



CITY OF KILLEEN

KCCC MIXED BEVERAGE OPERATION AUDIT Road to Recovery Slow But Steady

Audit Report #23-01

A Report to the City of Killeen Audit Committee

Committee Chair	Riakos Adams
Committee Members	Debbie Nash-King
	Ken Wilkerson
	Jack Ralston
	Bob Blair

Prepared by

The Internal Audit Department
Matthew Grady, City Auditor
December 2022

EXECUTIVE SUMMARY

KCCC Mixed Beverage Operation Audit

Mayor and Council,

I am pleased to present this audit of the Killeen Civic and Conference Center's (KCCC) Mixed Beverage Operation.

Audit Objectives

The objectives of the audit were to: (1) assess the impact of the Covid-19 Pandemic and Winter Storm Uri on KCCC's Mixed Beverage Operation; (2) assess the contractor's inventory management performance; and (3) assess opportunities to enhance Mixed Beverage Operation revenues.

Audit Results

Much like private industry's hospitality sector, KCCC's Mixed Beverage Operation was deeply impacted by the Covid-19 Pandemic. Revenues plummeted 67 percent in FY 2020, from a near-record pre-pandemic high of almost \$240,000 to just over \$78,000. The path to recovery has been slow, but steady with FY 2022 revenues of reaching \$129,000 or about half of pre-pandemic levels. Operationally, the contractor's inventory management showed marked improvement from the prior audit. However, wine variances, which spiked at 300 percent in February 2022 due to shrinkage continue to be problematic. Both management and contractor staff are aware of the issue and are considering options to bring down the variances. In addition, cost data used for the operation's monthly financial reports was outdated, causing cost of goods sold and ending inventories to be understated. In response, management has updated wholesale cost data to reflect recent price increases, and has adjusted KCCC's drink prices, accordingly. Finally, management did not have a process in place for addressing security vendor performance issues, which included chronic late arrivals and no-shows where bar service had to be delayed or cancelled altogether. Management has initiated a process going forward to establish clear criteria for addressing performance issues, as they arise.



AUDIT REPORT HIGHLIGHTS

Why Was This Audit Conducted?

The City Auditor conducted this audit, in accordance with the terms of the City's management services agreement for mixed beverage services.

What Was Recommended?

The City Auditor recommended updating wholesale cost data for liquor inventory and adjusting drink prices, as appropriate. The City Auditor thanks the KCCC Director and staff, Contractor and staff, and the Executive Directors of Finance and Community Development for their cooperation during this audit.

TABLE OF CONTENTS

INTRODUCTION	1
Background	1
Management Services Agreement.....	2
Inventory Management	2
Prior Audit Findings	4
FINDINGS AND RECOMMENDATIONS	5
Impact of Covid-19 on KCCC Mixed Beverage Operations	6
Inventory Management	7
Outdated Cost Data and Product Pricing	8
Impact of Security Performance Issues on Revenues	9
Recommendations:	11
VIEWS OF RESPONSIBLE OFFICIALS.....	12
OBJECTIVES, SCOPE AND METHODOLOGY.....	13
Objectives	13
Scope and Methodology	13
Statement of Compliance with Audit Standards	14

INTRODUCTION

The City Auditor conducted this performance audit of the Killeen Civic and Convention Center (KCCC) Mixed Beverage Operation pursuant to Article III, Chapter 40 of the City Charter, as Amended May 11, 2013, and in accordance with the City Auditor's Annual Audit Plan, approved by the Audit Committee, June 4, 2020, and amended January 13, 2022.

We included this audit in the Annual Audit Plan to comply with the City's Management Services Agreement for mixed beverage services, which requires that the City Auditor regularly conduct audits of the KCCC's mixed beverage operation.

The objectives of the audit were to: (1) assess the impact of the Covid-19 Pandemic and Winter Storm Uri on KCCC's Mixed Beverage Operation; (2) assess the contractor's inventory management performance; and (3) assess opportunities to enhance Mixed Beverage Operation revenues. The scope of the review focused on KCCC Mixed Beverage Operations for FY 2019 through FY 2022.

Background

Revenue from KCCC operations is largely event-driven and consists primarily of three revenue streams:

- 1) **Event Revenue**, from rental fees charged for the use of the Center's facilities and equipment;
- 2) **Mixed Beverage Revenue**, from the sale of spirits, wine, and beer; and
- 3) **Catering Revenue**, from fees collected from clients.

