CITY OF KILLEEN

KCCC MIXED BEVERAGE OPERATION AUDIT

MIXED BEVERAGE OPERATION SHOWS PROMISE UNDER NEW LEADERSHIP, BUT OUTSOURCED INVENTORY MANAGEMENT REMAINS A CONCERN

Audit Report #18-02

A Report to the City of Killeen Audit Committee

Committee Chair	Jonathan Okray
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April 2018

EXECUTIVE SUMMARY

AUDIT REPORT HIGHLIGHTS

Why Was This Audit Conducted?

The City Auditor conducted this audit to comply with the terms of the City's management services agreement for mixed beverage services.

What Was Recommended?

The City Auditor recommended alternatives to replace the current management services agreement, including (1) issue a new Request for Proposal (RFP), (2) bring the outsourced portion of the operation in-house, or (3) dismantle the operation.

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.

BACKGROUND

Since 2005, the KCCC's mixed beverage operation has been managed through a management services agreement with YH SF LLC dba Jester's. Under the agreement, Jester's provides bartending and bar management services, including inventory maintenance, in exchange for 40 percent of the operation's gross receipts. The agreement, which has been renewed several times, most recently in February 2016, expires in March 2019.

OBJECTIVES AND SCOPE

The objectives of the audit were to (1) review the status of corrective actions on prior audit recommendations; (2) assess the contractor's performance with regard to inventory management; (3) assess the appropriateness of the agreement's management fee; and (4) assess opportunities to enhance operation revenues. The scope of the review focused primarily on, but was not limited to KCCC's mixed beverage operation for FY 2017.

AUDIT RESULTS

The KCCC mixed beverage operation audit showed mixed results. The KCCC Director has made significant strides since the last internal audit to improve the operation's efficiency and effectiveness. However, inventory management continues to be a concern. Losses of inventory reported in the contractor's monthly inventory reports for FY 2017 were far beyond an acceptable level, and due in part to the lack of enforcement mechanisms in the agreement with regard to inventory maintenance. Based on these factors, the City Auditor recommends seeking alternatives to renewing the current agreement. The City Auditor thanks the KCCC Director and staff, and the Executive Director for Community Development for their cooperation during this audit.

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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, April 17, 2017.

We included this audit in the Annual Audit Plan to comply with the City's Management Services Agreement for mixed beverage services, which mandates that the City Auditor will audit the City's mixed beverage operation at least annually; and to follow up on the status of prior audit recommendations.

The objectives of the audit were to (1) review the status of corrective actions on prior audit recommendations; (2) assess the contractor's performance with regard to inventory management; (3) assess the appropriateness of the agreement's management fee; and (4) assess opportunities to enhance mixed beverage operation revenues. The scope of the review focused primarily on, but was not limited to KCCC mixed beverage operations for FY 2017.

Background

The concept of the urban conference center is as old as the nation itself, dating back to the Constitutional Convention of 1787, held in Philadelphia's Independence Hall. The KCCC opened its conference center doors for business in April 2002, amidst a nationwide surge in conference center construction. From 1990 to 2011, conference center space in America's urban centers nearly doubled, from 40 million to 70 million square feet.

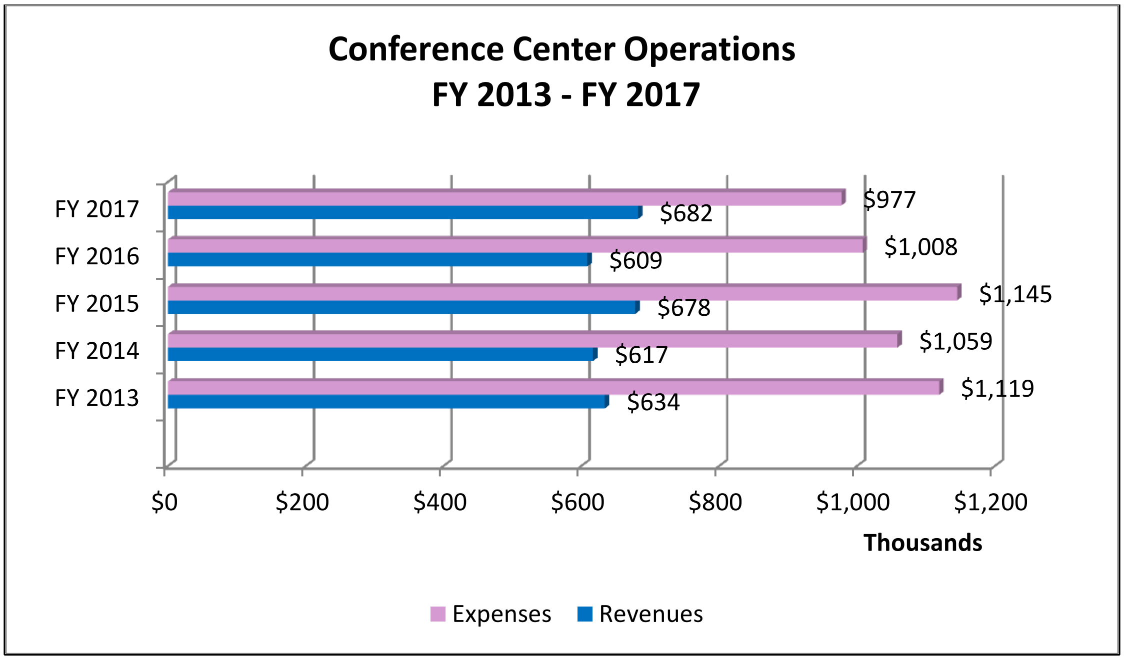
The sizes and purposes of these centers range from those intended to compete on the national stage for large scale events, like Chicago's McCormick Place complex, with a combined total of 2.6 million square feet of exhibit space; to smaller venues, generally less than 100,000 square feet, that are primarily intended to serve the civic needs of the local community, as is the case with the KCCC.

