REPORT TO THE HOUSE OF ASSEMBLY

Newfoundland and Labrador Liquor Corporation

OFFICE OF THE AUDITOR GENERAL
NEWFOUNDLAND AND LABRADOR

Office of the Auditor General
Newfoundland and Labrador

The Office of the Auditor General is committed to promoting accountability and encouraging positive change in the stewardship, management and use of public resources. The Auditor General reports to the House of Assembly on significant matters which result from the examinations of Government, its departments and agencies of the Crown. The Auditor General is also the independent auditor of the Province's financial statements and the financial statements of many agencies of the Crown and, as such, expresses an opinion as to the fair presentation of their financial statements.

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The Office of the Auditor General is an integral component of Government accountability.

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OFFICE OF THE AUDITOR GENERAL
NEWFOUNDLAND AND LABRADOR

February 2020

Honourable Scott Reid, M.H.A.
Speaker
House of Assembly

Dear Sir:

In compliance with the Auditor General Act, I have the honour to submit, for transmission to the House of Assembly, my Report on the Performance Audit of the Newfoundland and Labrador Liquor Corporation.

Respectfully submitted,

Julia Mullaley

JULIA MULLALEY, CPA, CA
Auditor General

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NEWFOUNDLAND AND LABRADOR LIQUOR CORPORATION

Independent Auditor’s Report

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Conclusions

The Newfoundland and Labrador Liquor Corporation (NLC) did not manage the procurement and sale of specialty wines in an effective manner and in compliance with legislation. In particular:

- There was no business case developed and approved for the initial establishment of the Bordeaux Futures program.
- Continued poor sales performance did not support an ongoing business case for the Bordeaux Futures program at inventory levels being procured.
- Procurement planning and acquisition decisions regarding type and quantity of Bordeaux Futures, as well as supplier selection, rested solely with the former Chief Executive Officer (CEO), were not documented or transparent, and did not follow the standard planning and acquisition process for other product lines.
- A conflict of interest relationship existed with respect to certain NLC acquisitions of specialty wines involving the former CEO and a close family member and:
    - The CEO did not take appropriate action to address this known conflict of interest risk.
    - The CEO participated in decisions to purchase specialty wines which benefited the close family member at the expense of NLC and which influenced the performance of the CEO's duties as a public office holder. As a result, the CEO breached NLC's Code of Conduct and may have breached his fiduciary duty to NLC.
- NLC misrepresented information in its response to the Office of the Citizens' Representative related to an investigation in 2016-17 of conflict of interest allegations involving the former CEO and the close family member.
- Unlike other NLC products, there was no prescribed guidance for pricing Bordeaux Futures wines. Rather, the former CEO generally established the prices with reference to certain other relevant information. Without such prescribed guidance and pricing documentation, the pricing of these wines was not transparent.
- NLC contravened federal and provincial legislation by knowingly selling and shipping, or arranging the shipping of, specialty wines directly to end customers in other provinces without going through the respective liquor authorities of those provinces. Price overrides and discounts were applied to most of these wines in an effort to reduce excess levels of specialty wine inventory.

NLC managed its entertainment, travel and Board expenses in a manner that promoted the appropriate use of shareholder (public) money, with exceptions noted for travel-related expenses for specialty wines.

The Liquor Corporation Act and the Province's Conflict of Interest Act do not adequately address conflicts of interest with respect to familial relationships, including the relationship between the former CEO and the close family member. In response to the 2017 report of the Citizens' Representative, in lieu of amending the Liquor Corporation Act to address this issue, Government committed to complete a Government-wide review to address conflicts of interest within the broader public service, including Crown entities. This review and draft legislative amendments are still being completed.

Why This Audit is Important

NLC operates with an expectation that it will generate revenue annually for the Government of Newfoundland and Labrador (Government) to reinvest in programs and services for the benefit of the people of the Province. NLC can best meet this expectation by bringing products that are of interest to its customers, such as specialty wine, to market in a cost-effective manner and that maximize sales for NLC in a socially responsible manner.

Therefore, it is important that NLC has defined product acquisition, sales and monitoring processes in place that support this expectation, that its product acquisition practices are fair and transparent and that its sales practices are compliant with legislation and NLC policies.

In June 2016, Government directed NLC to modify its travel and entertainment policies to make them consistent with those of Government, effective immediately. It is important that NLC complies with this directive designed to ensure that NLC, as a Crown entity, is incurring expenditures in a manner that promotes the appropriate use of public money.

Findings

Procurement and Sale of Specialty Wine

NLC uses two methods to select and buy new products. The primary and standard method used is the issuance of an open call to suppliers, through its well-defined and documented category review process. This process includes a comprehensive evaluation of new listing applications submitted by suppliers. On a more limited basis, NLC also purchases products on an ad-hoc or “one-time order” basis.

In June 2018, our Office was appointed by NLC as the independent auditor of NLC’s financial statements for the 2018-19 period. In late-Fall 2018, we became aware of concerns regarding NLC’s management of specialty wines. As a result, this performance audit focuses on the procurement of specialty wines and the related sales as generally this product category is procured outside the regular category review process.

Specialty wines are generally vintage sensitive or have some other unique offering that would warrant a listing outside the regular category review process. The large majority of specialty wines procured by NLC are Bordeaux Futures (Futures). NLC first developed a Bordeaux Futures program (Futures program) for its customers in 2006. The program offered customers the opportunity to buy specialty wine from Bordeaux, a specific region within France, while the wine is still aging in barrels. Many of these wines are produced in small quantities and only available as Futures.

Each year, top wine producers in France release Futures to negociants who in turn submit offers to sell and distribute the wines to wholesalers, importers and merchants worldwide. This typically occurs during the period April to June known as the En Primeur Campaign. Futures purchased by NLC through negociants are generally bottled and delivered to NLC approximately two years after they are sold to NLC. Upon receipt into inventory, NLC first arranges to sell the Futures to customers that had paid required deposits to NLC to purchase the wine at discounted prices while it was still aging in the barrel (referred to as NLC’s pre-sale period). All remaining Futures purchased by NLC are offered for sale to the general public.

Initial Establishment of the Bordeaux Futures Program

There was no business case developed and approved for the initial establishment of the Bordeaux Futures program.

Like any new program, introducing Futures into NLC's product lines included both benefits and risks. One key risk for Futures that was different than other non-specialty products offered for sale was that NLC bore the risk for unsold Futures product. For non-specialty products, the supplier bears the risk.

An NLC official familiar with the Futures program stated that the CEO at that time wanted a program for Newfoundland and Labrador customers that was similar to the Futures programs offered by liquor authorities in Ontario and Quebec. The then CEO instructed the Merchandising Division to establish a process to facilitate the purchase and sale of Futures to Newfoundland and Labrador customers. And so, in the 2006-07 fiscal year, following the annual Bordeaux En Primeur campaign, NLC began offering its customers the opportunity to purchase Futures at discounted prices during a pre-sale event on its website.

We would have expected that before a Futures program was introduced by NLC, a documented business case would have been developed that supported an evidence-based rationale for the program. Such a business case would have included, for example, market analysis and support for customer demand, alternatives to meet the expected demand, gross profit margins that could be expected from sales compared to other product lines, costs associated with selling the products, overall financial projections and consideration of the benefits and risks associated with implementing such a program.

NLC officials were unaware of any business case that had been developed and approved and were unable to provide any evidence that any such analysis was prepared. Furthermore, while the former CEO of NLC indicated that the Board of Directors (the Board) discussed the Futures program, we found no evidence, such as agenda items or minutes of the Board, to support that the initial implementation of the program was brought to the Board for review and consideration.

We did find reference in the January 2009 Board minutes that the Board was advised of NLC preparing a Fine Wine Strategy which would lead to increased inventories in the medium term but allow for continued growth in wine sales going forward. Fine wines include, but are not limited to, Bordeaux Futures. We were provided a one-page document titled “Fine Wine Strategy” from 2011. This document outlined, in bullet form:

- Rationale for the strategy - e.g. provide customers with the opportunity to purchase locally the wines that they had been acquiring outside the province.
- Process - e.g. develop supplier relationships in areas key to acquisition of desired products - Bordeaux, Burgundy, Italy, California.
- Strategy - e.g. build “special sections” into new stores to merchandise product.
- Risks - e.g. increased inventory.

NLC officials were unaware of a more comprehensive strategy having been developed and there was no further reference to this wine strategy in the Board minutes after January 2009 or otherwise.

Planning and Acquisition of Specialty Wines

Procurement planning and acquisition decisions regarding type and quantity of Bordeaux Futures, as well as supplier selection, rested solely with the former CEO, were not documented or transparent, and did not follow the standard planning and acquisition process for other product lines.

NLC prepares an annual budget which includes major product type (i.e. spirits, beer, wine, ready to drink), sales targets by major customer type (i.e. over the counter, liquor express, licensee and private orders) and the amount of dividend it will pay to Government. This budget requires approval of the Minister of Finance. Within the overall wine budget, NLC does not plan or set specific sales targets for its specialty wine products.

NLC policy requires product selections and listings to be managed by its Merchandising Division and approved by the Merchandising Category Manager, the Director of Merchandising and the Chief Merchandising Officer.

Each year, NLC's Merchandising Division conducts a well-documented planning and acquisition process (referred to as category review or listing and de-listing) to identify products it will purchase for the upcoming year. This process includes:

- Determining product need by completing market research to identify sales trends and customer preferences, as well as performing historical sales analysis of existing products.
- Identifying the specifications for new products it would like to list.
- Identifying and de-listing (discontinuing) under-performing products.
- Issuing an open call for suppliers to submit products for evaluation.
- Evaluating and selecting products to list based on specific criteria.

Specialty wines on the other hand are generally acquired through one-time orders. One-time orders are usually the result of a special offer or allocation from a supplier or may be a product that NLC would like to provide or test in its market. Thus, one-time orders do not generally coincide with the timing of annual listing calls but are deemed necessary to help NLC react to market needs and trends to help maximize sales. Evaluation and selection of one-time orders are required to be completed by the Merchandising Division.

Our audit found that, unlike the processes described above, a separate planning and acquisition process was used for the Bordeaux Futures program. This process was managed directly by the then CEO, was not documented or transparent and effectively eliminated the Merchandising Division from any evaluation and decision-making role. Information received from two liquor authorities in other provinces that offer a Futures program to their customers indicated that planning and acquisition decisions are processed through divisions equivalent to NLC's Merchandising Division.

During the 10-year period ended April 6, 2019, NLC purchased specialty wines with a landed cost totaling $25.8 million, of which $15.6 million, or 60 per cent, were Bordeaux wines. During this period, NLC issued 509 purchase orders to negociants for over 2,200 Bordeaux wine products. Additional details on the components of landed costs for wines are provided in Appendix I.

Landed Cost of Bordeaux Wine Purchases Ten-year period ended April 6, 2019						
Fiscal Year	Number of POs	Number of Products (SKUs) *	Number of Negociants	Landed Cost		
				Futures	Non-Futures	Total
2010	95	247	8	$1,380,889	$605,194	$1,986,083
2011	96	254	10	2,525,921	722,192	3,248,113
2012	86	312	9	3,784,763	236,957	4,021,720
2013	77	239	11	1,460,271	358,443	1,818,714
2014	29	207	12	931,029	170,076	1,101,105
2015	45	278	12	581,151	274,476	855,627
2016	36	384	12	998,657	289,763	1,288,420
2017	21	201	11	620,734	120,001	740,735
2018	23	172	11	453,401	69,173	522,574
2019	1	1	1	**17,326	-	17,326
Total	**509**	**2,295**	*******	**$12,754,142**	**$2,846,275**	**$15,600,417**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation
* Stock Keeping Units (SKU)
** Estimate – Futures orders not yet received
*** NLC issued purchase orders to a total of 22 different negociants during the 10-year period.

