide risk assessment completed by Deloitte, LLP and the pending ABC exemption from the Virginia Public Procurement Act, effective January 15, 2018. The planning phase of the review consisted of conducting interviews with selected members of executive and divisional management, assessing the risks identified during those interviews, and creating a detailed review plan to accomplish the review objectives.

The steps in the review plan were executed and the results discussed with PaSS management throughout the review process. Observations identified during the review and the agency's plan of action are included in the attached report.

OSIG appreciates the assistance provided by ABC's staff during this review.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael C. Westfall". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Michael C. Westfall, CPA
Acting State Inspector General

CC: Paul J. Reagan, Chief of Staff to Governor McAuliffe
Suzette P. Denslow, Deputy Chief of Staff to Governor McAuliffe
Brian J. Moran, Secretary of Public Safety and Homeland Security
Judy Napier, Commissioner of the Virginia Department of Alcoholic Beverage Control
Henry L. Marsh III, Commissioner of the Virginia Department of Alcoholic Beverage Control
Travis Hill, Chief Operating Officer, Virginia Department of Alcoholic Beverage Control

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Executive Summary

The Office of the State Inspector General (OSIG) reviewed the Department of Alcoholic Beverage Control's (ABC) existing procurement processes currently governed by the Virginia Public Procurement Act (VPPA) and ABC's potential post-VPPA exemption policies for its affected work unit, Procurement & Support Services (PaSS).

The review had the following objectives:

- Determine whether ABC's procurement activities are operating in an effective and efficient manner; and
- Determine whether an adequate management control framework exists and functions to provide reasonable assurance goods and services are acquired pursuant to predetermined levels of approval authority (delegated authority of financial responsibilities).

At the conclusion of the review, OSIG provided the following recommendations to ABC:

RECOMMENDATIONS
1. Develop and Implement Key Performance Indicators to Measure Performance.
2. Develop and Align Business Operating Plan with ABC's Strategic Plan.
3. Improve Vendor Management.
4. Develop Service Level Agreements Between PaSS and its Internal Clients.
5. Use Data Analytics to Help Manage the Process and Improve Client Service Deliveries.

Purpose and Scope of the Review

The Office of the State Inspector General (OSIG) conducted a performance review of ABC's PaSS as it transitions to an Authority and prepares for its exemption from the Virginia Public Procurement Act (VPPA), effective January 15, 2018.

This review was not designed as a VPPA compliance review of ABC's PaSS. Instead, the review was designed to support ABC's transition, and as such focus on those procurement activities which will become exempt from VPPA. OSIG reviewed financial information for Fiscal Years 2014, 2015 and 2016, as well as PaSS operations through the first quarter of Fiscal Year 2017.

Procurement currently performed under VPPA - reviewed by OSIG¹:

- Supplies and Materials;
- Professional Services; and
- Non-Professional Services.

Procurement currently exempt from VPPA - not reviewed by OSIG:

- Real Property and Leaseholds;
- Distilled Spirits for Resale;
- Wine for Resale; and
- Non-alcoholic products for Resale.

Objectives

Determine whether ABC's procurement activities are operating in an effective and efficient manner.

Effective

- Determine whether the acquisition of goods and services is timely and meets ABC's business unit needs (e.g., Does acquisition cycle time from requisition to in-service days satisfy business need?);
- Determine whether acquired goods and services adequately meet ABC's business unit needs (e.g., Are goods and services in sufficient quality and quantity to meet business need?); and
- Determine whether an adequate management control framework exists and functions to provide reasonable assurance goods and services are acquired pursuant to management's direction (Does delegated authority exist to discharge duties?).

¹ Effective January 15, 2018. VIRGINIA ACTS OF ASSEMBLY -- 2017 SESSION - CHAPTER 707

Efficient

- Determine whether ABC's procurement activities exercise adequate cost savings and cost avoidance:
 - Cost Savings – Reductions in budgets, staff resources, streamlined activities, discounts and refunds;
 - Cost Avoidance - Reductions from competitive bidding, negotiation and rate reductions; and
- Determine whether an adequate management control framework exists and functions to provide reasonable assurance goods and services are acquired pursuant to predetermined levels of approval authority (delegated authority of financial responsibilities).

