REPORT TO THE CITY COUNCIL
BY THE CITY INTERNAL AUDITOR

AUDIT OF THE CITY OF SHREVEPORT
CONVENTION CENTER HOTEL (HILTON)

INTERNAL AUDIT REPORT
(IAR) 210015-09

December 31, 2015

Report Highlights

- Available Net Operating Profit (Cash) should be transferred to City... 8-9
- Hotel management company received $266,000 in additional fees above contract amount 11
- The Convention Center Hotel is out-performing average of Shreveport-Bossier Hotels 15
December 31, 2015

Councilman Willie Bradford
Chairman, Shreveport City Council

Dear Councilman Bradford:

Subject: IAR 210015-09 – Audit of the Shreveport Convention Center Hotel (Hilton)

Attached please find the report mentioned above. Management comments are included in the report.

Sincerely,

[Signature]

Leanis L. Steward, CPA, CIA
City Internal Auditor

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Why We Did This Audit

We have completed an audit of the Shreveport Convention Center Hotel. This audit was conducted as one of our regularly scheduled audits included in the 2015 Annual Audit Plan developed by the City Internal Auditor. Our objective was to determine if HRI Lodging, Inc., the Manager of the Hotel, was operating efficiently and effectively within the guidelines of the City of Shreveport Qualified Management Agreement.

What We Recommended

To improve Hotel oversight we recommend the Convention Center Hotel Authority:

- Request in writing HRI transfer available Hotel Net Operating Profit to City
- Determine how to handle fees paid to HRI in excess of the Management Fee
- Require HRI to timely submit interim financial reports
- Review Fixed Asset purchases twice per year and count inventory at least once per year

To strengthen controls over Hotel Operations, we recommend that HRI:

- Transfer operating profit to City at Year-end
- Effective immediately, stop collecting 10% of fixed asset purchases
- Submit interim financial reports at the close of each Accounting Period
- Select a CPA to conduct an annual financial statement audit

Performance Audit:
Convention Center Hotel (Hilton)

What We Found

HRI was in compliance with the Hilton Franchise Agreement and other Hilton brand standards. In September of 2014 the Convention Center Hotel received an Acceptable rating on its Hilton Quality Assurance Evaluation and an Outstanding rating on its Service and Loyalty Tracking (SALT) performance, a measurement of overall service and guest room cleanliness. However, we found that HRI was not in compliance with the Qualified Management Agreement between HRI and the Convention Center Hotel Authority. Lack of oversight by the Convention Center Hotel Authority has allowed HRI to run the Hotel with minimal accountability.

We identified the following deficiencies:

- HRI did not transfer Net Operating Profit to the City at year-end for some of the years the hotel has been operating
- HRI paid itself “purchasing fees” in addition to the Management Fee
- HRI did not always submit monthly financial reports to the City
- HRI has not had a financial statement audit
- City does not inventory Hotel assets
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Introduction

In 2003, the Shreveport Convention Center Hotel Authority, operating for the benefit of the City of Shreveport, entered into a Qualified Management Agreement with HRI Lodging, Inc., engaging HRI to manage and operate the hotel. A Franchise License Agreement exists between HRI Lodging and Hilton Inns, Inc.; and it allows use of the Hilton name and access to and benefit of all Hilton branding and marketing. The hotel opened in June of 2007.

The annual budget and financial reporting for the Hilton is prepared by HRI and submitted to the City to be included in the City's Annual Operating budget as the Convention Center Hotel Enterprise Fund. Debt Service is paid by the City.

This report provides the results of the scheduled performance audit of Shreveport Convention Center (Hilton) Hotel. The purpose of this audit was to evaluate the effectiveness and efficiency of Hotel operations under the guidelines set forth in the Management agreement. The objective of this audit is to determine the following:

- Is HRI Lodging, Inc. in compliance with the Qualified Management Agreement and the Franchise License Agreement?
- Does the Hotel have policies and procedures in place to protect the City’s assets?
- How does the Convention Center Hotel’s key operating performance measurements compare to other Hilton Hotels in the U.S. and other hotel brands in the Shreveport-Bossier area?