Of the $15.6 million in Bordeaux wine purchases, $12.8 million, or 82 per cent, was purchased under the Futures program. We documented and walked through the process followed by NLC in identifying, evaluating and selecting Bordeaux Futures for purchase. We found the following:

Supplier Selection

There are hundreds of negociants that work with wine producers to sell Bordeaux wines. We found that NLC purchased from 22 different negociants over the audit period, but that seven of these 22 negociants accounted for $12.9 million or 83 per cent of the $15.6 million in Bordeaux wine purchases. NLC officials stated that the then CEO formed relationships with negociants and solely determined from which negociants NLC would purchase Futures. The former CEO indicated that negociants were selected based on specific products the CEO wanted to order and available allocation of these products from negociants. However, NLC could not provide any documentation to support why these particular negociants were chosen. As a result, the process of supplier selection was not transparent.

Product Selection

During the annual En Primeur campaigns, NLC received email offers from negociants as the wine producers they worked with released Futures products. This often occurred on a daily basis as individual Futures products were released to negociants in small batches. The offers specified the wine producer's product, the offer price and whether limited quantities were available.

All email offers were received by the CEO, and later in the audit period by certain management within the Merchandising Division as well. The CEO solely determined whether a negociant offer was to be accepted. Where offers were accepted, the CEO normally either:

- Placed the product order with the negociant by return email and copied the Merchandising Division on the email.

- Forwarded the negociants' email offer to the Merchandising Division, specifying the quantity of product to be ordered. The Merchandising Division then emailed the negociant to place the product order.

The former CEO indicated product selection was based on his experience, intuition and knowledge and available allocations from negociants. There was, however, no documentation to support these decisions nor was the Merchandising Division provided with any rationale for the CEO's decision to purchase either the product or the quantity specified. As a result, the process for product selection was not transparent.

The Merchandising Division's role in acquiring Bordeaux Futures was, for the most part, administrative in nature and generally limited to:

- Creating Stock Keeping Unit (SKU) numbers for products the CEO had directed to be ordered.

- Tracking Futures order quantity and SKU costs in an excel spreadsheet which was regularly forwarded to the CEO.

Merchandising officials indicated that up to 2014, they also met with the Vice-President of Sales prior to the annual En Primeur campaigns to provide historical sales performance and inventory reports for these products. Subsequent to 2014, they met directly with the then CEO to provide this same information. No minutes of these meetings were kept. Merchandising officials advised that they did not have any evaluation or decision-making role in these meetings.

Throughout the campaign, Merchandising provided the then CEO with a regularly updated spreadsheet summarizing all known Futures offers received and the quantity of products the CEO had requested to be ordered for each product offer. Where wine critic scores were known, these were also recorded on the spreadsheet. The CEO reviewed the spreadsheet and manually recorded additional products that Merchandising was then directed to order. Again, we found that no rationale was provided for the quantities ordered or, where multiple offers were recorded for the same price, why a particular negociant was selected over others.

Monitoring the Performance of Specialty Wines

Continued poor sales performance of Bordeaux wines did not support an ongoing business case for the Futures program at inventory levels being procured. Yet NLC continued to purchase Futures in quantities that far exceeded the level of customer demand. This resulted in a buildup of excess inventory and a provision for write-down of inventory of $1.3 million as of April 2019 for over-valued and/or unsellable product.

Since commencement of the Bordeaux Futures program until April 2019, NLC has estimated net profit to date of $1.4 million in relation to Bordeaux wines. However, once opportunity costs of $3.6 million are considered related to the cash tied up in excess inventory and prepayments to negociants, the net cost of these Bordeaux wines is estimated at $2.2 million ($1.4 million net profit less opportunity costs of $3.6 million). The final financial results for the Bordeaux program will not be known until the remaining inventory is sold or written off.

From the start of the Futures program in fiscal 2006-07 until NLC effectively ended acquisition of Futures in fiscal 2018, the program experienced low demand for pre-sales and a low inventory turnover. Continued poor sales performance of Bordeaux wines did not support an ongoing business case for the Futures program at inventory levels being procured.

Low Levels of Pre-sale Demand for Bordeaux Futures

Throughout this period, pre-sale levels were quite low compared to total inventory purchased, with an overall average of only 16.6 per cent. We found that it was a small group of seven customers that purchased the majority of Futures sold during most of the pre-sale periods. Arguably, the needs of this small number of customers could have been met through more cost-effective alternatives such as limiting purchases to the pre-sale level or using the long-standing practice of placing private orders for NLC customers through liquor authorities in other provinces. Information received from two liquor authorities in other provinces that offer a Futures program to their customers indicated that one pre-sells an estimated 75 per cent of product purchased while the other generally limits acquisition of Futures to those that are pre-sold to customers.

Approximate Landed Cost of Bordeaux Futures Purchased and Pre-sold Twelve-year period ended April 7, 2018					
Fiscal Year	Futures Vintage	Landed Cost of Futures Purchased	Futures Sold to Customers During Pre-sale		
			Number of Customers	Approximate Landed Cost	Percentage of Futures Pre-Sold
2007	2005	$1,174,756	27	$62,000	5.3%
2008	2006	727,558	19	55,000	7.6%
2009	2007	607,186	11	19,000	3.1%
2010	2008	1,380,889	27	336,500	24.4%
2011	2009	2,525,921	66	501,600	19.9%
2012	2010	3,784,763	61	369,400	9.8%
2013	2011	1,460,271	22	131,500	9.0%
2014	2012	931,029	35	259,000	27.8%
2015	2013	581,151	11	54,000	9.3%
2016	2014	998,657	56	230,500	23.1%
2017	2015	620,734	53	388,500	62.6%
2018	2016	453,401	22	127,000	28.0%
Total		**$15,246,316**		**$2,534,000**	**16.6%**

Source: Prepared by the Office of the Auditor General based on data obtained from the Newfoundland and Labrador Liquor Corporation

Low Inventory Turnover

During the 10-year period ended April 6, 2019, the inventory turnover rate of Bordeaux wines ranged from a low of 0.08 to a high of 0.31, with an overall average of 0.20 (i.e. inventory turns over once every five years). This is significantly lower than NLC's annual average inventory turnover rate of 3.0 (three times per year) for non-specialty wine products and lower than NLC would have generally expected. This low turnover rate was a clear indicator that the Bordeaux specialty wines were underperforming at the levels being purchased. Yet NLC continued to purchase Futures at levels that far exceeded the level of customer demand, resulting in a build-up of excess Bordeaux inventory, which reached a high of nearly $10 million in 2015.

Cost of Bordeaux Inventory Ten-year period ended April 6, 2019					
Fiscal Year	Opening Inventory	Inventory Received*	Inventory Sold**	Ending Inventory	Inventory Turnover**
2010	$2,271,645	$1,174,922	$376,838	$3,069,729	0.13
2011	3,069,729	1,097,219	639,562	3,527,386	0.14
2012	3,527,386	1,958,492	973,015	4,512,863	0.21
2013	4,512,863	2,937,413	1,589,638	5,860,638	0.28
2014	5,860,638	4,027,382	1,097,743	8,790,277	0.14
2015	8,790,277	1,714,999	860,642	9,644,634	0.08
2016	9,644,634	1,241,858	1,515,829	9,370,663	0.15
2017	9,370,663	659,841	2,541,993	7,488,511	0.30
2018	7,488,511	1,127,374	1,952,572	6,663,313	0.27
2019	6,663,313	620,734	1,891,002	5,393,045	0.31
Total		**$16,560,234**	**$13,438,834**		**0.20**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

* Inventory includes Bordeaux wines that were purchased as both Futures and non-Futures. Payments for purchases of Futures occurs approximately two years prior to when the wine is received into inventory. As a result, inventory received each fiscal year will not agree with the landed cost of Bordeaux purchases in earlier table.

** Inventory sold includes inventory adjustments for breakage, theft, donations and product sampling; inventory turnover excludes these adjustments.

We noted that during planning for the 2015 and 2017 En Primeur campaigns, the Merchandising Division provided the former CEO with documentation that highlighted poor sales performance, including that there were a significant number of Futures products with no sales or minimal sales since they were received into inventory. During the meeting with the CEO to discuss the upcoming 2017 En Primeur campaign, the Merchandising Division provided a presentation and:

- Cautioned against purchasing Bordeaux white wine as NLC still had 935 units in inventory that were over 10 years old which may have to be written off.
- Recommended continuation of a Futures program offering fewer SKUs and less inventory.
- Recommended limiting acquisition of Futures to the amounts pre-sold or transferring Futures procurement to Merchandising in order to take advantage of their research and sales experience and ensure more appropriate purchasing levels.

A Merchandising official stated that a response to the recommendations in the presentation was not received. We also noted that, despite these repeated concerns being expressed by Merchandising and other NLC executive members and knowledge of excess inventory levels, the CEO directed the purchase of approximately $700,000 in Futures during the 2017 En Primeur campaign, with pre-sales of only $127,000 or 18 per cent. The Chair of the Board was alerted to these purchases and a meeting was arranged with the former CEO and other executives within NLC. As a result, in the Fall of 2017, NLC cancelled approximately $250,000, or 36 per cent, of the $700,000 orders that had been placed with negociants during the campaign. Even at the reduced purchase level of approximately $450,000, only $127,000, or 28 per cent, was pre-sold.

Inventory Reduction Measures

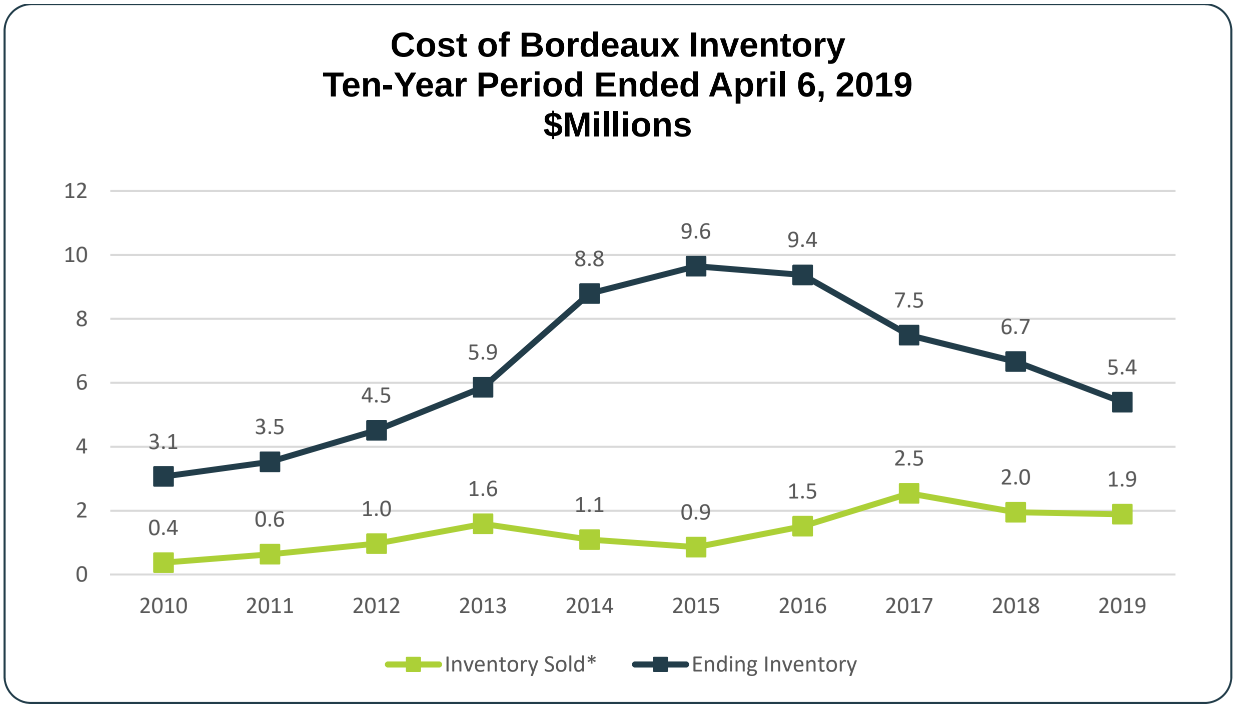
In 2012, NLC formed an executive committee to discuss ways to reduce inventory levels. This concern was heightened as inventory levels were going to significantly increase in fiscal years 2013 to 2015 following the purchase of almost $8 million in Bordeaux Futures during the three En Primeur campaigns in fiscal years 2011 to 2013.