In addition, the project included agreed-upon procedures to assist ABC in its transition efforts. The agreed-upon procedures include:

- Current state analysis of all state and agency policies governing procurement activities;
- Document showing crosswalk of current governing procurement policies and future governing procurement policies; and
- Analysis of procurement procedures and recommendations for future state procedures based upon proposed policy changes.

Background

The Department of Alcoholic Beverage Control (ABC) was formed in 1934 after the repeal of Prohibition, where power to regulate alcoholic beverages reverted to individual states. Virginia patterned its model after the Canadian provinces where a government agency assumes a role in the distribution of alcoholic beverages. In Virginia's case, ABC became the sole wholesaler and retailer of distilled spirits and the primary regulating authority for the manufacture, distribution, transportation, sale and consumption of other alcoholic beverages.

The mission of ABC is to generate a reliable stream of revenue for Virginia and promote public safety through the responsible sale and regulation of alcoholic beverages.

ABC has grown into a revenue source for the Commonwealth of Virginia (COV), increasing its contributions to state revenues totaling over \$392 million in Fiscal Year 2016.

Financial Results in Brief, Fiscal Year 2016					
REVENUE SOURCE	FY 2016	FY 2015	FY 2014	FY 2013	FY 2012
ABC profit transfers ⁽²⁾	\$164,888,413	\$152,037,837	\$139,987,344	\$134,576,751	\$132,021,784
State taxes ⁽³⁾	147,812,928	139,832,186	132,043,584	126,802,220	120,988,748
Wine liter tax ⁽⁴⁾	36,208,113	35,249,206	34,608,741	34,400,161	33,457,628
Malt beverage tax ⁽⁵⁾	43,181,973	42,948,462	43,341,595	42,846,308	43,660,370
Total	\$392,091,427	\$370,067,691	\$349,981,264	\$338,625,440	\$330,128,530

Source: ABC Annual Report for Fiscal Year Ended 2016

Total sales from store operations continue to show steady increases. ABC attributes some of the store sales increases to extended store hours and store expansion.

ABC Store Net Sales

	FY 2016	FY 2015	FY 2014	FY 2013	FY 2012
ABC Store Sales	\$747,664,735	\$708,192,980	\$668,568,655	\$641,997,839	\$612,861,516
% Change Prior Year	5.57%	5.93%	4.14%	4.75%	5.94%

Source: ABC Annual Reports for Fiscal Years Ended 2012, 2013, 2014, 2015, 2016

ABC Procurement

ABC departmentalizes its procurement functions. Product for resale, real estate services and PaSS all operate with separate reporting structures. Whereas exemptions currently exist for purchasing

² Statement of Revenues, Expenses and Changes in Net Position. Profits are reported in accordance with generally accepted accounting principles. Profits include licensing fees and ABC's portion of the wine liter tax.

³ State tax on distilled spirits is 20 percent. State tax on wine sold in ABC stores is 4 percent.

⁴ The non-ABC portion of the wine liter tax is \$.40 per liter. \$9,141,363 of the wine liter tax is transferred to the Virginia Department of Behavioral Health and Developmental Services.

⁵ Collections of Malt Beverage Tax

product for resale and leasehold acquisitions, the affected areas of ABC’s exemption from the VPPA is limited to activities managed by ABC’s PaSS.

ABC Procurement and Support Services

ABC’s PaSS unit reports issuing on average \$20,896,700 in purchase orders annually. Annual fluctuations occur due to the issuance of multi-year purchase orders. For example, in fiscal 2014 a \$8,244,800 purchase order was issued covering fiscal years 2014 and 2015 for the delivery of product to the retail stores.

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Purchase Orders⁶	<u>\$ 21,127,900</u>	<u>\$ 15,396,600</u>	<u>\$ 26,165,500</u>

Due to the upcoming VPPA exemption, PaSS needs to develop and implement its own set of policies and procedures to govern procurement activities. Despite the exemption, PaSS’s procurement activities remain subject to the Freedom of Information Act (FOIA).

Transition to Authority⁷

The 2015 General Assembly passed legislation to transition ABC from a state agency to an Authority. The 2017 General Assembly accelerated the effective date by about six months to January 15, 2018. Notable items in the 2015 legislation include:

- The number of Board members changes from three to five;
- Board members no longer “shall devote his full time to the performance of his official duties;”
- The Board governing the Authority must meet at least every 60 days;
- Establishes the position of Chief Executive Officer responsible for day-to-day operations;
- Exempts the Authority from the provisions of the Virginia Personnel Act; and
- Exempts the Authority from the VPPA.