The above-mentioned revenue streams have historically generated from \$600,000 to \$700,000 annually, covering about 60 to 70 percent of KCCC's operational costs, which have historically hovered around \$1 million. Operational costs that are not covered by KCCC-generated revenue are picked up by the City's HOT Fund balance. It should be noted that a certain degree of subsidization is common among municipal conference centers. While conference centers are often viewed as an economic benefit to the local business community, the conference centers, themselves typically operate at a loss.

Texas Alcoholic Beverage Commission Permits

The City of Killeen maintains a mixed beverage permit with the Texas Alcoholic Beverage Commission (TABC), which authorizes the sale and distribution of alcohol at the Civic and Conference Center complex, which includes the rodeo grounds and the Special Events Center. The City also has the ability to extend its mixed beverage operation to other facilities by requesting a TABC Temporary Event Permit, which the KCCC currently uses for events taking place at the Killeen Arts and Activities Center (KAAC) and City-sponsored events.

Management Services Agreement

The City has outsourced staffing and management of the Mixed Beverage Operation since the KCCC's opening in 2002. In December 2018, the City issued its most recent Request for Proposal (RFP) for management services, resulting in the selection of Let Us Do the Cooking, LLC (Contractor). The Management Services Agreement (Agreement) provides for a two-year contract with an option for two, two-year extensions. The Agreement is currently in the second year of its first, two-year extension.

Under the terms of the Agreement, Contractor *"will provide management, supervision, and direction of the Operation in a manner that is in accordance with **standards comparable to those prevailing in other first-class mixed beverage operations in Texas.** Such management services will include, without limitation, serving beverages, both alcoholic and non-alcoholic, to Permittee's customers in accordance with their needs, maintaining all records and financial information required of the Texas Alcoholic Beverage Commission.*

As compensation for services provided, the Agreement states the City shall pay a management fee to Contractor equivalent to *"Forty Percent (40%) of Gross Receipts realized by Permittee for alcoholic beverage service charges at the Complex."*

Inventory Management

A critical factor in effective bar management involves controlling inventory costs by minimizing the loss of alcohol to spillage and theft. Toward that end, the Agreement states that Contractor *shall conduct a monthly inventory and provide ending inventory balances to Permittee within five (5) days of completion of the inventory... Each monthly inventory shall fully report spills and/or breakage of alcoholic*

beverages, and sufficient documentation of spills and/or breakage shall be appended to each monthly inventory."

Variance (Shrinkage)

The purpose of the physical inventory from an internal control standpoint is to identify any significant variances between the estimated number of items sold per inventory and actual number of items sold per sales receipts. The bar and restaurant industry refers to these variances as inventory "shrinkage," which is generally attributed to spillage and/or theft. Spillage can take the form of broken bottles, partially used bottles of wine, accidental or intentional over pouring, or mistakes. Theft can take several forms, including intentional over pouring, giving away ("comping") drinks, undercharging for drinks, or outright theft of inventory.

Shrinkage is expressed as a percentage of the number of items sold, also referred to as cost of goods sold. For example, assume a beginning inventory of 200 bottles of beer, no inventory purchases, and an ending inventory of 95 bottles. This would indicate that 105 bottles of beer were sold. However, sales receipts indicate actual sales of only 100 bottles of beer. The shrinkage rate would be 5%, as follows:

$$\begin{aligned} \text{Beg. Inventory} + \text{Purchases} - \text{Ending Inventory} &= \text{Estimated Items Sold} \\ \text{Cost of Goods Sold} - \text{Estimated Items Sold} &= \text{Shrinkage} \\ \text{Shrinkage} \div \text{Cost of Goods Sold} &= \text{Shrinkage Rate} \end{aligned}$$

Therefore

$$\begin{aligned} 200 \text{ Bottles} + 0 \text{ Purchases} - 95 \text{ Bottles} &= 105 \text{ Bottles} \\ 100 \text{ Bottles} - 105 \text{ Bottles} &= -5 \text{ Bottles} \\ 5 \text{ Bottles} \div 100 \text{ Bottles} &= .05 \text{ or } 5\% \text{ Shrinkage Rate} \end{aligned}$$

While there is no industry standard per se for shrinkage, most bar and restaurant industry consultants identify shrinkage of 20 to 25 percent as the average for poured drinks, i.e., spirits, wine, and draft beer. Anything above 25 percent is generally considered a cause for concern. Average variances for bottled beer are lower since spillage is less of a factor than with poured drinks.