According to an NLC official, the committee met six times up to November 2013; however, no minutes of these meetings were kept. In February 2016, the committee began to meet again following a request from Government that NLC find savings in its budget. NLC proposed to address this request instead by increasing its dividend payment to Government. To enable this, NLC identified a significant volume of excess or slow-moving inventory that should be eliminated, including the Bordeaux inventory that had more than doubled to over $9.6 million during the three-year period ended April 2015.

The committee met seven times up to June 2017 when the meetings stopped. Again, no minutes were kept. However, based on discussion with an NLC official and review of an agenda for the first meeting in February 2016, we found that the committee discussed ways to reduce the Bordeaux inventory, such as selling the excess inventory to:

- Customers via discount sales or permanent retail price reductions.
- Suppliers from which they were purchased.
- Other provincial liquor authorities.
- Liquor outlets in the United States.
- International customers.

The Bordeaux inventory was reduced by approximately 44 per cent to $5.4 million by April 2019.



Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

* Includes inventory adjustments for breakage, theft, donations and product sampling.

Note: The $2.5 million inventory sold in fiscal 2017 included a single sales transaction of $1.2 million to an out-of-province customer.

Our audit identified that the level of inventory was reduced as the result of permanently reducing or overriding the retail price for certain Bordeaux products, conducting four separate Bordeaux wine sales for periods of time where retail prices were significantly discounted, completing a number of significant sales to other provincial liquor authorities at discounted prices and completing a number of significant sales to customers in other parts of Canada. Suppliers did not agree to purchase back any of the wines from the NLC.

Specialty Wine Sales - Merrymeeting Road

Source: Office of the Auditor General

The $5.4 million of Bordeaux inventory remaining as of April 2019 included an estimated 42,000 bottles of more than 1,200 different SKUs with an average cost of $128 per bottle. Approximately $2.1 million of the $5.4 million, or 39 per cent, related to approximately 2,300 bottles of more than 75 different SKUs where the cost per bottle ranged from $511 to over $3,400. Most of this inventory was four years old or more. As of April 2019, of the $5.4 million remaining inventory, NLC recorded a provision for the write-down of Bordeaux inventory in the amount of $1.3 million, representing an estimate of overvalued and/or unsellable product.

Poor Financial Performance of Bordeaux Wines

Since commencement of the Bordeaux Futures program to the year ended April 6, 2019, NLC has estimated an overall net profit on Bordeaux wines of $1.4 million. However, to fully evaluate the performance of the Futures program, it is important to consider opportunity costs, which are generally defined as the price of foregoing other uses of money that is tied up in excess inventory. For example, the available cash used to acquire the excess Bordeaux wine inventory could have earned interest or the cash could have been returned as dividends to Government for investment.

As a result of NLC's continued purchasing of Futures in quantities that far exceeded customer demand, inventory levels reached a high of almost $10 million in 2015. NLC has estimated the opportunity cost, associated with cash tied up in both excess inventory and prepayments to negociants for Futures two years in advance of receipt of these wines, to be $3.6 million. Thus, overall, the net cost of these Bordeaux wines to date is estimated at $2.2 million ($1.4 million net profit less opportunity costs of $3.6 million).

Acquisition of Bordeaux Futures was discontinued in fiscal 2018. The final financial results for the Bordeaux program will not be known until the remaining inventory is sold or written off.

Financial Performance of Bordeaux Wines
Thirteen-Year Period Ended April 6, 2019
$Thousands

Fiscal Year	Gross Margin (A)	Other Costs (B)	Net Profit before Opportunity Costs (C) = (A) – (B)	Opportunity Costs (D)	Net Profit (Cost) after Opportunity Costs (C) – (D)
2007	$ 59	$ 3	$ 56	$ 56	$ -
2008	165	7	158	111	47
2009	423	49	374	135	239
2010	315	140	175	188	(13)
2011	287	259	28	258	(230)
2012	328	232	96	380	(284)
2013	510	310	200	403	(203)
2014	575	504	71	415	(344)
2015	467	648	(181)	420	(601)
2016	550	328	222	408	(186)
2017	724	200	524	336	188
2018	532	858	(326)	288	(614)
2019	187	147	40	220	(180)
Total	**$ 5,122**	**$ 3,685**	**$ 1,437**	**$ 3,618**	**$ (2,181)**
Gross Margin %	**29%**				

Source: Newfoundland and Labrador Liquor Corporation estimates (unaudited)
(A) Sales less cost of goods sold
(B) Includes carrying and other costs except travel. The cumulative total for Other Costs includes a provision of a $1.3 million write-down for over-valued and/or unsellable product.
(D) Assumes 3.8 per cent cost of capital

Conflict of Interest in Acquisition of Specialty Wines

A conflict of interest relationship existed with respect to certain NLC acquisitions of specialty wines involving the former CEO and a close family member and:

- The CEO did not take appropriate action to address this known conflict of interest risk.
- The CEO participated in decisions to purchase specialty wines which benefited the close family member at the expense of NLC and which influenced the performance of the CEO's duties as a public office holder. As a result, the CEO breached NLC's Code of Conduct and may have breached his fiduciary duty to NLC.

NLC misrepresented information in its response to the Office of the Citizens' Representative related to an investigation in 2016-17 of conflict of interest allegations involving the former CEO and this close family member.

This close family member was the largest known single agent representing negociants from whom NLC purchased Bordeaux wines. Overall, $4.6 million, or 29 per cent, of the $15.6 million Bordeaux wine purchased from 2010 to 2019, was purchased from negociants who were represented by this close family member. Further, from 2010 to 2019, NLC purchased other specialty wines totaling $10.2 million, of which at least $1.9 million, or 19 per cent, were purchased from suppliers represented by the close family member.

The Liquor Corporation Act and the Province's Conflict of Interest Act do not adequately address conflicts of interest with respect to familial relationships, including the relationship between the former CEO and the close family member. In response to the 2017 report of the Citizens' Representative, in lieu of amending the Liquor Corporation Act to address this issue, Government committed to complete a Government-wide review to address conflicts of interest within the broader public service, including Crown entities. This review and draft legislative amendments are still being completed.

In 2010, the then CEO notified NLC's Board of Directors that a close adult family member, hereafter referred to in this section as the Non-Arm's Length Agent (NALA), was a sales agent for wines in Newfoundland and Labrador conducting business with NLC. The CEO's stated position at that time, and until his departure from NLC in early 2018, was that such agents deal directly with NLC's Merchandising Division and that as CEO, he is not involved with, nor does he interfere with, day-to-day decision making of the Merchandising Division. The Board accepted this position as, in essence, it should have effectively removed the CEO from any perceived or real conflict of interest matters in relation to the NALA.

Allegations of conflict of interest in relation to the former CEO and the NALA were the subject of a report issued by the Office of the Citizens' Representative (Citizens' Representative) in April 2017 and is referred to throughout this section of our report. The Citizens' Representative concluded, among other things, that they could make no findings as to whether the CEO, directly or indirectly, made decisions which benefited the NALA at the expense of other wine agents, as that type of inquiry would engage an audit function beyond the mandate or capacity of that office.

We completed additional audit procedures on acquisitions of specialty wines in view of the conflict of interest allegations and in view of the observations outlined in earlier sections of our report, namely:

- Procurement planning and acquisition decisions regarding type and quantity of Futures, as well as supplier selection, rested solely with the former CEO, was not transparent, and did not follow the standard planning and acquisition process for other product lines of NLC.

- Continued poor sales performance of Bordeaux wines did not support an ongoing business case for the Futures program at inventory levels being procured. Yet NLC continued to purchase Futures in quantities that far exceeded the level of customer demand, resulting in a buildup of inventory and continued financial cost for the program.

These audit procedures included email analysis on select accounts to assess whether we could identify any records between the former CEO and local agents regarding the acquisition of specialty wines. Results of these procedures identified concerns regarding various interactions and possible nepotism[1] involving the former CEO and the NALA. Further, we identified that NLC misrepresented information provided to the Citizens' Representative in its response to the conflict of interest allegations.

[1] Favoritism based on kinship – Merriam Webster Dictionary

NLC Response to Conflict of Interest Allegations

The investigation of the Citizens' Representative considered conflict of interest allegations - specifically that the former CEO of NLC was purchasing most of the Bordeaux wine for the Futures program from companies represented by the NALA at the expense of other wine agents. The concept of a local agent and how they interacted with NLC was a key principle in NLC's response to the conflict of interest allegations.

NLC policy encourages suppliers to obtain local representation (local agent) residing in the Province. Officials stated that suppliers pay commissions to local agents who work with NLC's:

- Merchandising Division - to assist with listing, de-listing and promotional activity decisions to maximize sales and profit.
- Supply Division - to assist with logistics and ordering issues to ensure adequate inventory levels and to maximize inventory turnover.
- Store Operations - to assist with store promotions, displays and regional sales opportunities.
- Marketing Division - to maximize the reach and scope of marketing campaigns.

To help sell the products on behalf of the supplier, locals agents, in turn, pay fees to NLC to participate in NLC promotional opportunities for the products they represent.

However, no local agents were recorded in NLC's system for Bordeaux Futures as the former CEO indicated he dealt directly with negociants. Information received from two liquor authorities in other provinces who offer a Futures program to their customers indicated that their equivalent to NLC's Merchandising Division also deals directly with negociants and no local agents are involved.

In defense of the conflict of interest allegations, NLC responded, in part, with the following information:

- The CEO's only involvement in wine purchasing is through the Futures Market and the CEO deals directly with negociants for purchasing. Local agents are not involved in NLC's purchases from the Futures Market.
- Local agents do not play any role in NLC's purchases from a particular negociant in the Futures Market.
- Local agents deal directly with NLC's Merchandising Division in relation to purchasing decisions and the CEO is not involved with, nor does the CEO interfere with, the day-to-day decision making of the Merchandising Division.
- NLC has procedures and policies in place to ensure fair treatment for all agents. Local agents deal with NLC primarily by submitting new listing applications (ie. category review process) or promoting the products they represent and these interactions are governed by published formal policies.

- The CEO does not exert any influence over NLC's dealing with local agents.
- NLC has no privity of contract with wine agents and has no knowledge of details of any contractual relationship between wine suppliers and agents.

In its response to the Citizens' Representative, NLC also stated that it was confident that any audit would reveal that the CEO has not engaged in any decisions, directly or indirectly, which benefited the NALA at the expense of others.

Our audit found that NLC misrepresented information provided to the Citizens' Representative in its response to the conflict of interest allegations. We also confirmed that the former CEO did make decisions that conferred a benefit upon the NALA and were not in the best interests of NLC.

In particular, with respect to the Futures program:

- There was three-way communication through emails among the CEO, the NALA and negociants relating to various product offers for Futures. Thus, contrary to NLC's position, the CEO had knowledge that certain Bordeaux negociants were represented by the NALA without the NALA being officially recorded in NLC's system as the local agent of record. This also contradicted NLC's position that the NALA, as a local agent, dealt directly with the Merchandising Division.

- Many of these three-way emails were offers for Futures originating from the negociant to the NALA. The NALA then forwarded them directly to the CEO, for what appeared to be for the purposes of influencing the purchasing decisions of Futures by the CEO (e.g. "you have to buy some of these", "good prices", "I scored this wine pretty high", etc). In a number of instances, we were able to confirm that the CEO purchased these specific products after receiving this communication from the NALA. This further contradicted NLC's position that the CEO dealt directly with the negociants and local agents were not involved in the Futures Market and did not play any role in NLC's purchases from a particular negociant.

- Acknowledgement orders and invoices from negociants, used by NLC to process payment for Futures and maintained in NLC's accounting records, identified the NALA, as well as other agents representing negociants, directly on these documents. This again weakens NLC's position that for Futures, it had no knowledge of details of any contractual relationship between wine suppliers and agents and local agents were not involved in NLC's purchases from the Futures Market.

- In response to our audit confirmation request to negociants regarding a number of select NLC purchases of Futures, one negociant represented by the NALA confirmed that the NALA received fees on these purchases. Other negociants confirmed that other local agents in Newfoundland and Labrador who represented them received in the range of a one to 3.4 per cent commission which was included in NLC's purchase price for these transactions. Also, in an email thread among a negociant, the NALA and the CEO regarding offers for Futures during the En Primeur campaign, the negociant confirmed that "… with primeur, we will give you [the NALA] two per cent on all." These examples provided additional evidence that local agents were involved in the Futures Market and also confirmed the existence of a benefit being received by local agents who represent negociants in the Futures Market.