Killeen Civic and Conference Center Operations

Conference Center operations are funded out of the City's Hotel Occupancy Tax (HOT) Fund by Center-generated revenue and the City's HOT revenue.

Conference Center revenue 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 a percentage-of-sales fee collected from event caterers.



Source: Annual Budgets and AS400/Superion

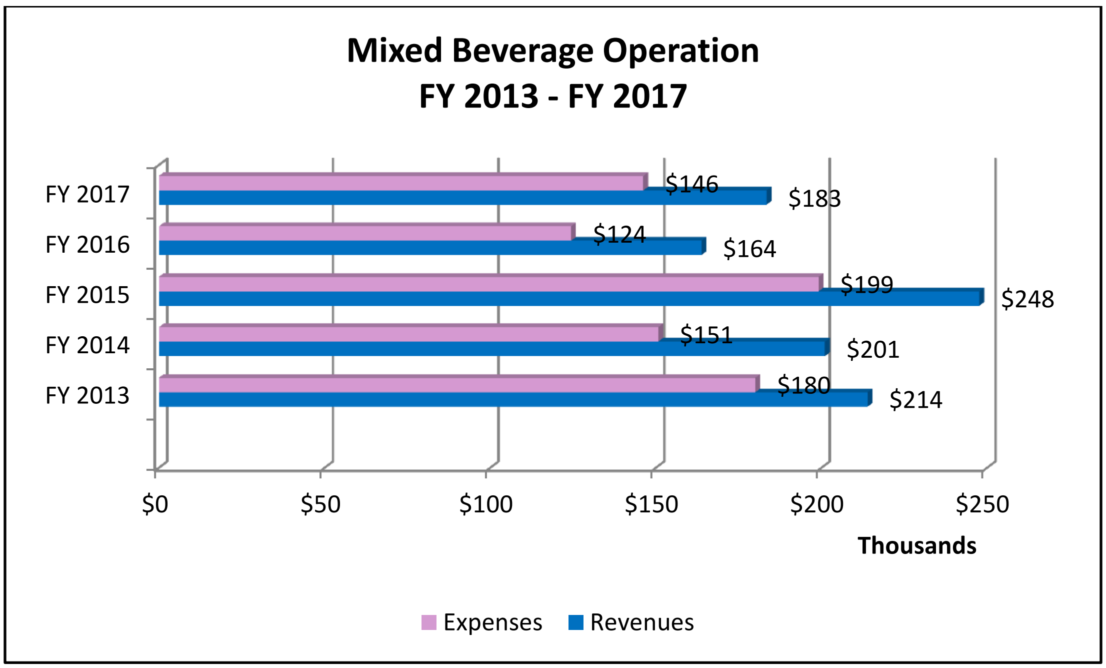
As shown in the table above, Conference Center operations generated revenue in the $600,000-to-$700,000 range over the past five years, 2017 being the highest. Operational costs hovered at around one million, 2017 being the lowest.

Percentage of operational costs covered by revenue ranged from a low of 57 percent in 2013, to a high of 70 percent in 2017. It should be noted that a certain degree of subsidization is fairly common among the nation's conference centers. While conference centers are often viewed as an economic benefit to the local business community, the centers themselves, more often than not operate at a loss. Operational costs that are not covered by KCCC-generated revenue are picked up by the City's HOT Fund balance.

Mixed Beverage Operation

The City maintains a 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 through its Beverage Cartage permit, which the KCCC currently uses for events taking place at the Killeen Arts and Activities Center (KAAC).

The KCCC's mixed beverage operation (Operation) accounts for about 30 percent of the Center's event-driven revenue. As shown in the table below, the Operation generated revenue in the $100,000-to-$300,000 range over the past five years, with a high of $248,000 in FY 2015.