Operating under the Hilton® name, the Convention Center Hotel is a 313-room facility that offers high-end amenities and has a lobby bar, three on-site restaurants, and a Starbucks® coffee shop.
The chart below summarizes the recommendations outlined in the report and our evaluation of risk for the recommendations. We evaluated the importance of each audit recommendation by assigning each a level of risk. The risk levels, as defined in the chart below, were determined based on the possible results for the entity if the recommendation is not implemented. This report contains three findings with seven recommendations.

<table>
<thead>
<tr>
<th>Risk Levels</th>
<th>Recommendations</th>
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</table>
| **High Risk**   | - At the close of each calendar year, HRI transfer Net Operating Profit to the City in order to mitigate Debt Service covered by the City *(Finding: Operating Profit)*  
- The City of Shreveport/Convention Center Hotel Authority consistently monitor Net Operating Profit on an interim basis *(Finding: Operating Profit)*  
- Effective immediately, HRI no longer charge additional fees for services executed under the Management Agreement *(Finding: Purchasing Fees)*  
- City Hotel Authority should determine whether or not HRI should refund the additional fees to either the Hotel Operating Account or to the City of Shreveport. *(Finding: Purchasing Fees)*  
- City Hotel Authority review Hotel Fixed Asset purchases no less than twice per year. *(Finding: Purchasing Fees)* |
| **Medium Risk** | - HRI submit interim accounting at the close of each Accounting Period *(Finding: Monthly Reports and Annual Audit)*  
- HRI select an independent certified public accountant to audit Hotel’s financial statements at each year end *(Finding: Monthly Reports and Annual Audit)* |
| **Low Risk**    | None  
- Possibility of continuing operating inefficiencies and some low-level non-compliance issues. |
Scope and Methodology

The scope of this audit includes Hotel operating activities and financial reporting and performance occurring during the years 2007-2015. To answer our objectives, we reviewed relevant internal controls and developed audit procedures that included but were not limited to the following:

- Interviewing City and Hotel administration and staff
- Researching the hotel industry
- Reviewing of hotel budget and financial reports
- Reviewing City Ordinances
- Reviewing all legal documents related to the construction, operation, and management of Hotel.

We conducted this audit in accordance with generally accepted government auditing standards, except that a peer review has not been performed. 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, conclusions, and recommendations based on our audit objectives.
Key Terms

Average Daily Rate (ADR)

Represents hotel room revenue divided by total number of room nights sold in a given period. ADR measures average room price attained by a hotel and ADR trends provide useful information concerning the pricing environment and the nature of the customer base of a hotel or group of hotels.

Debt Service

Debt Service is the monthly payment of principal and interest due under the Mortgage.

Gross Rooms Revenue

Revenue only from room sales (excluding revenues from Food & Beverages and other operated departments)

Occupancy

The total number of room nights sold divided by the total number of room nights available at a hotel. Occupancy measures the utilization of a hotel's available capacity. Management uses occupancy to gauge hotel demand in a given period and to help determine achievable ADR levels as room demand increases or decreases.

Revenue per Available Room (RevPar)

RevPar is calculated by dividing hotel room revenue by room nights available to guests for a given period. RevPar is considered to be a meaningful indicator of hotel performance as it provides a metric correlated to two primary and key drivers of operations at hotels: Occupancy and ADR.
FINDINGS AND RECOMMENDATIONS
Objective: Evaluate HRI’s compliance with the Qualified Management Agreement and the Franchise License Agreement

HRI has maintained compliance with Hilton’s Franchise agreement and has kept a good working relationship with Hilton corporate. All Hotel furnishings, marketing materials and customer satisfaction surveys are in line with Hilton brand standards. However, we found that HRI was not in line with the Qualified Management Agreement in the following aspects:

- HRI did not transfer Net Operating Profit to the City to offset Hotel Debt Service for some of the years of operations
- HRI paid itself additional fees (10% of the cost of fixed asset purchases) for services HRI is obligated to provide under the Management Agreement
- HRI did not submit monthly financial reports to the City; and HRI has not had hotel financial statements audited by a certified public accountant

Operating Profit

Paragraph 4.2.1 requires that if the Operating Profit is insufficient to pay Debt Service, “Manager shall notify Owner of the amount of the Debt Service Deficiency within five (5) days after Manager’s preparation of the accounting statement for such Accounting Period”; and “Manager shall, in good faith, attempt to notify Owner of any expected Debt Service Deficiency prior to issuance of the accounting statement for the applicable Accounting Period.”