Overall, $4.6 million, or 29 per cent, of the $15.6 million Bordeaux wine purchased from 2010-2019, was purchased from four negociants who were represented by the NALA. Of the $4.6 million of Bordeaux wine purchased from these negociants, $3.7 million, or 80 per cent, was Futures and $0.9 million, or 20 per cent, was non-Futures. For each of the years 2015-2018, Bordeaux wine purchased from these four negociants ranged from 53 per cent to 61 per cent of total Bordeaux wines purchased.

Landed Cost of Bordeaux Wine Purchases
Fiscal Years 2010 to 2019

Fiscal Year	Landed Cost	Negociants Represented by NALA			
		Futures	Non-Futures	Total	Total as % of Landed Cost
2010	$ 1,986,083	$ 169,619	$ 51,514	$ 221,133	11.1%
2011	3,248,113	393,465	546	394,011	12.1%
2012	4,021,720	964,676	173,666	1,138,342	28.3%
2013	1,818,714	531,772	29,664	561,436	30.9%
2014	1,101,105	291,492	93,649	385,141	35.0%
2015	855,627	295,305	183,493	478,798	56.0%
2016	1,288,420	460,867	223,356	684,223	53.1%
2017	740,735	294,118	106,344	400,462	54.1%
2018	522,574	262,537	56,676	319,213	61.1%
2019	17,326	-	-	-	-
Total	**$ 15,600,417**	**$ 3,663,851**	**$ 918,908**	**$ 4,582,759**	**29.4%**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

The NALA was also the largest known single agent representing negociants from whom NLC purchased Bordeaux wines.

Landed Cost of Bordeaux Wine Purchases Fiscal Years 2010 to 2019 Summary of Negociant and Associated Agent			
Negociant	**Associated Agent**	**Bordeaux Total**	**%**
Negociants #1-4	Agent A - NALA	$ 4,582,759	29.4%
Negociants #5-6	Agent B	1,382,934	8.9%
Negociants #7-8	Agent C	867,833	5.6%
Negociant #9	Agent D	801,218	5.1%
Negociant #10	Agent E	309,164	2.0%
Negociant #11	No Known Agent	4,403,673	28.2%
Negociant #12	No Known Agent	1,961,555	12.6%
Negociant #13	No Known Agent	1,087,326	7.0%
Negociants #14-18	No Known Agent	183,407	1.2%
Remaining Negociants #19-22	Agents F, G, H	20,548	-
Total		**$ 15,600,417**	**100%**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation and audit procedures performed.

The NALA also represented suppliers of specialty wines other than Bordeaux. During the 10-year period 2010 to 2019, NLC purchased other specialty wines totaling $10.2 million, of which at least $1.9 million, or 19 per cent, were purchased from suppliers represented by the NALA.

With respect to specialty wines, other than Futures:

- There were numerous examples of three-way communication through emails among the former CEO, the NALA and various negociants or suppliers regarding these various specialty wine offerings. These communications contradict NLC's position to the Citizens' Representative, as well as the former CEO's position to NLC's Board of Directors, that for all products other than Futures, agents deal directly with NLC's Merchandising Division and the CEO is not involved.

- Further, NLC officials advised that, in addition to Futures, the CEO often directed the purchase of other specialty wines. While this direction was generally not documented, NLC was able to provide some documentation and we confirmed numerous such examples. In most of these examples, the NALA was the local agent.

  Again, this contradicts NLC's position to the Citizens' Representative, as well as the CEO's position to NLC's Board, that the CEO's only involvement in wine purchasing is in Futures and for all other wines, agents deal directly with NLC's

Merchandising Division, acquisitions follow published formal policies, and the CEO is not involved with, nor does the CEO interfere with, the day-to-day decision making of that Division. Such examples of the CEO directing purchases of other specialty wines and thus, conferring a financial benefit upon the NALA in the form of commission, included the following which involved three different suppliers:

- In July 2017, the CEO directed NLC officials to complete a rush order from a supplier for 96 bottles of specialty wine at a cost of $23,098. The supplier confirmed that the NALA was paid commission on this order of 1,372 Euros (8.8 per cent), equivalent to $2,037. Further, the NALA was included in an email exchange between the supplier and the CEO regarding this offer and was listed on the supplier invoice. These wines carry a retail price of $539 per bottle and to date, only four have been sold, bringing into question the reason and necessity of a rush order. NLC officials could not provide a definitive explanation for this rush order but observed that this timeframe coincided with the annual summer closure of the related vineyard. The former CEO indicated that he had "lined up" two customers to buy these products but that these customers did not ultimately buy these products due to the proposed retail price. We were unable to confirm a potential sale for these products.

  The four bottles that were sold were requested by the NALA on December 29, 2017 for sampling purposes and under NLC's sampling policy, they could be purchased at the landed cost of $261 each, not the retail price of $539. These four bottles were then picked up by the former CEO before they were entered into NLC's inventory with a commitment to pay later. Payment was not received until 15 months later on March 26, 2019, when the outstanding balance was identified by NLC officials. The actual price paid was $211 per bottle, which was $50 below landed cost. This pricing was generated at the point of sale whereby a set discount is applied to remove a standard gross margin amount in order to approximate the landed cost. However, the gross margin of this product, given its high price, was less than the standard and resulted in the system applying a larger discount than warranted and so the full landed cost was not recouped.

- In March 2015, a negociant made an offer of non-Futures specialty wine to the CEO at 215 Euros and the CEO agreed to purchase 36 bottles. The negociant later requested to increase the price in order to provide a 10 Euro per bottle commission (4.4 per cent) to the NALA. The CEO agreed and stated, "We'll make sure he helps us sell the product". NLC purchased these 36 bottles in April 2015 at a total cost of $11,677, which was $519 ($14.42 per bottle) higher than the price directly offered by the negociant originally. This wine was not sold until 2018, mostly to another provincial liquor authority as part of NLC's inventory reduction measures.

- In January 2014, a negociant emailed the NALA with an offer of a specialty wine at 12 Euros per bottle (750 ml), or 6 Euros per half bottle (375 ml). The NALA instructed the negociant to add a 10 per cent commission to the price and make the offer directly to the CEO of NLC with “no need to mention me in the offer”. The NALA indicated they had spoken with the CEO and asked him to buy this product and indicated the CEO would probably buy 10 to 15 cases right away.

  The final offer by the negociant to the CEO was 13.4 Euros and 6.7 Euros for a half bottle, which was higher than the price directly offered by the negociant originally as it then included the 10 per cent commission to the NALA as instructed. NLC purchased 96 half and 18 full bottles (representing 11 cases) in March 2014 at a total cost of $1,311.

  The NALA emailed the CEO on another matter but which also included the above email exchange between the negociant and the NALA regarding this offer and subsequent purchase. Further, in responding to the negociant’s offer, the CEO indicated that “with the NALA’s support” he could confirm NLC’s agreement to purchase this wine.

We also noted various other types of direct communication between the former CEO and the NALA that are indications that the CEO’s judgements and actions may have been influenced, inadvertently or otherwise, as a result of this relationship. For example:

- The former CEO forwarded an email to the NALA that had been received into NLC’s general information email account which is accessed by key individuals within NLC, including the CEO and staff in the Merchandising Division. This email was from a wine agent in Bordeaux who was expressing interest in introducing their products to the Newfoundland and Labrador market and inquiring into the process to do so. As was standard protocol, Merchandising officials responded to this individual and upon further inquiry, provided this individual with a full listing of local agents. The former CEO, however, forwarded this email directly to the NALA with the NALA replying “Are you going to write him back?”

- In an email exchange between the former CEO and the NALA involving a particular product, the NALA asked, “You know I sell it right?” to which the CEO responded, “I do. That’s why I ordered it”.

- The NALA was copied on an email from the former CEO to a supplier represented by the NALA seeking an allocation of a specialty wine and further indicating that, “I understand that we passed on an offer last year, but frankly that happened without my knowledge and won’t happen again” and “if they had any other specialties we would have interest in small quantities”.

- A Merchandising official sent an email to the former CEO seeking the CEO's preference for a date to hold NLC's En Primeur showcase in St. John's. This was a tasting event that gave customers an opportunity to taste a barrel sample from a specific vintage sent over by negociants before purchasing Bordeaux Futures. The CEO forwarded this email to the NALA seeking their input.

Conflict of Interest Legislation and Related Policies

As part of its review of the conflict of interest allegations involving the former CEO, the Citizens' Representative reviewed relevant conflict of interest provisions of the Liquor Corporation Act and the Province's Conflict of Interest Act.

1. Liquor Corporation Act

Section 11(1) of the Liquor Corporation Act states:

> 11 (1) A member of the board or an officer of the corporation shall not, directly or indirectly… have an interest in or receive a benefit, directly or indirectly, from (a) the manufacture, sale or distribution of, or other dealing in, alcoholic liquor…

The Citizens' Representative concluded that as the former CEO did not receive a direct or indirect benefit from the contractual arrangement between NLC and the NALA, the CEO was compliant with the legislation.

2. Provincial Conflict of Interest Act

The Province's Conflict of Interest Act regulates the standard of conduct for non-elected public office holders. Sections 3 and 9 state:

> 3 A public office holder shall not make or participate in making a decision in his or her capacity as a public office holder where the public office holder knows or ought reasonably to know that in the making of the decision there is the opportunity to benefit himself or herself or a member of his or her family improperly, directly or indirectly.
>
> 9 A public office holder shall not engage in an activity,
> (a) that interferes with or adversely influences the performance of his or her duties or is likely to do so;
> (b) that places him or her in a position of conflict of interest, or is likely to do so; and
> (c) in which he or she may acquire an advantage derived from employment as a public office holder.

Section 2(d) of the Conflict of Interest Act defines “family” as follows:

2(d) “family” means a person who is

i. a public office holders spouse or cohabiting partner,
ii. a minor child of the public office holder, or a minor who is dependent primarily on the public office holder …
iii. a relative of the public office holder or the public office holders spouse or cohabiting partner who lives as part of the public office holders household and is primarily dependent on the public office holder or the public office holders spouse or cohabiting partner for financial support.

The Citizens’ Representative outlined that the definition of family, when dealing with children, is confined to a minor child or a minor who is primarily dependent upon the public office holder. As a result of this restricted definition, the Citizens’ Representative concluded that the CEO was compliant with the Conflict of Interest Act as the NALA was an adult child of the CEO.

We note that the Liquor Corporation Act and the Province’s Conflict of Interest Act do not adequately address conflicts of interest with respect to familial relationships, including the relationship between the former CEO and the close family member. While the former CEO may not have technically breached provincial conflict of interest legislation due to the restricted definition of “family member”, based on our audit findings, we conclude that a conflict of interest relationship existed with respect to certain NLC acquisitions of specialty wines involving the former CEO and a close family member and:

- the CEO did not take appropriate action to address this known conflict of interest risk; and
- the CEO participated in decisions to purchase specialty wines which benefited the close family member at the expense of NLC and which influenced the performance of his duties as a public office holder.

The Citizens’ Representative recommended that the Board of Directors of NLC establish an anti-nepotism policy tailored for employees and contractors who are in familial relationships with board members or persons in positions of authority within NLC. NLC accepted that recommendation and in 2019, the Code of Conduct was amended to specifically address nepotism and to include, in its conflict of interest section, the relationship represented by the NALA.

The Citizens’ Representative further recommended that the Department of Finance, to whom the NLC reports, review the conflict of interest provisions of the Liquor Corporation Act to ensure that apparent conflicts of interest between familial members are adequately addressed in that legislation. The Department of Finance responded that it concurred with the importance of addressing conflicts of interest, and apparent conflicts of interest, within the public service and Crown entities. However, in order to adequately address this issue, Government indicated it would be taking a broader approach. As such, the Department of Finance did not plan to bring forward amendments to the Liquor Corporation Act to address apparent conflicts of interest between familial members at that time and would await the outcomes of a broader Government-wide review. This review and draft legislative amendments are still being completed.