Source: Annual Budgets and AS400/Superion

In terms of direct operational costs, the Operation has consistently operated "in the black," with revenues exceeding expenses by about $40,000, on average.[1]

[1] Operational costs include the cost of inventory, i.e., cost of goods sold, management fees paid to Jester's, liquor liability insurance premiums, TABC licensing costs, and office supplies.

Management Services Agreement

The City has outsourced staffing and management of its Operation since the KCCC's opening in 2002. According to Center staff, the City initially outsourced the staffing and management of its Operation to the Central Texas College (CTC). In 2005, the City issued a Request for Proposal (RFP) for management services, resulting in the selection of YH SF LLC dba Jester's (Contractor). The City has continued to renew its Management Services Agreement (Agreement) with Contractor over the past 13 years. The current Agreement, dated February 23, 2016, expires in March 2019.

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 (KCCC) 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 theft and spillage. 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.*"

<u>Variance (Shrinkage)</u>
The purpose of the physical inventory from an internal controls aspect is to identify any significant variances between the estimated number of items sold per inventory and actual number of items sold. The bar and restaurant industry refers to these variances as inventory "shrinkage," which is generally attributed to spillage and theft.

Spillage can take the form of broken bottles, leftover uncorked bottles of wine, accidental over pouring, bartenders making the wrong drink, or actual spills. Theft can take several forms, including intentional over pouring, unauthorized “comping,” i.e., giving away drinks, undercharging for drinks, or outright theft of inventory.

Shrinkage is expressed as a percentage of the total number of items sold. For example, assume a beginning inventory of 200 bottles of beer, an ending inventory of 95 bottles, no inventory purchases during the period, and actual sales of 100 bottles of beer. The shrinkage rate would be 5%, as follows:

Beg. Inventory + Purchases – Ending Inventory = Estimated Items Sold
Actual Items Sold – Estimated Items Sold = Shrinkage
Shrinkage ÷ Actual Items Sold = Shrinkage Rate

Therefore

200 Bottles + 0 Purchases – 95 Bottles = 105 Bottles
100 Bottles – 105 Bottles = -5 Bottles
-5 Bottles ÷ 100 Bottles = -.05 or -5% Shrinkage Rate

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, in the 1-to-2 percent range, since spillage is less of a factor.

Pour Cost

One of the main performance measures used in the bar and restaurant industry to gauge the cost effectiveness of a bar operation is the *pour cost*. Pour cost is a percentage ratio determined by dividing cost of goods sold by total sales. Other industries refer to this ratio as *gross margin*.

Pour cost is related to shrinkage in that high shrinkage rates will adversely affect the pour cost. For example, assume a glass of wine costing $1.20 is sold for $6. The pour cost would be 20 percent, as follows:

Cost of Goods Sold ÷ Sales = Pour Cost
$1.20 ÷ $6.00 = .20 or 20%

Now, assume that the monthly inventory shows 100 glasses of wine consumed, but only 80 glasses were sold. Wine shrinkage for the month would be 20 glasses, with a shrinkage rate of 25 percent, as follows:

Actual Items Sold – Estimated Items Sold = Shrinkage
Shrinkage ÷ Actual Items Sold = Shrinkage Rate

80 Glasses – 100 Glasses = -20 Glasses
-20 Glasses ÷ 80 Glasses = -25% Shrinkage Rate

Factoring in shrinkage, pour cost would increase from 20 percent to 25 percent, as follows:

Cost of Goods Sold ÷ Sales = Pour Cost
(100 x $1.20) ÷ (80 x $6.00) = Pour Cost
120 ÷ 480 = .25 or 25%

Again, there is no industry standard per se for ideal pour costs. However, industry consultants generally consider pour costs greater than 25 percent to be a cause for concern.

Prior Audit Findings

The former City Auditor identified a number of findings in past audits, many of them concerning internal control deficiencies and inappropriate cash handling practices. Those findings were usually addressed and resolved by management prior to the next audit. However, inventory management was one area where the City Auditor consistently noted repeat deficiencies. These deficiencies included discrepancies in ending and beginning inventories, and unresolved variances in alcohol products from one month to the next. For this reason, the scope of this audit was modified to more fully examine Contractor's performance in managing the City's inventory.