Paragraph 4.2.2 requires distribution of Net Income in the following order of priority:

1. An amount equal to Debt Service
2. An amount Manager (HRI) has reasonably determined to be Available Cash Flow for the Fiscal Year to establish a reserve for management fee
3. An amount required to fund the Franchise Termination Fee Reserve
4. Any remaining balance of Operating Profit unless Manager determines that there will be a Debt Service Deficiency
Based on financial reports obtained from HRI, for the years ending December 31, 2007 to December 31, 2014, the Hotel realized a cumulative Net Operating Profit of $10.2M and has transferred $4.9M of that profit to the City. During that same period the total Hotel Debt Service was $13.8M. After deducting furniture and equipment purchases, HRI should have $2.6M available to transfer to the Hotel Enterprise Fund.

Table 1 summarizes Hotel Operating Profit transferred to the City and the remaining Debt Service surplus (deficit) for each year from 2007 to 2014.
Recommendation 1: At the close of each calendar year, HRI transfer Net Operating Profit to the City in order to mitigate Debt Service covered by the City.

Recommendation 2: The City of Shreveport/Convention Center Hotel Authority consistently monitor Net Operating Profit on an interim basis and make timely requests of monies due to City from Hotel.

Hotel Management Response:

Throughout the duration of the contract the management company received written requests regarding timing and amounts of funds transfer. Quarterly and Yearly reviews took place with the city each year throughout these time periods during which cash balances / transfers were discussed with no indication that funds were requested. Discussion was also around Capital planning and Hilton Brand Standards that needed to be addressed to ensure the asset was well maintained and in compliance with the Hilton Brand standards. Reserves needed to be kept to address future years' capital plans. The current cash balances within the operating accounts, if transferred, would fully meet the requirements in section 4.2.2.

City of Shreveport Management Response:

- **Recommendation 1:** City Management recognizes that the operating cash available for transfer from HRI is $2.6 million. City Finance will prepare a letter of request to HRI to pay this amount to the City within 15 days after receipt of the letter. Furthermore, the letter of request shall include language requiring that HRI comply with paragraph 5.1.2 of the Qualified Management Agreement by delivering a detail statement of operations within 60 days after the end of each fiscal year, and distributing operating profit within 15 days of the City's receipt of such statement.

- **Recommendation 2:** HRI and City management has maintained quarterly and annual reviews of the hotel performance. In addition, City Finance shall ensure the Hotel's delivery of interim financial statements within 20 days after the close of each accounting period as stipulated in Paragraph 5.1.1. Furthermore, Finance shall review and monitor net operating profit as reports are received and shall make timely requests of money due from the hotel.
Purchasing Fees

We reviewed invoices totaling $352,333 of the $438,950 HRI spent on furniture and equipment in 2014, and identified $36,000 in “10% purchasing fees” that HRI’s corporate office charged the Hotel for performing services related to the procurement of supplies and equipment. Internal Audit did not review the remaining $86,617 worth of invoices; however, we estimate $7,874 of those amounts are HRI purchasing fees (asset purchases plus the additional 10% totaling $86,617). Based on financial reports provided by HRI, we estimate the total purchasing fees paid to HRI since the inception of the Hotel in 2007 through December 31, 2014 are $241,620 and $266,134 through November 30, 2015.

The Qualified Management Agreement provides for a Base Management fee of $476,858 as a deduction of Gross Revenues paid to HRI in twelve equal monthly installments. The Management Agreement does provide for an Incentive Management Fee of .2% of Gross Revenues when there is available cash flow, ONLY after Hotel Debt Service has been paid. Under Article 2 of the Management Agreement, the procurement of supplies and equipment is part of the services HRI is required to provide. Compensation for those services is the management fee noted above, not a percentage of each purchase.