Prior Audit Findings

The City Auditor in his prior audit of KCCC's Mixed Beverage Operation identified significant concerns with inventory management and recommended several alternatives, including the issuance of a request for proposal (RFP). The City had not issued an RFP for mixed beverage services since 2005. The City followed through on the City Auditor's recommendation and issued a new RFP, which resulted in the selection of the current vendor.

Statement of Compliance with Audit Standards

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

FINDINGS AND RECOMMENDATIONS

Impacted severely by the Covid-19 Pandemic, KCCC's Mixed Beverage Operation showed slow but steady growth in FY 2021 and 2022.

As with private industry's hospitality sector, KCCC's Mixed Beverage Operation was severely impacted by the Covid-19 Pandemic. Revenues plummeted 67 percent from a near-record high of about \$240,000 in FY 2019 to just over \$78,000 in FY 2020, as the onset of the pandemic caused closures and dampened social activity. FY 2021 saw a moderate increase to \$104,372, and the recovery continued in FY 2022 with revenues climbing to \$129,000, or about half the pre-pandemic high. On the operational side, the contractor's inventory management has shown marked improvement since the prior audit, although wine losses due to shrinkage continued to be problematic.

Management and the contractor are considering options to address the problem. In addition, the KCCC had not adjusted its product pricing to keep pace with the rising cost of its alcohol products. KCCC's pricing for spirits, wine and beer drinks have remained unchanged for over six years, while the wholesale cost of those products has risen on average 13 percent over the same period. In addition to eroding the Mixed Beverage Operation's operating margin, use of the outdated cost data causes both the cost of operations and the value of inventory to be understated. While the Contractor is largely responsible for managing KCCC liquor inventory, the contract is silent as to which party is responsible for monitoring the cost of inventory and adjusting inventory tracking sheets, when appropriate. Future contracts should clearly delineate who is responsible for these activities. Finally, the KCCC is required to have a security presence at all engagements where alcohol is served per City policy. The KCCC had experienced multiple performance issues with one of its recommended security vendors, but lacked a formal process for addressing these performance issues. Going forward, management has initiated a process to communicate clear performance expectations to its security vendors and established clear criteria for removal of vendors from its recommended list for non-performance.

Impact of Covid-19 on KCCC Mixed Beverage Operations

The Covid-19 Pandemic had a deep impact on KCCC's Mixed Beverage Operation, mirroring that of the pandemic's impact on the private industry's hospitality sector. The KCCC closed its doors in March 2020, and they remained closed until June 2020, when the facility reopened at 25 percent capacity. It remained open at various percentages of occupancy until February 2021, when Winter Storm Uri forced its brief closure. The facility returned to full capacity in April 2021, 11 months after its initial closure and shortly before Bell County rescinded its local disaster declaration, as shown in the timeline below.

KCCC COVID TIMELINE



Source: KCCC and Emergency Services

Not surprisingly, revenues declined dramatically during the period, falling from a near record, pre-pandemic high of \$239,716 in FY 2019 to \$78,243 in FY 2020, representing a 67 percent drop in revenue.