3. Federal Conflict of Interest Legislation

We noted that various guidance is available to Government in any consideration of legislative changes to improve the accountability and transparency of Crown Corporations, including the NLC, with respect to conflict of interest and the definition of “family”. A good example of such guidance is the federal Conflict of Interest Act, which expands upon the definition of “family members” by including a definition of “relatives” in section 2(3) as follows:

> 2(3) Persons who are related to a public office holder by birth, marriage, common-law partnership, adoption or affinity are the public office holder’s relatives for the purposes of this Act unless the [Conflict of Interest and Ethics Commissioner] determines, either generally or in relation to a particular public office holder, that it is not necessary for the purposes of this Act that a person or a class of persons be considered a relative of a public office holder.

This Act defines a “conflict of interest” in Section 4 to include relatives or friends. This section reads as follows:

> 4 For the purposes of this Act, a public office holder is in a conflict of interest when he or she exercises an official power, duty or function that provides an opportunity to further his or her private interests or those of his or her relatives or friends or to improperly further another person’s private interests.

This Act also specifically addresses the concepts of “preferential treatment” in Section 7, “insider information” in Section 8, and “influence” in Section 9. These sections read as follows:

> 7 No public office holder shall, in the exercise of an official power, duty or function, give preferential treatment to any person or organization based on the identity of the person or organization that represents the first-mentioned person or organization.

> 8 No public office holder shall use information that is obtained in his or her position as a public office holder and that is not available to the public to further or seek to further the public office holder’s private interests or those of the public office holder’s relatives or friends or to improperly further or to seek to improperly further another person’s private interests.

> 9 No public office holder shall use his or her position as a public office holder to seek to influence a decision of another person so as to further the public office holder's private interests or those of the public office holder's relatives or friends or to improperly further another person's private interests.

By including the definition of "relatives" in the Act and providing the Office of the Conflict of Interest and Ethics Commissioner with a statutory discretion to determine when an individual should be considered a relative for the purposes of the Act, greater accountability and transparency is achieved.

A good example of the Act in operation is the "Leblanc Report"[2] issued by the Office of the Conflict of Interest and Ethics Commissioner. In this report, the Commissioner determined that Cabinet Minister Dominic Leblanc contravened subsection 6(1) of the Act by making a decision that placed him in a conflict of interest in relation to the decision to award a license to a company which would be employing a relative of the Minister as the general manager. The Commissioner provided the following useful guidance on page 12 of his report:

> Public office holders are not expected to have knowledge of the private affairs of each of their birth relatives, much less of relatives by affinity. However, when they are aware of an opportunity to further the private interests of a relative through the exercise of an official power, duty or function, they must be vigilant in taking appropriate action to avoid a conflict of interest.

4. NLC Code of Conduct Policy

NLC's internal Code of Conduct policy that existed from 2011 through to early 2019 contained provisions relating to conflict of interest. As noted earlier in our report, in 2019, NLC further strengthened its Code of Conduct to specifically include a provision in its conflict of interest section to address the relationship represented by the NALA and the concept of nepotism.

Extracts from NLC's Code of Conduct in existence in 2011, and continued in the revised 2014 Code, outlined that "A conflict of interest may arise when employment at the NLC is used – or is perceived to be used – for personal, commercial or financial gain or to unfairly advantage family, friends, colleagues or anyone else, whether directly or indirectly." It also included:

- "To help recognize a potential conflict of interest, an employee should consider the following questions: …. Will my actions unfairly advantage a relative or a friend more than any other individual in the same circumstance?.....Am I compromising what is in the best interests of the NLC?"

[2] Leblanc Report, September 2018 – Office of the Conflict of Interest and Ethics Commissioner

- "The following circumstances may represent a conflict of interest…..Transacting business on behalf of the NLC with a near family member…or close personal friend; making confidential NLC information available to your spouse, near family member, or close personal friend for your personal benefit or theirs."

Based on our audit findings regarding NLC dealings between the former CEO and the NALA, the conduct of the former CEO was a violation of NLC's Code of Conduct.

5. Fiduciary Duty

It is settled law that the fiduciary duty owed by directors and officers of a corporation imposes strict obligations. There are common threads running through the concept of fiduciary duties that arise from the relationships marked by discretionary power and trust, such as that of an officer or director, which include loyalty and the avoidance of a conflict of duty and interest.

The duties imposed on directors and officers requires them to respect the trust and confidence that has been placed in them to manage the assets of the corporation in pursuit of the corporation's objectives, which in the present case includes the generation of revenue to benefit the province. Directors and officers must also serve the corporation selflessly, honestly, and loyally and must maintain the confidentiality of information they acquire by virtue of their position.

Based on our audit findings regarding NLC dealings between the former CEO and the NALA, the CEO may have breached his fiduciary duty to NLC as, among other matters, the CEO did not take appropriate action to avoid this known conflict of interest risk, conferred a financial benefit upon an adult family member to the detriment of NLC, and allowed the relationship to influence the CEO's performance of duties as a public office holder.

Specialty Wine Sales

Unlike other NLC products, there was no prescribed guidance for pricing Bordeaux Futures wines. Rather, the former CEO generally established the prices with reference to certain other relevant information. Without such prescribed guidance and pricing documentation, the pricing of these wines was not transparent.

NLC contravened federal and provincial legislation by knowingly selling and shipping, or arranging the shipping of, specialty wines directly to end customers in other provinces without going through the respective liquor authorities of those provinces (i.e. illegal exportation of alcohol). Further:

- The particular NLC branch manager who facilitated these out-of-province sales had been tasked with reducing the excess level of specialty wine inventory.
- Price overrides and discounts were applied to most of these wines in the effort to reduce this specialty wine inventory. This particular branch manager could, with approval, provide price overrides at the point of sale for the sole purpose of reducing this inventory. In March 2018, an internal audit of price overrides was completed for the period March 2009 to February 2018 which identified total price overrides of an estimated $448,000. The review found that the required approvals of these price overrides were requested, on average, 13 days after the sales transaction.
- In order to facilitate these out-of-province sales, the branch manager also contravened NLC policies, such as accepting email money transfers into their personal account before they in turn made payment to NLC accounts and obtaining credit card information over the phone, by email or other means.

Pricing of Bordeaux Wines

NLC applies a fixed mark-up and a variable mark-up percentage on the landed cost of unit products in accordance with its wine pricing policy as outlined in Appendix I. For NLC's wine category, this generally results in a gross margin of between 55 and 60 per cent. The pricing policy allows price reductions to clear discontinued, time sensitive or over-stocked product. The pricing policy is approved by the Chief Financial Officer (CFO) and CEO. NLC's Finance Division, applying this policy, sets retail prices.

Our audit of the pricing of Bordeaux Futures indicated that unlike other wine products, there was no prescribed guidance for pricing Bordeaux Futures wines. Rather, the former CEO generally established the prices with reference to certain other relevant information as described in the section below. Information received from two liquor authorities in other provinces offering a Futures program indicated that the division equivalent to NLC's Merchandising Division establishes the prices of all wines and some flexibility in pricing is applied to the Bordeaux wines on a case-by-case basis.

Without documentation and prescribed guidance on pricing Bordeaux Futures wines, as is the case for other wine products, the pricing of these wines was not transparent.

1. Bordeaux Futures Pre-Sale Pricing

We found that the prices offered through NLC's website during the annual pre-sale periods were set by the CEO based on a review of product information documented in an excel spreadsheet prepared by the Merchandising Division. Information included details such as product SKU and description, retail prices calculated by NLC's Finance Division in accordance with NLC pricing policy, Liquor Control Board of Ontario (LCBO) pricing where available, and wine scores and tasting notes. Following a review of the information, the CEO established the price for each SKU on the spreadsheet, which was then returned to Merchandising to update the Bordeaux Futures portal in NLC's website.

The established prices for fiscal years 2010 to 2018 were, on average, 24 per cent lower than those calculated by NLC's Finance Division using NLC's retail pricing policy.

Average Retail Price Reductions for Futures Offered During Pre-Sale Periods Fiscal Years 2010 to 2018

Fiscal Year	Vintage Year	Number of SKUs	Average Reduction	Number of SKUs not Reduced
2010	2008	195	17%	59
2011	2009	223	22%	-
2012	2010	303	18%	8
2013	2011	194	21%	-
2014	2012	168	24%	2
2015	2013	183	25%	-
2016	2014	303	32%	-
2017	2015	180	30%	-
2018	2016	125	28%	1
Total		**1,874**	**24%**	**70**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

We reviewed supporting documentation and held discussions with NLC officials and found:

- Retail price reductions for SKUs inconsistently ranged from 1 per cent to 55 per cent, without any supporting explanation. A Merchandising official stated this may have been the result of various factors such as the amount of product ordered, product shelf life or comparative LCBO pricing.

- The average price reductions increased from 18 per cent up to 32 per cent during the period 2012 to 2016 without documentation being available to support the rationale for these price adjustments.
- In most of the 70 cases where there was no retail price reduction, we found that the retail price agreed with NLC's pricing policy. However, there were some cases where the retail price was adjusted upward without supporting explanation.

2. Bordeaux Futures Pricing for the General Public

Approximately two years following the end of an En Primeur campaign, Futures purchased during the campaign are received into inventory. Futures products sold during the pre-sale period are reserved for those customers and the remaining Futures inventory is priced and released for sale to the general public. As noted previously in this report, in most years, approximately 75 per cent or more of the Futures purchased by NLC were released for sale to the general public.

NLC officials advised that the retail prices of Futures for the general public were also set by the CEO. This followed the CEO's review of the pricing provided by NLC's Finance Division, which is calculated in accordance with NLC retail pricing policy, as well as other information such as the pricing of products in other markets and NLC inventory levels.

For fiscal years 2012 to 2019, general public retail prices were often not compliant with NLC's pricing policy.

Compliance to Pricing Policy - Futures Released to General Public
Fiscal Years 2012 to 2019

Fiscal Year	Vintage Year	# of SKUs	Compliant		Not Compliant			
			# of SKUs	%	Price lower than policy	%	Price higher than policy	%
2012	2008	195	131	67%	38	20%	26	13%
2013	2009	224	162	73%	61	27%	1	-
2014	2010	303	123	41%	153	50%	27	9%
2015	2011	194	-	-	192	99%	2	1%
2016	2012	168	168	100%	-	-	-	-
2017	2013	157	32	20%	125	80%	-	-
2018	2014	303	-	-	303	100%	-	-
2019	2015	180	-	-	180	100%	-	-
Total		**1,724**	**616**	**36%**	**1,052**	**61%**	**56**	**3%**

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

We reviewed supporting documentation and held discussions with NLC officials. We found:

- Retail prices for the general public in 2019 for the 2015 vintage (180 SKUs) were established at 30 per cent less than the prices calculated in accordance with pricing policy, which made the prices comparable to those offered during the 2017 pre-sale period. An NLC official stated that its current executive made this decision in an effort to reduce the Bordeaux inventory level.

- For all prior years, retail pricing for the general public was determined by the former CEO. For the fiscal years 2012 to 2018, we were unable to determine the rationale for the prices of 872 SKUs (1,052 less 180 in 2019) set below NLC's pricing policy and the 56 prices set above. When prices were set below the pricing policy calculation, the average annual reduction ranged from 3 per cent to 17 per cent. A Merchandising official stated this may have been the result of various factors such as the amount of product ordered, product shelf life or comparative LCBO pricing.

3. Price Overrides

Once the retail pricing for products is established, policy requires any pricing changes to be approved by the Director of Merchandising, CFO and CEO except for price overrides at corporate stores for purposes of correcting sales system scanning errors. Any other unauthorized price reductions at the point of sale is considered internal fraud.

We were advised, however, that for the purposes of reducing the high level of inventory of Bordeaux wines, an exception to NLC's policy for price overrides at the point of sale was made. We were further advised that this price override provision was only provided to a particular NLC branch manager specifically tasked with reducing the Bordeaux inventory. In this case, any price override could be approved by either the Director of Merchandising or the CEO, with no approval of the CFO being necessary.