Section 2.2.1.3: Establish, implement, and revise, as necessary…procedures for the control of revenue and expenditures, for the purchasing of supplies and services…and for the scheduling of maintenance....
Recommendation 3: Effective immediately, HRI no longer charge additional fees for services executed under the Management Agreement.

Recommendation 4: City Hotel Authority should determine whether or not HRI, Inc. (parent company) should refund the additional fees to either the Hotel Operating Account or to the City of Shreveport, put determination in writing, and remit to HRI with the estimated time frame for execution if payment is to be made.

Recommendation 5: City Hotel Authority review Hotel Fixed Asset purchases no less than twice per year.

Hotel Management Response: While the management company agrees that the HMA does not expressly include purchasing fees within the indicated management fees, section 2.2.1.7 indicates the manager's obligation to procure all goods and services in the most cost effective manner available. All fees relating to procurement of capital goods up to and including renovation projects were remitted only after market inquiries indicated that the usage of other third party vendors would result in either a higher price point or a higher procurement fee. The management company immediately ceased charging purchasing fees upon being notified of the auditor's opinion pending resolution to this issue.

City of Shreveport Management Response:

- **Recommendation 3:** HRI has agreed to cease charging fees for purchasing services and to continue to provide for the purchasing of supplies and services at the most cost effective manner available.

- **Recommendation 4:** City Finance along with Hotel management shall determine the estimate amount of cumulative purchasing fees paid to HRI since the inception of the hotel. In order to fully comply with the terms of the management agreement, City Management shall request reimbursement of that amount to be due from the Hotel as reimbursement from HRI parent company within 15 days after receipt of the reimbursement request.

- **Recommendation 5:** City Finance performs an annual verification of the hotel's inventory. Furthermore, controls have been put in place by Finance for the proper purchase and disposal of the hotel's assets. The hotel is now required to complete and submit the city's standard fixed asset form with every asset purchase or disposal. The city shall continue to review fixed asset activity as it occurs.
Monthly Reports and Annual Audit

HRI did not submit interim accounting/financial reports to the Hotel Authority in accordance with the contract. At the commencement of our work accounting reports for the previous three months had not been received; and on three occasions during the eight months of field work, we had to initiate HRI submitting accounting reports to City Administration as it became necessary to complete our work. Accounting reports, as of November 30, 2015, have been submitted; however, none of the year-end financial statements have been audited by an independent certified public accountant.

Section 5.1.1
Within twenty (20) days after the close of each Accounting Period, Manager shall deliver an interim accounting to Owner showing a balance sheet, Gross Revenues, Deductions, Operating Profit, departmental income statements, and sources and uses of cash.

Section 5.2
An annual audit conducted by a certified public accountant selected by Owner and paid from Gross Revenues as a Deduction shall be made of the Hotel’s financial statements.

Recommendation 6: We recommend HRI submit interim accounting at the close of each Accounting Period per the guidelines in the Management Agreement.

Recommendation 7: Within thirty (30) days of year-end, HRI should select an independent external auditor. The Hotel Operating Budget should include the estimated cost of audit services. Within six (6) months of each year-end, HRI should submit a financial statement audit report prepared by an independent certified public accountant.

Hotel Management Response: No objection regarding recommendation 6, it should be noted that the period indicated represents three consecutive months in 2015 during which the property controller’s position was in transition. Currently all monthly reports have been forwarded to the City accounting offices and are completely up to date. No other exceptions have taken place during the duration of the contract. A CPA firm has been retained to review all required financial statements.

City of Shreveport Management Response:

• Recommendation 6: HRI has filled the vacant property Controller’s position that was cause for the 3-month consecutive lapse in financial reporting. HRI has resumed monthly reporting and shall continue with enforcement from city finance.