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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

FINDINGS AND RECOMMENDATIONS

Mixed Beverage Operation shows promise under new leadership, but outsourced inventory management remains a concern

The City Auditor's review of KCCC's mixed beverage operation (Operation) showed mixed results. Management has made a noteworthy effort to improve both the efficiency and effectiveness of its Operation since the last internal audit. In 2016, the newly promoted KCCC Director replaced the Operation's aging, obsolete cash registers with a state-of-the-art, point-of-sale system. In 2017, the Director installed security cameras, and in 2018, upgraded the Center's airwalls. Finally, during the course of the audit, the Director replaced the operation's theft-prone open beer tubs with locking bar coolers. These improvements represent positive change for the Operation; however, long-standing challenges remain in the area of inventory management. Monthly inventory reports provided by Contractor in FY 2017 were error-ridden, and contained dramatic swings in inventory variances from month to month, indicating losses of inventory far beyond an acceptable level. This was due, in part to the lack enforcement mechanisms built into the contract with regard to inventory maintenance. The City pays a sizable fee — 40 percent of gross receipts — for its Contractor's management services, which according to the terms of the Management Services Agreement (Agreement) are to be performed "*in a manner that is in accordance with standards comparable to those prevailing in other first-class mixed beverage operations in Texas.*" In view of the firm's performance, and the need for additional enforcement tools with regard to inventory maintenance, the City should consider alternatives to renewing the Agreement. Possible alternatives include (1) issuing a new Request for Proposal (RFP) for bar management services, (2) bringing the outsourced portion of the mixed beverage operation in-house, or (3) dismantling the mixed beverage operation.

Management Improvements

Since the last internal audit, both the KCCC Director and Executive Director of Community Development have made several significant improvements that have had either a direct or indirect impact on the Operation.

Point-of-Sale System Implemented

In December 2016, the KCCC replaced its aging cash registers with the Clover, point-of-sale system (Clover). Prior audits had repeatedly cited internal control deficiencies related to the operation's obsolete cash registers, such as the failure to consistently provide date-stamped sales reports, and inaccurate cost-of-goods-sold figures. Further, bartenders were unable to take credit card payments with the old registers, which not only created an inconvenience for customers, but also forced management to operate in a higher-risk, all-cash environment. Finally, the Clover system can produce itemized sales reports that provide for better inventory tracking and management.

Cameras

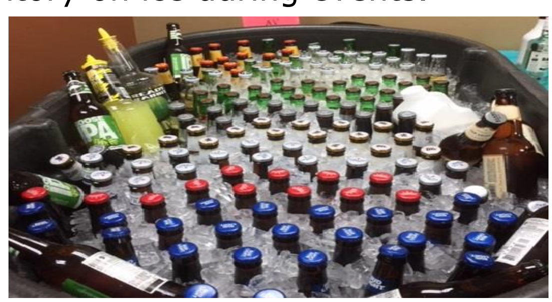
In February 2017, the Center installed three motion-activated cameras for its Operation, one in the kitchen facing the walk-in cooler where beer and wine are stored, one in the liquor storage room, and one in the hallway facing the entrance to the liquor storage room.

Airwalls

In April 2017, the Executive Director of Community Development obtained approval from City Council to replace the Conference Center's aging partitions, also known as "airwalls." While the upgrade was not directly related to the Operation, the improved soundproofing provided by the new airwalls has afforded management the opportunity to increase bookings, which in turn has the potential to increase revenue. According to the KCCC Director, in the past, management sometimes had to forgo bookings of available ballroom space because of the potential for noise-bleed from adjacent ballrooms, particularly if a group had a live band. With the new airwalls in place, that problem has been largely alleviated.

Bar Coolers

The KCCC Director recently obtained wheeled, lidded bar coolers to replace the open tubs used to keep inventory on ice during events. The open tubs, shown here, had to be manually hoisted onto a handcart, and were unsecured, leaving the inventory susceptible to theft. As will be discussed in the following section, ineffective management of the City's inventory continues to be a cause for concern for the Center's Operation.



Inventory Management Practices

The former City Auditor had in prior years' reports repeatedly cited deficiencies related to Contractor's monthly inventories, including discrepancies between ending and beginning inventory balances, and lack of follow-up on significant variances. The current City Auditor's review of monthly inventory reports for FY 2017 found that ending and beginning inventory balances for the most part, agreed. However, the reports still contained multiple errors indicating a lack of due diligence. More importantly, significant variances in liquor, wine and beer inventories indicated a failure on Contractor's part to effectively manage the City's assets.

<u>Review of Monthly Inventories</u>
The City Auditor's review of all 12 monthly inventory reports for 2017 found wild swings in variances from month to month, ranging from 5 percent to over 300 percent. Monthly wine inventories, in particular showed the greatest variances, some of which strain credulity and call into the question the overall reliability of the reports.

For example, in February 2017, Contractor estimated $606 in wine sales, based on its physical count of wine inventory. This equates to just over 100 glasses of wine. According to the sales reports, however, wine sales for the month amounted to only $289 or less than half the estimated amount. Based on these figures, Contractor reported a wine variance of 103 percent for the month. At the same time, the monthly report showed only $18 in spillage, about 3 glasses of wine, which explained less than 1 percent of the variance. Taken at face value these figures indicate that for every glass of wine sold in February 2017, a glass went unaccounted for.