PaSS Post Authority Transition

It is reasonable to expect PaSS will face several challenges, which could radically change its existing workload. One of these challenges is replacement of ABC’s legacy information systems. Upon transition to an Authority, the use of VITA services by ABC becomes optional, effective October 1, 2018. If ABC chooses to not use VITA, then ABC will be responsible for returning technology equipment to VITA and re-acquiring the necessary technology to operate. ABC estimated an initial upfront cost of \$4 million to \$5 million to acquire laptops and servers. The ongoing non-personnel operating costs and fees associated with maintaining its own information technology infrastructure would be over and above acquisition costs. While current information

⁶ Value of Purchase orders issued per PaSS staff based on eVa report.

⁷ 2017 legislation established January 15, 2018 as the VPPA exemption date.

technology (IT) expenditures managed by PaSS are significant, transitioning ABC's IT outside of VITA will profoundly skew the focus of PaSS activities toward IT acquisitions. Additionally, while transparency associated with FOIA requirements remain relevant, PaSS's attention may be more aligned with cost avoidance and savings may take priority over public policy initiatives such as VPPA.

Review Methodology

The performance review procedures included

- Conducting interviews and observations/walk-throughs concerning existing business processes;
- Examining existing and proposed procurement policies and procedures impacted by the forthcoming VPPA exemption, including sharing observations and recommendations with staff for consideration in development of procurement policies and procedures in the Authority environment;
- Collecting and analyzing relevant data; and
- Benchmarking business processes, activities and performance metrics against similar activities in private industry.

OSIG staff planned for this review by:

- Reviewing pertinent documents;
- Conducting interviews with pertinent staff, including
 - Senior members of the PaSS staff;
 - ABC's Transition Coordinator;
 - ABC's Transition Vendor for Procurement Activities; and
- Performing analytical procedures as necessary.

As a result of the interviews, observations and independent research, OSIG staff identified opportunities for PaSS's consideration as it transitions into the VPPA exemption. In addition, indicators or opportunities for fraud, waste or abuse were assessed in the risk areas. Based on our review of procurement changes related to the authority transition, OSIG did not observe any material increases in opportunities for fraud, waste or abuse.

Review Results

OBSERVATION #1: DEVELOP AND IMPLEMENT KEY PERFORMANCE INDICATORS TO MEASURE PERFORMANCE

To monitor and report results of operations, Key Performance Indicators (KPIs) are frequently used. KPIs are developed and monitored periodically to measure performance toward stated objectives.

Currently, PaSS only measures Small, Women and Minority (SWaM) spending levels due to system usage and limitations. To date, PaSS's focus has been compliance with VPPA. In addition, system limitations have hindered PaSS's ability to fully develop and implement additional KPIs to measure results of its operations.

PaSS is currently limited in its ability to quantify KPIs to measure its success. Thus, PaSS is limited in its ability to quantify results of its operations, and subsequently its contributions toward the achievement of ABC's business financial goals, objectives and risk acceptance.

RECOMMENDATION:

PaSS needs to assess the business and determine which KPIs are best to monitor results of operations toward the achievement of ABC's business goals. KPIs should represent not only the results of operations, but be responsive to quantifiable assessments, such as cost benefit and risk reduction. Periodic monitoring and reporting of KPIs provides the basis for quantitative performance management and ongoing process improvements.

Procurement groups use a wide array of KPIs to measure and monitor their performance. Some common private industry KPIs include:

- Procurement Costs as a Percentage of Spend;
- Average Purchase Order Processing Cost;
- Procurement ROI;
- Savings Rate;
- Spend per Full-Time Equivalent (FTE) is an Efficiency Metric; and
- Service Satisfaction Level (Procurement Stakeholders' Satisfaction).

While aspects of the act remain relevant, such as open bidding on contracts and transparency of transactions, going forward PaSS will need to demonstrate its direct contributions toward the achievement of ABC's business financial goals and objectives, and reduction of procurement risk.

VIRGINIA ABC RESPONSE AND ACTION PLAN – OBSERVATION #1:

Virginia ABC has read the above issue and agrees with the conditions of Observation #1. Virginia ABC is in the process of developing and reporting on KPIs throughout the organization. Cycle time was identified by executive leadership and business units as the most important KPI for reporting by PaSS. Data collection for this measure started on May 1, 2017. A KPI Governance Team has been formed within Virginia ABC to put in place programs to assist in the organization's

development and governance by KPIs. PaSS will work toward collecting data for additional measures and reporting results as we progress in this initiative.