In March 2018, NLC's Enterprise Risk Management Division carried out an internal audit of price overrides in this branch. It showed that the prices of approximately 7,900 bottles of specialty wine were reduced by the branch manager at the point of sale from March 2009 to February 2018. The discounts granted in these instances totaled just over $448,000. The internal audit noted that the required approvals were requested after the sales transaction had been concluded and on average, 13 days after the fact.

Inter-Provincial Sales

The inter-provincial trade of alcohol within Canada is governed strictly by federal and provincial legislation. This includes the establishment by provinces of importation limits that govern how much alcohol an individual can transport (i.e. on their person) into their province from another province for their personal consumption. Any direct shipping of alcohol to individuals in another province must be processed through the relevant provincial liquor authorities.

NLC has identified the illegal importation of alcohol into the Province as the highest risk it faces to its success. As a result, its Regulatory Services Division carries out many activities to reduce this risk and ensure that all purchases made by individuals in Newfoundland and Labrador are through a licensed NLC supplier or imported on their behalf by NLC from other liquor authorities outside the Province. NLC has, in the past, pursued legal action against individuals who have imported alcohol from other Canadian provinces in a manner that is contrary to provincial legislation. Similarly, to address the risk of illegal importation of alcohol, other provinces also control and enforce the amount of alcohol their residents may bring into their province and the means in which they can acquire and transport it.

Section 3(1) of the federal Importation of Intoxicating Liquors Act requires essentially that, except for personal importation limits established by provinces, no person shall import, send, take or transport or cause to be imported, sent, taken, or transported into any province alcohol, unless to paraphrase, it is processed through the government of a province or the body in the province which is vested with the right of selling alcohol.

Additionally, except for provincial personal importation limits, section 124 of the Newfoundland and Labrador Liquor Control Act similarly prohibits an out-of-province transport or sale of alcohol without processing it through the appropriate provincial liquor authority. A person who breaches this section is guilty of an offence and is liable on summary conviction. Further, under section 126 of this Act, an officer, director, agent or employee of NLC who authorized, participated or acquiesced in the commission of the offense may be prosecuted. This exposes not only the individual(s) to prosecution but also NLC as a corporation.

In July 2016, NLC’s Finance Division identified specialty wines being sold over the counter (at point of sale) by one of their branches to customers whom, according to the address in NLC’s accounting records, lived in other areas of Canada. NLC’s Finance staff expressed concern to members of the Executive that these sales may be contravening federal and provincial legislation.

It is now known that NLC had been engaging in the practice of selling excess specialty wines at discount prices to out-of-province customers and that NLC directly handled and arranged for shipping direct to these customers via couriers. This practice supported the effort to reduce the excess specialty wine inventory.

When NLC's Finance staff raised the concern in 2016, the former CEO sought legal advice regarding the interprovincial movement of products and in particular, whether NLC had any obligation to investigate whether the products sold to customers might be transported to another province. Three legal opinions were obtained regarding this issue on August 24, 2016, October 31, 2016 and November 2, 2016. The opinion given was that NLC does not have an obligation to investigate whether a customer that purchased liquor from a licensed retailer intends to transport alcohol to another province; however, that advice was given with the following caveats:

- "We have based the following advice on certain assumptions: NLC does not ship products directly to customers in other Provinces".

- "We have not specifically considered any knowledge NLC may have in relation to out-of-province addresses contained in accounting records, as we are unaware of any specific information about it".

- "You have made it clear to me and NLC's Bordeaux Futures documentation also makes it clear, that delivery of product purchased via the Futures program is delivered to the end customer at a Newfoundland Liquor Corporation liquor store"

The former CEO then expressed the opinion that over the counter sales to customers living outside the Province of Newfoundland and Labrador were appropriate as long as the product was picked up at a branch store. NLC advised that following receipt of this legal advice, staff were informed that any future shipping of alcohol to customers in other provinces had to be processed by NLC's Finance Division through a private order procedure with the provincial liquor authorities of those provinces.

To address this identified risk and ensure that officials were complying with this clarified policy, we completed select email analysis on certain accounts. This analysis identified that a particular NLC branch manager knowingly continued to sell and ship, or arrange the shipping of, specialty wines at discounted prices and/or with price overrides, directly to end customers in other provinces without going through the respective liquor authority of those provinces. We further noted that this NLC branch manager was the manager who had been tasked with reducing the excess level of specialty wine inventory and could, with approval, provide price overrides at the point of sale for purposes of reducing this inventory.

Through the email analysis, we were able to confirm documented instances for 24 such sales transactions between May 2017 and January 2019 at an estimated amount of $286,000. More specifically, the analysis indicated that, one or more of the following issues were noted for these transactions:

- There was an established relationship between the branch manager and a particular courier in regularly facilitating the direct shipping of alcohol to out-of-province customers. Customer orders were prepared for pick up at the branch store by the courier/delivery service or for drop off to the courier for direct shipping to customers in another province.

- The branch manager instructed out-of-province customers to pay a representative of the courier for product and shipping and to have the representative make the purchase for them in the branch store.

- The branch manager instructed customers to send email money transfers to the branch manager's personal email account and the customer orders in turn were paid using a gift card, credit card or debit card. For these specific transactions identified, we confirmed that all expected funds collected by the branch manager were, in turn, processed through the records of NLC.

- Credit card information was obtained by the branch manager over the phone, by email or from information kept on file to process customer orders. This is contrary to NLC policy which requires the customer to be present for the transaction at the store. In one instance, this practice resulted in a purchase being charged to the wrong credit card.

- The branch manager sometimes provided incorrect cost quotes to out-of-province customers for their orders, and adjusted the charges for shipping boxes to offset resulting shortfalls in customer payments.

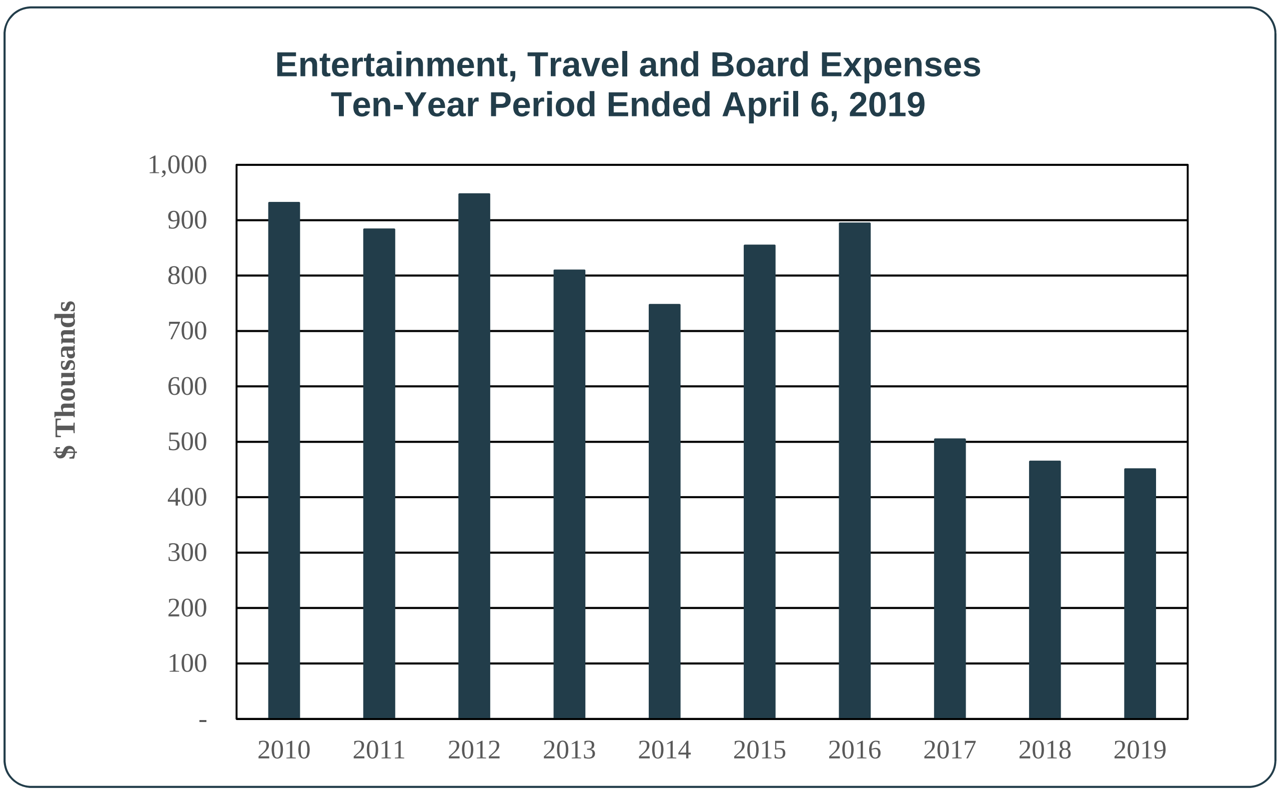
- An extra bottle of product, valued at $1,025, was provided to an out-of-province customer as a gift (without charge).

These findings were reported to NLC on March 19, 2019 for validation and appropriate action. The Auditor General Act requires the Auditor General to report to the Lieutenant-Governor in Council, through the Minister of Finance, instances the Auditor General becomes aware of during the course of an audit which may involve improper retention or misappropriation of public money or another activity that may constitute an offence under the Criminal Code of Canada or another Act. As a result, these findings were also reported to the Minister of Finance at a meeting on March 28, 2019, followed with a letter on May 31, 2019. On March 27, 2019, our Office also informed the Royal Newfoundland Constabulary for the purpose of determining if this matter needed to be investigated under either the Criminal Code of Canada or Provincial legislation. This matter was reported to the above parties at that time as it was understood that there were time limits for prosecution under the relevant legislation should that course of action have been deemed appropriate. NLC subsequently terminated the employment of the branch manager who facilitated these out-of-province sales.

Upon being notified by our Office of the continued out-of-province sales direct to customers, NLC began a review of sales corporate-wide to determine if this was occurring in other stores. NLC executive had a meeting on April 1, 2019 with, and subsequently provided documentation to, all store managers regarding the legal obligations in regards to facilitating a sale of product to a customer outside the Province. Details of the process to be followed if a manager suspected the transaction could involve an inter-provincial sale were also provided. NLC also designed reports to alert management of large or unusual sales. Management began reviewing such reports effective April 1, 2019, and forwarded these reports to Regulatory Services.

Entertainment, Travel and Board Expenses

In carrying out its mandate, NLC incurs entertainment, travel and Board expenses. For the 10-year period ended April 6, 2019, expenditures of this nature totaled $7.5 million, ranging from a yearly high of $946,800 in 2012 to a low of $450,400 in 2019.



Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

In May 2016, the Department of Finance, to whom NLC reports, completed a high-level review of NLC expense claims to determine if reimbursements were reasonable and consistent with Government's travel policies and practices. The Department of Finance's review identified a number of inconsistencies between NLC's and Government's travel policies and practices, such as:

- Frequent Executive travel outside the Province and Canada to attend conferences, many attended by multiple NLC officials.
- NLC meal per diems were higher than rates for Government Executives and NLC Executive frequently claimed the actual cost of meals rather than applicable per diem rates while travelling.

As a result of this review, on June 2, 2016, Government directed NLC to modify their entertainment and travel reimbursement policies to be consistent with those of Government, effective immediately. Our audit included an examination of these expenses for the period subsequent to June 2, 2016 to assess compliance with this directive.

Consistency with Government Policies

NLC policies for entertainment, travel and Board expenses were consistent with those of Government in all material respects.

During 2016 and 2017, NLC introduced and/or updated a number of policies to address the areas covered by Government in its review. These include policies for general expense claims, travel expense claims, business-related meal expenses and personal vehicle use. We reviewed these revised policies and assessed them against the comparable policies issued by Government's Human Resource Secretariat relating to entertainment expenses and travel-related expenses for transportation, meals, accommodations, miscellaneous costs and private vehicle use.

We found that NLC's revised entertainment and travel policies were comparable to Government's in all material respects, with some differences, highlighted as follows:

Policy Area	Government Policy Expenses/requirements*	NLC Policy Expenses/requirements*
Entertainment Expenses	With Deputy Minister approval, $200 per day entertainment expenses, $7,500 per trade event, $2,500 per reception.	Hospitality/entertainment meals $200/Manager, $300/ Director, $500/Vice-President/CEO. ** Alcoholic beverages are not reimbursable.
Transportation	Economy airfare to be booked through a travel agency and detailed receipts required for taxis, airport parking, sea travel, car rentals.	Comparable.