In July 2017, Contractor reported a staggering 320 percent wine variance, with inventory counts indicating $1,882 in wine sales, compared to actual sales of $447. Remarkably, the inventory report showed zero spillage for the month, leaving the entire $1,435 variance, roughly 40 bottles of wine, unexplained. Again, taken at face value these figures indicate that for every glass of wine sold in July 2017, three went unaccounted for.




Large variances were not limited to wine. In August 2017, Contractor reported a 48 percent variance in bottled beer, with inventory counts indicating $803 in sales, compared to actual sales of $541. The report showed no spillage, leaving the entire $261 variance, about 60 bottles, or two and a half cases of beer unexplained.

It is difficult to imagine how variances of such magnitude could occur short of spillage on the scale of a full blown riot, or the brazen, wholesale theft of inventory. What is more likely is that haphazard inventory practices resulted in inaccurate inventory counts, which in turn created distorted sales estimates, resulting in these large unexplained variances. This likelihood was evidenced in a number of instances, in which Contractor's staff recorded what amounted to nonsensical figures in its monthly inventories.

For example, in March 2017, Contractor's staff recorded a beginning inventory of 27 bottles for a particular beer, and an ending inventory of 73 bottles, reflecting an increase of 46 bottles, or about 2 cases during the period. However, there were no purchases of this particular beer during the month to account for the increase in inventory. Clearly, the discrepancy was the result of a miscount during either the beginning or ending inventory. However, rather than explore the anomaly, Contractor's staff dutifully completed their analysis, subtracting the ending inventory balance of 73 bottles from the beginning inventory balance of 27 bottles to come up with a nonsense figure of negative 46 bottles of beer sold. The City Auditor noted similar "negative" sales in beer, wine and liquor in 5 of the 12 monthly inventories.

<u>Variance Methodology</u>

The methodology used by Contractor to analyze inventory shrinkage involved converting estimated items sold to expected sales, and then comparing total expected sales to actual sales to determine the overall variance as a percentage of sales, as follows:

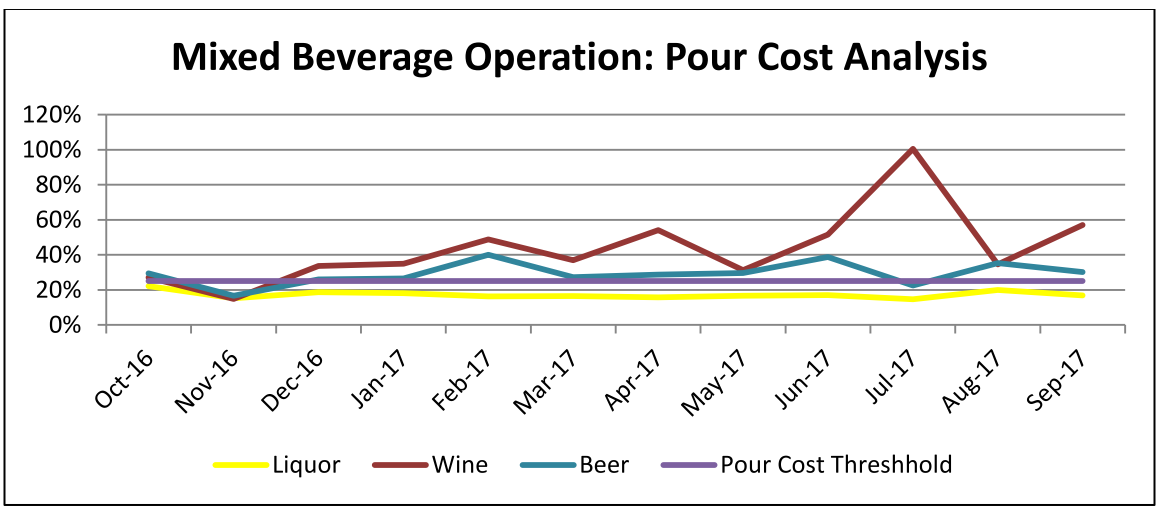
Beg. Inventory + Purchases – Ending Inventory = Estimated Items Sold
Estimated Items Sold x Sales Price = Expected Sales
Actual Sales – Expected Sales = Shrinkage
Shrinkage ÷ Actual Sales = Shrinkage Rate

There is nothing wrong with this methodology from a mathematical standpoint, and indeed, this was the most expedient method available under the prior system, given that the old cash registers were not designed for inventory tracking. The weakness in this methodology is that it provides variances only at the summary level for the alcohol categories, and does not allow management to drill down within each category to analyze variances on a product-by-product basis.

For example, undercharging is a common form of theft in the bar industry, in which bartenders intentionally charge the customer for a less expensive drink. For example, a bartender serving a craft or imported beer might charge the customer for a domestic beer. A review of beer inventory at the summary level would not reveal such activity because the equal-but-opposite variances at the product level would cancel themselves out.