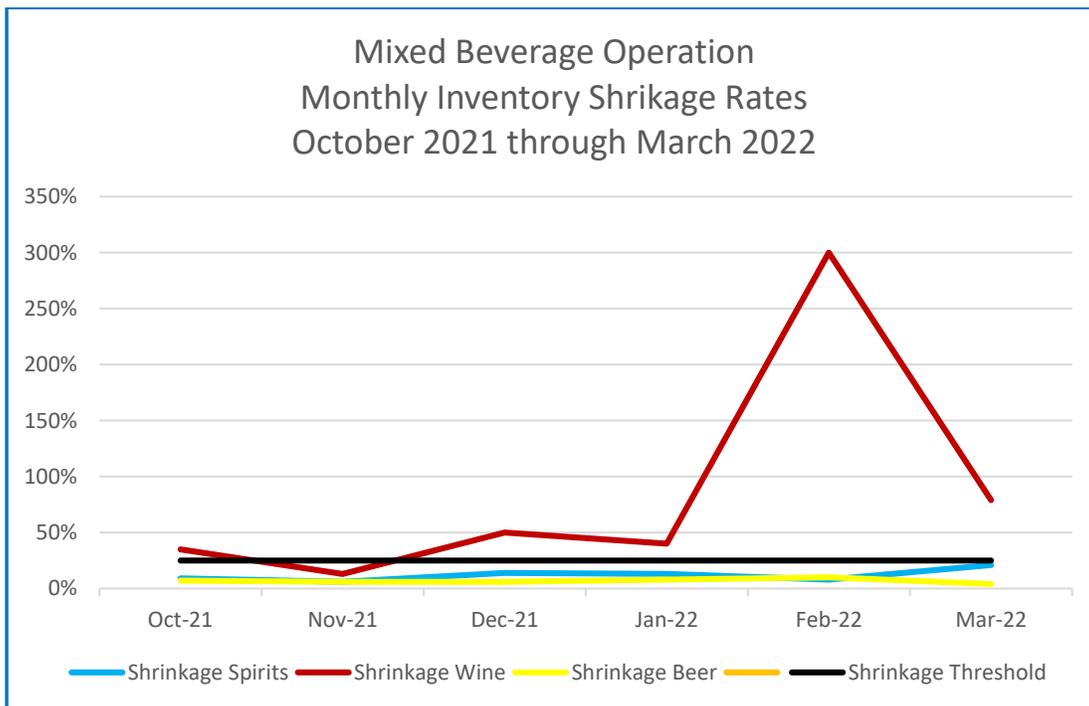


Recovery from the depths of the pandemic has been steady, but gradual going from \$104,000 in FY 2021 to \$129,000 in FY 2022, or roughly half the operation's FY 2019 totals. The City's FY 2023 budget projects \$143,750 for the current year, anticipating that the pace of the recovery will continue, at least in the short term. If this growth pattern holds, it should be several years before the operation returns to its pre-pandemic levels.

Inventory Management

Poor inventory management was identified as significant concern in the City Auditor's prior report. The City Auditor reviewed the Mixed Beverage Operation's monthly activity reports for October 2021 through March 2022 to assess Contractor's efficiency in managing the KCCC's alcohol inventory.

The review found a marked improvement in inventory shrinkage ratios for spirits and beer, which were consistently below the 25 percent threshold of concern. However, variances for wine continued to be a challenge, with shrinkage above the 25 percent threshold for most months, spiking at 300 percent in February. The February figure indicates that for every glass of wine sold three were lost to shrinkage. In sales dollar terms it equates to about \$270 in losses on \$90 in sales.



Source: Monthly Mixed Beverage Operation Reports

It should be noted that the Mixed Beverage Operation operates primarily in a banquet type setting. Industry consultants acknowledge that this is among the most difficult environments for controlling variances, especially wine, where bar crews may be left with multiple open bottles of wine at the end of a function. Unless there is another function within the 3-to-5-day shelf life of an open bottle, the unused portion will have to be discarded. Both Contractor staff and management acknowledged that this was likely the cause for the February spike.

The Contractor and management are aware of the issue and are considering options for addressing the problem, including the possible use of keged wine, which comes in sixtels, i.e., one-sixth the volume of a traditional beer keg. Kegged wine typically has a shelf life of 4-to-6 weeks, which could significantly reduce the volume of wine lost to spoilage. While the market for keged wine is still relatively small, it has gained steadily in popularity over the past decade for its profitability, as well as its eco-friendliness.



Outdated Cost Data and Product Pricing

The City Auditor noted that wholesale cost data used in KCCC's monthly activity reports have remained unchanged since at least 2016. At the same time, the actual wholesale cost of alcohol products has risen anywhere from 8 to 18 percent. On average, the prices paid by KCCC for alcohol products have gone up 13 percent since 2016, based a review of KCCC's invoices.

The impact of the use of outdated cost is twofold: (1) it understates cost of goods sold, thereby overstating the results of operations; and (2) it understates the value of KCCC's liquor inventory.

For example, the City's financial management system shows cost of goods sold of about \$26,000 for FY 2022, which is based on the historical wholesale cost data contained in the monthly activity reports. The actual figure is probably closer to \$29,000 based on the average increase in wholesale costs of 13 percent, as follows:
 $\$26,000 \times 1.13 = \$29,380.$

As for inventory, KCCC maintains on average about \$30,000 in inventory. Again, this is based on the historical whole cost data maintained in the inventory sheets. The actual value of inventory appears closer to \$34,000 based on an average increase in wholesale costs of 13 percent, as follows: $\$30,000 \times 1.13 = \$33,900$.

These variances are not materially significant in the context of the operation as a whole, which includes both room/equipment rental revenue and catering revenue. Nevertheless, management should strive to provide the most accurate cost data available.