Policy Area	Government Policy	NLC Policy
	Expenses/requirements*	Expenses/requirements*
Meals	Per diems Breakfast $8.00, Lunch $14.00, Dinner $21.70 – variable rates for travel outside the Province. Breakfast/Dinner qualifies only if more than two hours outside start/end time worked.	Comparable, except for omission of a qualifying period greater than two hours being specified.
Accommodations	Standard commercial room, booked through a travel agency or $25 for private accommodations.	Comparable, except employee is to book own room and submit detailed receipt for reimbursement.
Miscellaneous	$5 per day incidentals per diem. With receipts, one five-minute long distance call/day, excess luggage fees, and for out-of-country travel, passport, medical insurance and foreign currency fees.	Comparable, except Wi-Fi, seat selection, airline delay fees specified; passport and medical insurance not specified. Alcoholic beverages are not reimbursable.
Private Vehicle Use	$0.3472 per kilometre, adjusted quarterly. $10 per week parking. If a condition of employment, $0.4862 per kilometre and $400 per year business insurance. Fines for traffic violations not reimbursable. Private vehicle usage report required.	Comparable.

Source: Prepared by the Office of the Auditor General based upon policy documents of Government and the Newfoundland and Labrador Liquor Corporation

*Highlights of basic policy coverage only. In some cases, policies detail special circumstances under which exceptions may be approved and by whom.

** Although not specified by policy, a $10 per employee spend limit is used for guidance in employee recognition/engagement activities that occur during office hours.

Our audit found that some expenses of the former CEO were exempt from the requirements of NLC's travel polices. In 2010, Government approval was given to amend the former CEO's employment contract to provide an annual automobile allowance in the amount of $8,000 and entitlement to reimbursement for fuel expenses, consumable liquids and related expenses incurred while traveling on business related to NLC.

In addition to the expense policies, we compared NLC's and Government's practices regarding cash advances provided to travelling employees. Government encourages use of a corporate card by travelling employees but in accordance with policy, will provide a trip advance that must be repaid within 30 days of travel and must be monitored by the respective departmental finance staff. NLC has a Cash Advance Request form but does not have a formal policy covering trip advances. Our audit included some instances of cash being provided to employees in advance of travel, and in these instances, we were satisfied that NLC's processes adequately ensure recovery of such advances upon completion of travel. However, accountability for same would be improved if the process was documented and formalized in policy.

Finally, we also compared NLC's Travel Authorization Request Form to Government's Official Journey Authorization Form. These forms set out the necessary documentation and approvals required before employees travel. We found that NLC's form was comparable to Government's in all material respects, except that NLC's form is required to be completed for out-of-province travel only, while Government's must be completed for all travel outside an employee's headquarters area. Some modifications to NLC's form, such as the addition of the signature of the travelling employee, the departure location and the printed names of signatories, would improve the accountability and audit trail intended by the form.

Compliance with NLC Policies

NLC's entertainment, travel and Board expenses complied with approved policies in most respects but some improvements were needed in the processing of travel claims.

We examined a sample of 134 expenditures made from June 2, 2016 to April 6, 2019 to determine whether NLC's entertainment, travel and Board expenses complied with the requirements of its approved policies. Samples were selected judgmentally based on large amounts, frequent travelers, staff functions and position (executive and board members). We found that NLC complied with its policies in most, but not all, instances. Our testing also showed that some improvements in the processing of claims would result in a better audit trail and hence accountability for compliance to policies.

Travel Preauthorization

NLC policy requires a Travel Authorization Request Form to be prepared and submitted in advance of all out-of-province travel. This ensures appropriate approval of travel before commitments are made, in particular for non-refundable airfare. Our audit found 11 instances where this preapproval was not evident. In most cases, the form was completed late or was undated, but in four cases, no form could be located at all.
For example, airfare, some at business class, was booked by the former CEO for a January 2018 trip to Colorado for the CEO and four employees. This airfare, totaling $15,292, was booked on the CEO's personal credit card and reimbursed to the CEO in December 2017 without a Travel Authorization Request Form being completed for any of the employees. Approvals were subsequently given for only two employees to travel to this event, requiring three tickets to be cancelled and held as credits for future use by other employees.

Dates of Coverage

NLC policy allows travel to be covered from the day before to the day after a business session and the Travel Authorization Request Form requires information, such as a conference agenda, to be attached to determine the appropriate period of coverage. However, our audit found that conference details or other documents supporting the period of coverage were not always attached to travel claims. This made it more difficult to determine the proper entitlement for per diem amounts and reimbursement for hotel accommodations. For example, a Board member travelled to St. John's for a May 17, 2016 Board meeting, entitling the member to be reimbursed for expenses incurred May 16-18, 2016. Actual reimbursement covered the period May 15-18, 2016 and no documentation was attached or could be provided to support the period of coverage.

Use of Travel Agency

For travel management services, NLC makes use of a travel agency and online booking tool as part of a Government-wide contract for these services. This contract helps NLC save money, minimize the administration of bookings/rebookings and for airfare, manage flight credits. The use of a corporate credit card with the agency also streamlines the payment process and ensures any subsequent credits are received directly by NLC. Our audit found that this requirement is not articulated clearly in NLC's travel policy and some travel was booked without using the travel agency and/or the online process. As well, our audit found that some travel arrangements are charged to a personal credit card, which then requires an expense claim to be filed by the employee, a reimbursement payment to be processed by NLC and any subsequent cancellations to be followed up and recovered from the employee. In these instances, the benefits of using the travel agency are not achieved and risks exist that credits will not be recovered.

Other

Some other examples of non-compliance identified in our testing included such things as:

- reimbursement for alcoholic beverages (4)
- staff expenditures/functions requiring preapproval being approved after the fact (5)
- credit card receipt or hotel charge, with no detailed receipt, provided as support (5)
- extra airline fees not approved in advance (2)
- reimbursement based on a price quote instead of actual receipt (1)

Overall, the examples illustrated above are indications that the processing of claims did not always receive the attention to detail necessary to ensure full compliance with NLC policies or may have been subject to management override.

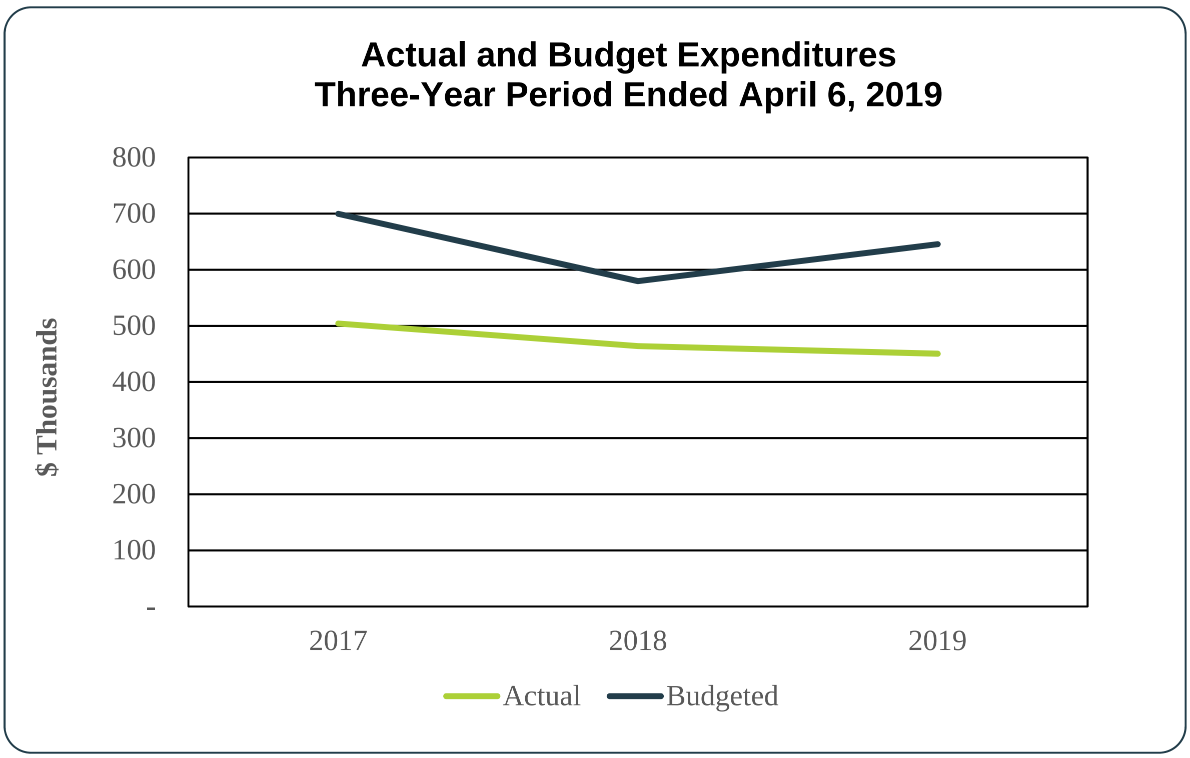
Budget and Consideration of Costs

NLC's entertainment, travel and Board expenses for the period June 2, 2016 to April 6, 2019 were incurred within approved budget and with due consideration of the cost to the public.

Travel expenses for the 10-year period ended April 6, 2019 in relation to specialty wines were not always managed in a manner that promoted the appropriate use of public money.

There were some weaknesses in NLC's processes for reviewing travel-related expense claims, which resulted in overpayments.

For the three-year period ending April 6, 2019, we found that actual expenditures incurred for entertainment, travel and Board expenses were below the approved budget for the same period.



Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation

NLC officials reported that a zero-based budgeting program was introduced in the 2017-2018 fiscal year and fiscal restraint measures included the elimination of discretionary international travel. These measures, along with the new policies and procedures implemented over the same period, were indications that NLC's entertainment, travel and Board expenses in recent years had been incurred with due consideration of the cost to the shareholder.

Travel and Entertainment – Specialty Wines

Our analysis of travel and entertainment expenses associated with specialty wines showed that an estimated $170,600 was spent by NLC officials mainly for travel to Europe for various events from 2009 to 2016. Appendix II provides additional details on these expenses. The necessity and benefit associated with the related travel expenses is not clear given the poor performance of the Futures program.

We also made the following observations from our analysis of the travel claims processed during that period:

- In 2016, the former CEO requested and was approved by the former Chair of the Board to be reimbursed for expenses incurred during a personal vacation trip to Italy, in recognition of visiting some wineries in the area while on vacation. Expenses of $1,697 reimbursed by NLC included two nights' accommodations and related expenses.

- In 2015, the NALA, who was the close family member of the CEO referenced earlier in this report, occupied a hotel room paid for by NLC that was originally reserved for an employee who did not attend the event. The amount of $2,079 was paid by NLC four months before the event and was not recovered from the NALA until identified by an NLC official four months after the event.

- In 2013, the former CEO was reimbursed $8,312 for four hotel rooms paid for on the CEO's personal credit card in advance of an upcoming event in France in June 2013. Records indicate these rooms were non-refundable. We found:

    - Two of these rooms were reserved for non-NLC individuals, one of which was the NALA. These two individuals were also registered by NLC as an NLC agent and NLC consultant respectively and badges produced on their behalf.

    - NLC officials confirmed that the two non-NLC individuals did not reimburse NLC for these rooms.

  - NLC was refunded one night's stay on all four rooms, and 872 Euros ($1,226) was credited to the former CEO's personal card by the hotel. The refund to the CEO's personal credit card was not detected until identified during our audit and NLC officials confirmed that, up to that point, the refund had not been recovered by NLC.

- Similarly, in 2009, the former CEO was reimbursed for the prepayment of four hotel rooms, for four NLC representatives, in the amount of $7,639. One of these was reserved for the NLC Chairman who later could not attend this event in France. We found that some effort was made to cancel one hotel room but as the booking was non-refundable, NLC was unable to cancel or receive a refund. Three NLC employees attended this event.