• Recommendation 7: A CPA firm has been retained and the Hotel has agreed to perform an annual independent external audit of the Hotel financials as required by paragraph 5.2 of the agreement. Annual enforcement of the completion of this audit will be provided City Finance.
Objective: Compare Hotel performance to other Hilton hotels and other hotel brands in the Shreveport-Bossier area

Hilton Hotels

Hotels branded under the Hilton name include Hilton Hotels & Resorts, Hilton Garden Inn, and Hilton Grand Vacations. The Shreveport Hilton is a Hilton Hotels & Resorts property. According to the Hilton Worldwide 2014 Annual Report, the flagship full-service Hilton Hotels & Resorts brand is the most recognized hotel brand in the world. We compared the Shreveport location to the Hilton-system hotel information provided in the Hilton’s 2014 annual report. As of December 31, 2014, the Hilton brand included 4,322 hotels with 715,062 rooms.

Table 2

<table>
<thead>
<tr>
<th>Year Ended, December 31</th>
<th>Convention Center Hotel</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
</tr>
<tr>
<td>Occupancy</td>
<td>72.3%</td>
</tr>
<tr>
<td>ADR</td>
<td>$104.67</td>
</tr>
<tr>
<td>RevPar</td>
<td>$74.27</td>
</tr>
</tbody>
</table>

*Table 2 shows the Occupancy, Average Daily Rate (ADR), and Revenue per Available Room (RevPar) over the past three years for the Convention Center Hotel.*

Table 3

<table>
<thead>
<tr>
<th>Year Ended, December 31</th>
<th>Hilton Hotels System-Wide</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
</tr>
<tr>
<td>Occupancy</td>
<td>74.6%</td>
</tr>
<tr>
<td>ADR</td>
<td>$141.52</td>
</tr>
<tr>
<td>RevPar</td>
<td>$105.63</td>
</tr>
</tbody>
</table>

*Table 3 shows the Occupancy, Average Daily Rate (ADR), and Revenue per Available Room (RevPar) over the past three years for the Hilton System.*

While the Hilton System experienced steady growth from 2012 to 2014, the Convention Center Hotel revenue per room peaked to $78 in 2012, fell to $72 in 2013 and rose slightly to $74 in 2014. Although Convention Center Hotel occupancy increased from 71% in 2012 to 73% in 2013, the ADR and RevPar decreased. An inverse relationship between number of rooms sold (occupancy) and income per room (ADR, RevPar) in a given period indicates an increase in room discounts for that period. This could also indicate that more rooms are being sold on lower-rate days (week days) than higher-rate days (weekends or holidays).
Chart 1 compares the 2009-2014 Hotel revenue trends to Hilton System revenue trends for the same period.

The Convention Center Hotel revenues peaked in 2010, experienced a decline from 2011 to 2013, and increased slightly in 2014.

Shreveport-Bossier area Hotels

The Shreveport-Bossier area currently has just over 10,000 hotel rooms. According to Smith Travel Research, Shreveport/Bossier hotels reported an ADR of $74 and an Average Occupancy (Avg. Occ.) of 58% for May 2015. As illustrated by Charts 1 and 2 below, the Convention Center Hotel out-performed hotel average in the Shreveport-Bossier area. At $109, the ADR was about $34 more than that of other area hotels; and the Avg. Occ. of 75% was about 17% more than the area average as of May 31, 2015.
This section discusses matters that were not part of our audit program but are significant to the unique relationship between the City of Shreveport and Hotel management. We address the status of previous Internal Audit recommendations and answer questions/concerns brought by the City Council, Administration, and/or circulated in the news media.

**2007 IA Auditing Alert**

In a July 30, 2007 Auditing Alert, the Internal Audit Office reported the results of its limited scope work performed to determine if the fixed assets of the Convention Center Hotel had been inventoried. The criterion for this work was City’s Administrative Procedure A.P. 3-6, which requires that all asset transactions are timely reported and accurately documented.

The City of Shreveport responded to Internal Audit’s recommendations with a Management Plan of Action that stated that they would establish guidelines for accounting for Hotel fixed assets, determine the frequency, and conduct periodic inventories of those assets. The chart below gives the current status of each recommendation.