Product Pricing

While the cost of alcohol products has risen, drink prices have remained static, at least since 2016. Management should review its price list with respect to current product costs to determine where drink price increases might be warranted. As previously mentioned, there was a range of increases with some costs increasing only moderately.

Going forward, management should clearly delineate whether staff or the contractor will be responsible for monitoring and updating product cost data. While the current contract assigns overall responsibility for managing inventory to the contractor, it is silent on monitoring and updating cost data. Providing clarity on this issue will ensure cost data is updated on a timely basis.

Management Response: *Management agreed with the findings and took corrective action prior to the issuance of this report. Specifically, Let Us Do The Cooking staff, in conjunction with the implementation of their new inventory app updated cost data for all alcohol products purchased by KCCC to reflect their current price values. In addition, the KCCC Director implemented Mixed Beverage Operation's first drink price increase since 2016 to adjust for the rise in product costs and to bring prices closer in line with local bar and restaurant establishments. The City Auditor concurs with management's corrective actions.*

Impact of Security Performance Issues on Revenues

City Council Memorandum Resolution 10-012R updated security requirements for Civic and Conference Center events where alcohol is served. The resolution requires that security be arranged through the KCCC at the lessee's expense, and that security must be provided by

certified bonded security officers or off-duty police officers. Per the resolution, events with alcohol require one officer per 300 participants.

While KCCC management prefers to use off-duty KPD officers at City facility functions, the resolution does allow for private security, if the client wishes to arrange for security. In such cases KCCC management provides the client a list of recommended vendors, which includes several private security firms, as well as other local law enforcement agencies with available off-duty officers.

The City Auditor learned in discussions with management and Contractor staff of multiple performance issues primarily concerning one of the private security vendors used by clients. The incidents included at least 8 late arrivals, ranging from 5 to 30 minutes late, causing bar service to be delayed, and two no-shows, where bar service had to be cancelled altogether. The vendor's no-shows were clearly the most egregious performance issues, costing the City at a minimum, hundreds in revenue and inconveniencing guests and bar staff alike. However, even late of arrivals 25 or 30 minutes can have a significant impact on revenues, as well as the quality of experience for guests, given that some events may last only 2 hours. Finally, the chronic nature of the security vendor's performance issues runs the risk of causing reputational damage to the KCCC as a potential event venue.

Because management lacked a formal process for removal of a vendor from its recommended list, management should address the issue going forward by establishing clear criteria for removal of vendors from their recommended list for performance issues. In the case of law enforcement agencies this would apply not to the agency, but only to the specific off-duty officers under contract with performance issues.

Management Response: *Management agreed with the finding and has developed an application process for security vendors that clearly delineates performance expectations and establishes clear criteria for removal of non-performing vendors. The City Auditor concurs with management's corrective action.*

Recommendations:

The City Auditor recommends that the KCCC Director:

1. Update wholesale cost data to reflect accurate cost of goods sold and ending inventory value in monthly financial reports. -- Implemented
2. Consider price increases for drinks, as appropriate to adjust for increases in wholesale costs. -- Implemented
3. Establish criteria going forward for removing vendors with performance issues from the list of recommended security vendors. – In progress

VIEWS OF RESPONSIBLE OFFICIALS

Copies of the draft report were provided to the Executive Director of Community Development and the KCCC Director for review and comment. Management agreed with the findings and recommendations and their corrective actions are reflected in the body of the report.

OBJECTIVES, SCOPE AND METHODOLOGY

Objectives

The objectives of the audit were to: (1) assess the impact of the Covid-19 Pandemic and Winter Storm Uri on KCCC's Mixed Beverage Operation; (2) assess the contractor's inventory management performance; and (3) assess opportunities to enhance Mixed Beverage Operation revenues.

Scope and Methodology

The audit scope focused on but was not limited to analysis of operations from October 2019 through September 2022.

To address the audit objectives, the City Auditor:

- ▶ Reviewed prior audit findings, and corrective actions taken.
- ▶ Obtained monthly financial reports submitted to Finance by Contractor from October 2019 through May 2022.
- ▶ Obtained timeline of events affecting KCCC operations during Covid-19 Pandemic.
- ▶ Obtained and analyzed budget data on revenues and expenses for FY 2019 through FY 2022.
- ▶ Discussed mixed beverage operations with the KCCC Director and Let Us Do the Cooking bar manager and owner.
- ▶ Observed monthly inventory performed by Contractor's staff.
- ▶ Determined monthly variance ratios for liquor, wine, and beer from October 2021 through March 2022.

Statement of Compliance with Audit Standards

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