- Supporting documentation, particularly in relation to airline fees and change fees, was sometimes difficult to follow especially where original receipts were not provided, which sometimes resulted in errors being made. In one instance, the former CEO was reimbursed $1,654 in April 2014 for airfare for an upcoming trip to France based on an airfare quote from the travel agency. A month later, the travel arrangements were finalized and the CEO paid $1,533 on his personal credit card and was reimbursed this amount by NLC in July 2014. In another example, an airline fee of $270 was reimbursed to the CEO twice. In these instances, the overpayments were not detected until identified during our audit and NLC officials confirmed that these overpayments, up to that point, had not been recovered by NLC.

- Executive/Business class airfare was sometimes booked although the booking was well in advance of travel dates, contrary to NLC policy.

These kinds of observations indicate that NLC did not always manage the travel expenditures incurred in relation to specialty wines in a manner that promoted the appropriate use of public money. This also indicates that there were some weaknesses in NLC's processes for reviewing travel-related expense claims, resulting in the above-identified overpayments.

Recommendations

1. Introduction of new programs by NLC, such as the former Bordeaux Futures program, should be supported by an approved business case.

NLC's Response

NLC management agrees with this recommendation. NLC will work to develop and apply policies and practices that ensure that its business case review process is consistently followed for all new programs and that such policies and processes are reviewed regularly by its internal audit personnel for both compliance and opportunities for improvement.

2. Acquisition of specialty wines should follow a well-documented and approved process that achieves transparency and accountability in the procurement of these wines.

NLC's Response

NLC management agrees with this recommendation. In recent years NLC has taken action to significantly reduce exceptions to standard product acquisition processes. Management will assist the Board in the development of an appropriate Board policy to deal with any perceived need for exceptions, such that if and whenever such exceptions are considered necessary, the process will include documented Board of Directors approval, in advance, with appropriate risk mitigation controls.

3. NLC should ensure that there is prescribed guidance for the pricing of all products, including any required pricing exceptions, which would promote transparency in pricing.

NLC's Response

NLC management agrees with this recommendation. NLC will continue its efforts to ensure its pricing policy, including the process for pricing exceptions, is consistently applied to all products and will include this matter in an annual internal audit review, with reporting to the Board of Directors.

4. To reduce the risk of overpayment related to travel, entertainment and board expenses, NLC should ensure that:
   - all staff are aware of the related policies; and
   - the reimbursement of any expenses are supported by adequate documentation. This would include reconciling any pre-paid travel-related expenses, such as flights and hotels, with final trip details.

NLC's Response

NLC management agrees with these recommendations. Furthermore,

- NLC will establish and seek Board of Director's approval of a Policy specifically mandating an annual sign off process whereby all applicable employees and members of the Board of Directors will review and confirm understanding of employee/Board expense claim and travel-related policies.

- NLC will review and make any appropriate recommendations to the Board of Directors, to update its employee/Board expense claim and travel-related policies, including travel authorization forms, other required documentation and reconciliation of prepaid travel expenses, to ensure a thorough review and approval process is consistently followed.

5. The Department of Justice and Public Safety should complete the planned Government-wide review to adequately address conflicts of interest within the public service and Crown entities, including the NLC. This review should consider any necessary legislative amendments required to improve the accountability and transparency with respect to conflict of interest and the definition of "family".

Department of Justice and Public Safety's Response

A comprehensive review and analysis has been undertaken and work on draft amendments is underway. These amendments would not only address the concerns outlined by the Office of the Citizens' Representative and your office but would also provide for other needed changes. Any legislative amendments would be tabled in the House of Assembly for consideration.

Background

NLC is incorporated under the Liquor Corporation Act as an agent of the Crown. It is responsible for the importation, sale and distribution of beverage alcohol and cannabis in Newfoundland and Labrador. A Board of Directors appointed by the Lieutenant-Governor in Council oversees NLC's operations. The Chief Executive Officer of NLC is responsible for carrying out duties and responsibilities assigned by the Board. NLC is expected to generate revenue for the Government of Newfoundland and Labrador, its sole shareholder.

NLC sells beverage alcohol to the general public through 29 retail stores and supplies products to over 140 liquor express operators and 1,400 licensees throughout the Province. NLC employs over 580 staff located at a head office and warehouse in St. John's and the retail stores throughout the Province. Beverage alcohol sales and beer and cannabis commissions for 2018-19 totaled $329 million, of which approximately $77.5 million was category wine sales.

Approximately 94 per cent of wine sold by NLC are core products, which are acquired through an established annual listing and de-listing selection process managed by NLC's Merchandising Division. The remaining six per cent are non-core products such as specialty wine, which are acquired from suppliers outside of the annual listing and de-listing selection process. Over the 10-year period ended April 6, 2019, revenues for specialty wines totaled $40.8 million, or approximately $4 million annually.

Objectives

The objectives of our audit were as follows:

1. To determine whether NLC was managing the procurement and sale of specialty wines in an effective manner and in compliance with legislation.

2. To determine whether NLC was managing its entertainment, travel and Board expenses in a manner that promoted the appropriate use of shareholder money.

Scope

Our audit covered the 10-year period that began April 5, 2009 and ended April 6, 2019. To ensure completeness of information regarding whether the initial implementation of the Futures program had been brought to the Board for review and consideration, we extended our scope period back to January 2005 for the review of Board minutes. Certain tables in our report include information related to years prior to our scope period.

We examined NLC's management of the procurement and sale of specialty wines, including associated travel and entertainment expenses. In addition to our analysis of travel and entertainment expenses associated with specialty wine, our audit also included an examination of other travel, entertainment and Board expenses for NLC operations for the period that began June 2, 2016 and ended April 6, 2019.

Our audit included an examination of documentation associated with the acquisition of and sale of specialty wines, as well as documentation associated with travel and entertainment expenditures, including policies and procedures, meeting minutes, internal audit and other reports, legal documentation, employee travel claims, employee emails and NLC correspondence. We sent audit confirmation letters on select NLC purchases of specialty wines to certain negociants in France. We obtained and analyzed data maintained in the financial systems to assist with our audit procedures. We performed detailed sampling of travel, entertainment and Board expenses. We also reviewed a report from the Office of the Citizens' Representative addressing conflict of interest allegations and other complaints against NLC. We held discussions with NLC management and staff, and interviewed the former CEO.

We obtained confirmation from management at NLC that all known information that had been requested, or that could affect the findings or audit conclusions, had been provided. Sample selections were non-statistical and based on risks identified from our audit procedures.

About The Audit

This independent assurance report was prepared by the Office of the Auditor General of Newfoundland and Labrador on NLC's management of the procurement and sale of specialty wine, as well as travel and entertainment expenditures. Our responsibility was to independently audit the management of the procurement and sale of specialty wine, as well as travel and entertainment expenses, to provide objective information and recommendations. Management at NLC acknowledged their responsibility for the audit subject matter.

Our audit was performed to a reasonable level of assurance in accordance with the Canadian Standard on Assurance Engagements (CSAE) 3001 – Direct Engagements set out by the Chartered Professional Accountants of Canada and under the authority of the Auditor General Act.

The Office applies Canadian Standard on Quality Control 1 and, accordingly, maintains a comprehensive system of quality control, including documented policies and procedures regarding ethical requirements, professional standards, and applicable legal and regulatory requirements.

In conducting the audit work, we have complied with the independence and other ethical requirements of the Rules of Professional Conduct of the Association of Chartered Professional Accountants of Newfoundland and Labrador.

We obtained sufficient and appropriate audit evidence on which to base our conclusions on February 11, 2020, in St. John's, Newfoundland and Labrador.

Use of Expert

During our audit we used the services of a lawyer to provide advice on the interpretation of legislation and policy related to conflict of interest and fiduciary duty and application to our audit.

Subsequent Events

On April 30, 2019, subsequent to our scope period, NLC concluded its review of corporate-wide sales and determined that inter-provincial sales were not occurring in other stores. On May 1, 2019, all store employees who perform management duties were provided with information regarding the process required to be followed with respect to sales of products to customers outside the Province.

NLC also began process changes in November 2019 such that stores are no longer allowed to set up new customers to process transactions for which a credit card is not present. NLC expects these changes to be fully implemented by February 2020.

In February 2020, the former CEO repaid $3,150 to NLC, which represents all three overpayments to the CEO for travel-related expenses identified in this report.

Criteria

Criteria were developed specifically for this audit based upon relevant legislation, NLC policies and procedures, our related work, reviews of literature including reports of other legislative auditors, and consultations with management. The criteria were accepted as suitable by the senior management of NLC.

We assessed the Specialty Wine Program against the following criteria:

1. NLC should establish a business case for offering specialty wines and monitor performance to support a continued program.

2. NLC should acquire specialty wines in a fair and transparent manner and in accordance with NLC policy.

3. NLC should sell specialty wines in accordance with legislation and NLC policy.

We assessed Entertainment, Travel and Board Expenses against the following criteria:

1. NLC's policies on entertainment, travel and Board expenses should be consistent with those of Government, as directed by Government on June 2, 2016.

2. NLC's entertainment, travel and Board expenses should be in compliance with approved policies.

3. NLC's entertainment, travel and Board expenses should be within approved budget amounts and incurred with due consideration of the cost to the shareholder.

Appendix I

Components of Retail Prices for Wine	
Component	**Explanation**
Purchase order	Amount paid to supplier for product (in supplier's currency).
+ Foreign exchange	NLC sets standard foreign exchange rates for countries from which it purchases product. The rate for the country of origin is applied to the purchase order cost to convert the cost to Canadian dollars. The rate applied is the rate in effect as of the purchase order date.
+ Freight	NLC sets freight standard costs for each shipping point from which its product is shipped. When product is received, the applicable freight rate is added to the product cost. The rate as of the product receipt date is applied.
+ Excise	Excise duties are based on government specified rates. The standard rate as of the product receipt date is applied to the product cost.
+ Tariff	Customs tariffs are based on the supplying countries' trade agreements with Canada. The standard rate as of the product receipt date is applied to the product landed cost.
= Landed Cost	
+ Fixed Mark-Up	Fixed $ rate per ml in selling unit, rate is as per NLC's Pricing Policy for Wines.
+ Variable Mark-Up	Variable percentage rate applied to the landed cost, rate is as per NLC's Pricing Policy for Wines.
= Base Retail Rate	
+ HST	15 per cent of base retail rate.
+ Bottle Deposit	Amount varies (ex. $0.20 per wine bottle).
= Final Retail Rate	

Source: Newfoundland and Labrador Liquor Corporation (unaudited)

Appendix II

Travel and Entertainment – Specialty Wines Fiscal Years 2010 to 2019				
Event	**Location**	**# of Attendees***	**Date**	**Total**
Vinexpo 2009	Bordeaux, France	3	Jul 2009	$ 30,278
Supplier Meeting	London, England	1	Dec 2009	5,273
Industry Meeting	Italy	1	Apr 2010	1,464
En Primeur Tasting	Bordeaux, France	1	Apr 2011	9,008
Vinexpo 2011	Bordeaux, France	4	Jun 2011	25,154
Bordeaux/Europe Trip	Bordeaux, France	1	Oct 2011	9,570
Bordeaux/Europe Trip	Bordeaux, France	3	Apr 2012	22,284
Bordeaux Tasting Event	St. John's, NL	N/A	Feb 2013	3,563
Bordeaux/Europe Trip	Bordeaux, France	1	Apr 2013	8,683
Vinexpo 2013	Bordeaux, France	2	Jun 2013	20,179
Bordeaux/Europe Trip	Bordeaux, France	1	Apr 2014	7,152
Burgundy/Europe Trip	Bordeaux, France	1	Jul 2014	3,894
Bordeaux/Europe Trip	Bordeaux, France	1	Apr 2015	6,776
Vinexpo 2015	Bordeaux, France	2	Jun 2015	15,635
Winery Tours	Italy	1	Nov 2016	1,697
				$170,610

Source: Prepared by the Office of the Auditor General based upon data obtained from the Newfoundland and Labrador Liquor Corporation
* The CEO was an attendee in all events
Total expenses of $170,610 included: transportation ($99,239), accommodations ($46,678), meals/other ($24,693)

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