As of January 2017, the KCCC implemented its Clover point-of-sale system. Among other things, the system provides an itemized breakdown on the number of each product sold. As such, it readily allows for a product-by-product analysis of inventory variances. KCCC management and staff stated they had requested that Contractor's staff use these detailed point-of-sale reports on multiple occasions during 2017 to perform their inventories. However, Contractor's staff did not do so.

<u>Pour Cost</u>
As previously mentioned, *pour cost* is a performance measure used in the bar and restaurant industry to gauge the cost effectiveness of a bar operation. Pour cost can be thought of as having two cost components, the cost of inventory actually sold to customers, and the cost of inventory lost in the course of business due to shrinkage, i.e., spillage and theft. Contractor does not include pour cost analysis in its monthly inventory reports, although it collects the data necessary to do so, i.e., cost of goods sold and sales. The City Auditor conducted his own pour cost analysis based on the information provided in Contractor's monthly reports for FY 2017, with the following results.



Source: Monthly Inventory Reports

The pour cost analysis for FY 2017 reveals several important trends. The pour costs for liquor, although somewhat high, appear fairly stable and are consistently lower than the 25 percent threshold often cited by industry consultants as the demarcation between good and bad pour costs. Pour costs for wine, on the other hand, were wildly erratic, fluctuating from under 20 percent to over 100 percent. Pour cost fluctuations for beer were not as severe as wine, but pour costs for both beer and wine were consistently above 25 percent, sometimes markedly so. Pour costs in excess of 25 percent generally indicate the presence of theft, according to industry consultants.

Analysis of Inventory Shrinkage

As of January 2017, the KCCC acquired the capacity to track inventory sold on an itemized basis through its Clover point-of-sale system. Using those itemized reports from Clover and the cost of inventory consumed per the monthly reports, the City Auditor estimated the cost of inventory loss for the nine-month period from January through September 2017 at $2,484. When annualized, the cost figures amount to approximately $3,313. Broken down by category, estimated annualized losses were as follows:

	Shrinkage Annualized	Unit of Sale	Loss in Units	Loss in Bottles	Monthly Average
Liquor	$1,557	Ounce	2,022	63	5
Wine	$708	Glass	536	89	7
Beer	$1,048	Bottle	1,001	1,001	83
Total	$3,313				

Source: Monthly Inventory Reports

In terms of average monthly inventory loss, the analysis indicates that the amount of beer lost to shrinkage averaged 83 bottles, or about 3.5 cases. For wine, average monthly shrinkage was about 7 bottles, and for liquor, about 5 bottles per month.

A certain amount of skepticism is warranted in reviewing these results based on the questionable reliability of Contractor's physical counts. However, taken at face value, these numbers indicate losses of inventory that cannot be explained by spillage alone. More than likely, the losses are due to a combination of spillage and theft. As previously mentioned, theft can take several forms, including intentional over pouring, under charging, unauthorized comping of drinks, and theft of inventory.

Contractor provides one, part-time bar manager to manage the Center's Operation. However, large events may have up to seven serving stations operating at one time. Further, the bar manager may have to staff a serving station, on occasion, if a bartender is a no-show. As a result, the bar manager's ability to effectively supervise the operation may at times be sharply reduced, which creates an environment conducive to waste and abuse.

In terms of sales, the total estimated loss of inventory in liquor, wine, and beer in FY 2017 had a combined sales value of approximately $15,000, as shown in the graphic below:

Source: Monthly Inventory Reports

Total estimated losses in sales value amount to 8 percent of the operation's $183K revenue for FY 2017. While there may be multiple factors contributing to these losses, the underlying cause lies in the fact that Contractor bears no financial responsibility under the current Agreement for its performance in the area of inventory maintenance.

Financial Incentive for Maintenance of Inventories
Under the terms of the Agreement, Contractor is required to "*conduct a monthly inventory and provide ending inventory balances to Permittee within five (5) days of completion of the inventory…*" However, there is no enforcement mechanism built into the Agreement to ensure that Contractor minimizes the loss of inventory to spillage and theft.

By contrast, the Agreement clearly delineates Contractor's financial responsibility with regard to cash receipts. Specifically, the Agreement states that Contractor is "*accountable for all cash receipts from the Operation.*" The Agreement further states that Contractor "*is responsible for any losses that occur between collection of the cash and delivery of the cash*…." i.e., if bartenders' cash drawers come up short, the loss is borne by Contractor, not the City. Therefore, it is in their financial interest to minimize cash shortages. No such incentive exists with regard to inventory maintenance.

The loss of City assets in the form of inventory is no different than the loss of City assets in the form of cash. While a certain amount of inventory shrinkage is unavoidable in any bar operation, future agreements should establish an acceptable, agreed-upon threshold for inventory losses, beyond which the contractor should be held financially accountable.