OBSERVATION #2: DEVELOP AND ALIGN BUSINESS OPERATING PLAN WITH ABC’S STRATEGIC PLAN

Procurement business plans should directly support ABC’s strategic plan. One of the characteristics of a best-in-class procurement group is how it supports the entity’s overall mission, goals and objectives.

PaSS has not finalized a business plan in direct support of ABC’s strategic plan. PaSS’s mission was primarily driven by performing its tasks in compliance with the Virginia Public Procurement Act. At one time, developing and executing a business plan was not a priority. ABC completed strategic working sessions in FY 2016; however, PaSS has not completed the process of developing its business plan.

The lack of a PaSS business plan and its alignment to ABC’s strategic plan limits PaSS’s ability to fully support ABC’s strategic goals and objectives. As a result, PaSS may not be adequately deploying its resources toward achievement of ABC’s goals and objectives.

RECOMMENDATION:

PaSS should develop its business plan in support of ABC’s strategic plan. The business plan, at a minimum, should define PaSS’s available resources and goals that support the pillars of ABC’s strategic plan. Quantitative performance measures should be employed to measure results of operations.

VIRGINIA ABC RESPONSE AND ACTION PLAN – OBSERVATION #2:

Virginia ABC has read the above issue and the conditions of Observation #2. Virginia ABC currently engages in a strategic planning process where each division reviews its own operations to identify opportunities and develop initiatives that support strategic pillars established by the ABC Board. During the strategic planning process, division directors are tasked with exploring strategic opportunities from a divisional perspective. Through stakeholder analysis and environmental scanning (a review of internal and external factors influencing organizational success including conducting a SWOT analysis, reviewing solicited customer feedback and researching industry best practices), each division looks to identify its own goals, available resources and how it can support the overall agency. As these processes mature, each division will further develop plans, be they “strategic” or “business,” that will inform and support the agency’s strategic plan. Further, given the focus on agility and streamlined operations through the agency’s transition to an authority structure, Procurement has started the planning process to implement more than 30 new policies and procedures. This divisional-level authority implementation plan will be integrated into the division’s overall business operating plan.

OBSERVATION #3: IMPROVE VENDOR MANAGEMENT

Vendor scorecards are useful in monitoring and reporting vendor performance. Vendor scorecards are most successful when deployed as part of an overall vendor evaluation business process. Measuring and monitoring vendor performance against an agreed-upon Service Level Agreement (SLA) is useful to help vendors know expectations and their performance against those expectations. Furthermore, it allows ABC to monitor the quality and quantity of goods and services delivered in a timely manner.

PaSS is not actively managing processes for scoring vendor performance. To date, any vendor monitoring rests solely upon contract administrators and may or may not occur in a systematic manner.

Actively monitoring vendor performance has not been a PaSS priority. PaSS provides initial guidance on vendor monitoring to business units assigned contract administrators, but systematic and periodic follow up by PaSS to assess performance is not consistently performed.

The lack of systematic vendor performance monitoring limits ABC's ability to leverage its position with vendors. Typically, only performance problems are addressed as necessary and perhaps without assistance from PaSS. The absence of an active vendor monitoring program limits PaSS's ability to proactively address potential issues quickly in advance of major problems.

RECOMMENDATION:

PaSS should develop contract administrator training and vendor scorecards for use by contract administrators. PaSS should actively manage new and annual contract administrator training for contract administrators and the vendor scorecard process. Vendor scorecards should be used in existing contract management to improve service delivery and as a tool in the negotiating process for future contracts.

Vendor scorecards and performance metrics should be aligned with the PaSS business plan, which supports ABC's strategic goals. Scorecards should be frequently shared with vendors. If scorecards are not shared with vendors, performance improvement typically will not result.

VIRGINIA ABC RESPONSE AND ACTION PLAN – OBSERVATION #3:

Virginia ABC has read the above issue and agrees with the conditions of Observation #3. Policies for both Contract Administration and Vendor Management were created and will be implemented when Virginia ABC transitions to an Authority in January 2018. Appropriate training will be developed for the newly created Authority policies including Contract Administration and Vendor Management. As we work toward an effective Vendor Management program, vendor scorecards will become part of that process.