It should be noted that Contractor assigned a new bar manager in January 2018, who is currently working with the KCCC Director to improve the inventory process. In addition, the KCCC Director is working with the Finance Department to improve the accuracy, consistency, and utility of the monthly reports.

Management Fee

Under the terms of the original Agreement established in 2005, the City agrees to pay Contractor 40 percent of gross receipts realized by the Operation. From FY 2005 through March 2018, the City paid out approximately $1 million in management fees. The percentage fee has not been revisited in the 13 years since it was established.

The fee may indeed represent fair compensation for the services provided. However, it is not clear on what basis the fee was determined. Further, a limited review by management of the labor breakdown between KCCC and Contractor's staff indicates that KCCC staff performs the overwhelming majority (approximately 80 percent) of the staff work involved in planning and staging events that include mixed beverage services. This includes event planning, assisting Contractor with inventory ordering, conference room set-up, conference room breakdown, assisting Contractor with pre- and post-event liquor-cart inventories, assisting Contractor with monthly inventories, and event bookkeeping.

Based on the lack of any analytical justification for the original fee, a more detailed analysis is warranted to determine if the City should renegotiate its rate of compensation for future agreements. While the contractor is certainly entitled to a profit, the amount should be reasonable and in line with industry averages.

Mixed Beverage Operation at Crossroads

As the KCCC enters the third and final year of its renewed Agreement, it is approaching a crossroads. In the coming months, the Center will need to decide whether to continue along the current path, or to chart a new course. Based on the contractor's past performance and on the lack of enforcement mechanisms in the original Agreement, the City Auditor does not recommend renewing the 2005 Agreement for another term, and instead recommends one of the following alternatives:

Alternative 1: Issue a new Request for Proposal.

This option may ultimately result in the selection of the same vendor. However, the RFP process will give the City the opportunity to revise the terms of its contract to incorporate financial penalties for inventory losses beyond a certain threshold, and to assess the appropriateness of the original management fee, and make adjustments if warranted.

Alternative 2: Bring Mixed Beverage Operation fully in-house.

KCCC staff already performs the overwhelming majority of work associated with Center events, so this would amount to an incremental change. A number of convention centers have in-house mixed beverage operations, including the Lake Granbury Convention Center, in Granbury, Texas. Although smaller in size, the Granbury operation is comparable to that of KCCC. According to the Lake Granbury Center

Director, the mixed beverage operation is staffed by on-call, part-time, employees.

Bringing the operation in-house would require the hiring of a full-time bar manager, according to the KCCC Director. The cost for this position, and the part-time, on-call employees would be offset, at least partially by funds previously used to pay the management fee. Further, additional time and effort would be required of Human Resources, at least in the initial staffing up phase. However, under this option management would be better able to hold staff accountable for their performance, and management would have greater flexibility in responding to clients' needs.

Alternative 3: Dismantle the Mixed Beverage Operation

Under this option, the Center would essentially shed itself of the mixed beverage service and shift the burden to the Center's clients. The clients would then have to arrange on their own for caterers to provide mixed beverage services at their events. The caterers would then pay a fee to the KCCC for use of its facilities and equipment, much the same as food caterers do now.

This would simplify the KCCC operation by eliminating its need to maintain inventory and retain servers, contract or otherwise. However, its implementation would be problematic. There are at present relatively few vendors in the Central Texas area, who provide mixed beverage catering services. As a result, Conference Center clients may not only be inconvenienced by the lack of available options, but may ultimately be forced to forgo the services if they are unable to find a caterer, or can't afford the additional cost. In addition, the Center currently provides services at the City's annual Rodeo Killeen, as well as a number of events at the KAAC, and a handful of events at the Special Events Center. In all likelihood, the Center would have to retain a scaled-down portion of its operation for these events to avoid a disruption of service, which would defeat the main purpose of the alternative.

Ultimately, the path chosen boils down to the philosophical question of how the Civic and Conference Center envisions its role as a public gathering place, i.e., as a no-frills venue, a full-service provider, or something in between.

Conclusion

The KCCC, under new leadership has made significant strides to improve its mixed beverage operation since the last internal audit. Taken as a whole, these improvements should serve to enhance both the efficiency and effectiveness of the operation. However, the Center continues to struggle with the outsourced portion of the operation, in particular in the area of inventory management. According to Contractor's monthly inventory reports for FY 2017, the operation suffered unexplained losses in its beer and wine inventories far beyond an acceptable level. Total estimated losses for all inventory in terms of sales value amounted to approximately $15,000, or about 8 percent of total sales revenue for the year. In order to address this problem, management needs to exert greater control over the operation, either through enforceable contract provisions, or by bringing the outsourced portion of the Operation in-house.

Recommendation:

The City Auditor recommends that the Community Development Director and KCCC Director consider one of the following alternatives to renewing the City's management services agreement for KCCC's mixed beverage operation:

1. Develop and implement a plan to issue a new RFP to seek bidders for the mixed beverage operation. The RFP process should include modification of the original contract terms to include financial penalties for inventory losses above a stated threshold. In addition, the City should assess the appropriateness of the original management fee and make any adjustments deemed necessary.

2. Develop and implement a plan for bringing the outsourced portion of the mixed beverage operation, in-house.

3. Develop and implement a plan for dismantling the mixed beverage operation and shifting the responsibility for beverage services to the client.

OTHER MATTERS

Opportunities to Enhance Revenues

The KCCC's Beverage Cartage permit allows the Center to extend its mixed beverage services to other City venues. The KCCC currently utilizes this permit to provide services for wedding receptions and other events at the Killeen Arts & Activities Center. The combined revenue for these events in FY 2017 was $8,544, representing only 5 percent of the year's revenue. However the potential exists to enhance revenue through greater utilization of this permit. Potential areas to consider include:

<u>Killeen-Fort Hood Regional Airport</u>
The airport has not had mixed beverage services since 2009. While a routine operation may not be practical, there may be occasions where mixed beverage services could be provided by the KCCC through its Beverage Cartage permit.

<u>Bob Gilmore and Lion's Club Park Senior Centers</u>
The Community Services Department organizes a number of senior citizen social events annually, some of which may benefit from the addition of mixed beverage services.

<u>Killeen Public Library</u>
A number of library districts in other states have in recent years begun incorporating alcoholic beverages into their adult programming. The programs typically occur after regular hours, are tightly controlled, and must provide some educational or cultural benefit. The City Auditor's discussions with several Library Directors indicated the programs were highly successful and well-received. The Library Director for the Lemont Library District in Illinois, for example, said the District's programming, included a booklovers discussion group with cocktails, a home brewing program with beer tasting, and murder mystery/escape room events. The Kalamazoo Public Library in Michigan, capitalized on Kalamazoo's vibrant American craft beer industry, and launched its "Booktoberfest" program several years ago. Initial programming included presentations on the history of brewing in Kalamazoo, home brewing, beer and food pairing ideas, and how to start your own brewery.[2]

[2] The Brewers Association defines American craft brewers as "small, independent, and traditional" breweries, also referred to as "microbreweries."

APPENDIX A

OBJECTIVES, SCOPE AND METHODOLOGY

Objectives

The objectives of the audit were to (1) Review the status of corrective actions taken in response to prior audit recommendations; (2) assess the contractor's performance with regard to inventory management; (3) assess the appropriateness of the management fee established under the initial agreement; and (4) assess opportunities to enhance liquor operation revenues. The scope of the review focused primarily on, but was not limited to KCCC Mixed Beverage Operations for FY 2017.

Scope and Methodology

The primary focus of the audit encompassed an analysis of the monthly inventory reports from October 2016 through September 2017. The audit also included some activity in FY 2018, primarily regarding operational improvements in progress. To address the audit objectives, the City Auditor:

- Reviewed prior audit findings, and corrective actions taken.
- Reviewed KCCC mixed beverage operation policies and procedures.
- Obtained and reviewed all monthly inventory reports submitted for FY 2017.
- Discussed mixed beverage operations with the KCCC Director and Community Development Director.
- Observed monthly inventory performed by Contractor's bar manager.
- Conducted research on conference centers, and on bar and restaurant industry with regard to best practices in management of liquor inventory.
- Determined monthly pour cost ratios and shrinkage rates for liquor, wine, and beer for FY 2107.

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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

MANAGEMENT RESPONSE

CITY OF KILLEEN - CITY AUDITOR
KCCC Mixed Beverage Operation Audit

Rec No.	Recommendation	Lead Department	Agree/Partially Agree/Do Not Agree/Comment	Estimated Implementation Date
1.	The Community Development Director and KCCC Director should consider one of the following alternatives to renewing the City's Management Services Agreement for KCCC's mixed beverage operation: 1. Develop and implement plan to issue a new RFP to seek bidders for the mixed beverage operation. The RFP process should include modification of the terms of the original agreement to include financial penalties for inventory losses above an agreed upon threshold. In addition, the City should assess the appropriateness of the original management fee and make adjustments, if warranted. 2. Develop and implement plan to bring the outsourced portion of the mixed beverage operation, in-house. 3. Develop and implement plan to dismantle the mixed beverage operation and shift the responsibility for beverage services to the client.	Community Development	The Executive Director of Community Development and the Director of the Killeen Civic and Conference Center will explore the recommendations #1 and #2. Recommendation #3 does not appear to be in the best interest of the City nor the facility, due to the inability to provide proper oversight of alcohol entering and exiting the facility.	March 2019