OBSERVATION #4: DEVELOP SERVICE LEVEL AGREEMENTS BETWEEN PROCUREMENT AND SUPPORT SERVICES AND THEIR INTERNAL CLIENTS

An SLA may serve many of the same functions as contracts between business entities. The SLA constitutes a single document that contains the terms of the agreement as understood by each party. An SLA sets out delivery performance expectations -- a means to measure performance -- which can allow a service provider and their clients to improve expectations and performance by each party.

Currently PaSS does not have an SLA or equivalent document outlining service levels and expectations with its internal clients. As a result, it is difficult to manage expectations between two or more internal departments.

Defining an SLA based on each party's needs, ABC's strategic plan and available resources was not a priority. PaSS's focus to date has been compliance with VPPA.

Without SLAs defining service and service quality expectations, it is difficult to manage breaches and proactively manage service delivery. Not having an SLA can lead to divergent points of view about the process and service expectations.

RECOMMENDATION:

PaSS should formalize and document its service level commitments with its internal clients. This documentation should outline each party's roles and responsibilities to achieve service level commitments, designed to meet business needs. Input and support from ABC senior management is necessary to achieve success. The SLA, or its equivalent, should also be a part of the PaSS business plan. Periodic monitoring and review of delivery levels should occur, allowing PaSS to address issues impeding the delivery of goods and services.

VIRGINIA ABC RESPONSE AND ACTION PLAN – OBSERVATION #4:

Virginia ABC has read the above issue and agrees with the recommendations of Observation #4. As part of Virginia ABC's ongoing efforts to transition to an Authority in 2018, all divisions are developing Key Performance Indicators (KPI) to help measure division operational performance. Once KPI's are established, divisions will turn their attention to the development of SLAs that will help to drive productivity between the work units and help to establish consistent and reasonable expectations around getting work done. In addition, divisional-level authority implementation plans, to include service level agreements (SLAs) and key performance indicators (KPIs), will be integrated into each division's overall business operating plan.

OBSERVATION #5: USE DATA ANALYTICS TO HELP MANAGE THE PROCESS AND IMPROVE CLIENT SERVICE DELIVERIES

To achieve improved client service levels and streamline processes involved in service delivery, entities make technology work for them. Data analysis is critical in formulating qualitative and

quantitative business decisions. For example, to date the preferred method of procurement for the Commonwealth is the Quick Quote or Invitation for Bid. These procurement methods are awarded on the lowest responsive and responsible bidder. Going forward the focus may turn more toward the Total Cost of Ownership (TCO). Evaluating TCO requires data analysis from internal and external sources to quantify the TCO for use in the decision process. For procurement organizations, just as in other business services, superior planning and analysis drives superior function performance.

System limitations in the procurement module of ABC's Performance Financial Management system and the limited information transferred to eVA hinder PaSS's ability to formalize data analytics for use in supporting business decisions. Additionally, to date the ability to develop data analysis skills and tools to use has not been a priority within PaSS and ABC.

Currently, PaSS uses a near end-of-life legacy information system to support its procurement activities. The legacy system does not have readily available reporting capabilities, which avails itself to perform procurement data analytics.

Absent the ability to analyze data, business and procurement support decisions are forced to be made without substantive quantifiable background. Common management data points such as procurement cycle counts and spend under procurement management are difficult to cobble together. As a result, PaSS can find itself in a reactionary mode to address client needs versus a proactive mode to further its contribution to the success of ABC's strategic objectives.

RECOMMENDATION:

As ABC moves forward with replacing its existing Enterprise Resource Planning system, and PaSS implementation of eVA as its Procurement System, consider providing additional tools and training necessary for PaSS to enhance availability and accuracy of information for use in its business decision processes. Also, train PaSS staff to improve their data analysis skill sets. As availability to information and skill sets improve, PaSS should use the information in its business planning and decision processes.

VIRGINIA ABC RESPONSE AND ACTION PLAN – OBSERVATION #5:

Virginia ABC has read the above issue and agrees with the conditions of Observation #5. Virginia ABC will be transitioning to eVA prior to the implementation of a new financial management system. A training allowance for PaSS staff will be needed and has been requested in the 2018 budget. The need for additional tools for data collection and analysis will be evaluated after eVA has been implemented and the tools of that procurement solution have been assessed.