<table>
<thead>
<tr>
<th>Finding</th>
<th>Recommendation</th>
<th>Current Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>City personnel had no guidelines to account for fixed assets of the Hotel</td>
<td>Establish guidelines for accounting for Hotel fixed assets</td>
<td>City of Shreveport Hotel Fund Accountant and Fixed Asset Accountant work together with HRI to account for Hotel fixed assets</td>
</tr>
<tr>
<td>No account or location code for the Hotel had been established in the Fixed Assets Accounting System</td>
<td>Establish guidelines for accounting for Hotel fixed assets</td>
<td>Hotel fixed assets are included in the City's Fixed Asset Accounting System</td>
</tr>
<tr>
<td>No inventory had been taken of any items at the Convention Center Hotel</td>
<td>City of Shreveport representatives immediately conduct an inventory of all Hotel assets</td>
<td>City of Shreveport has updated its procedures to include Hotel fixed assets in the annual review process</td>
</tr>
<tr>
<td>HRI did not give the City details of fixed assets purchased (i.e. number of items purchased, total amount spent in relation to the amount budgeted, etc.)</td>
<td>HRI provide the necessary documents and details to all assets purchased</td>
<td>HRI currently reports any changes to City of Shreveport Fixed Asset Accountant (purchases, disposition, transfers, etc.)</td>
</tr>
</tbody>
</table>
Sale of Hotel

A question often asked is should the Hotel be sold to a private hotelier. This section explains some of the legal and financial consequences involving the sale of the hotel.

1. The City would have to reimburse the State of Louisiana $12,000,000 disbursed from a 2003 G.O. Bond issued to begin construction of the hotel. Under the terms of a Cooperative Endeavor Agreement between the State of Louisiana and the City of Shreveport and the Convention Center Hotel Authority, the State would be entitled to the original $12M bond issue plus any interest that would have been accrued and realized from the time of the bond sale to the date of the sale of the hotel.

2. Hilton, Inc. has the right to first offer before Hotel Authority publicly markets. The Franchise Agreement requires that Hilton is given written notice of intent to sell with all required and appropriate information regarding the sale. The Hotel Authority must accept or reject Hilton's offer within twenty (20) days and may not sell the hotel for less than the amount offered by Hilton if Hilton's offer is rejected.

3. Hilton has the right to collect outstanding Royalty payments if the Hotel is sold and a new Franchise Agreement with Hilton is not enacted. A Termination Fee will be calculated by multiplying the Average Monthly Fees paid to Hilton over the preceding twenty-four (24) month period by thirty-six (36).

Termination Fee Calculation Example:

<table>
<thead>
<tr>
<th>2013 Royalty Payments*</th>
<th>$ 411,151.60</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014 Royalty Payments</td>
<td>$ 425,050.47</td>
</tr>
<tr>
<td>24-month Total</td>
<td>$ 836,202.07</td>
</tr>
</tbody>
</table>

*IA calculated 2013 Royalty Payments as a percentage of Gross Revenues provided by HRI. Due to software and personnel changes, actual 2013 Royalty Fees were not available.

Average Monthly Fees: 836202 ÷ 24 = $34,842/month

Termination Fee: 36 × $34,842/month = $1,254,303
Fair Share Participation

The Fair Share program was developed to ensure contracting and purchasing opportunities are made available to small, economically-disadvantaged businesses. Program participants are certified Disadvantaged Business Enterprises (DBE), Minority Business Enterprises (MBE), Women Business Enterprises (WBE), and Fair Share entities. The goal is 25% participation on all City procurements.

The management agreement requires that the HRI comply with the Fair Share Ordinance except where goods and services from Hilton-approved vendors are required. Fair Share utilization at the Hotel has dropped from 21.9% in 2009 to 7.7% in 2014. In 2014 the Hotel was successful in using Fair Share/DBE vendors for laundry and dry cleaning, car washing and detailing, landscaping, and office supplies.

IA identified DBE-eligible expenditures in the following areas:

- Audit Services
- Automotive Repairs
- Car Wash/Detailing Services
- Cleaning Services
- Exterminating Services
- Florists and Floral Supplies
- Gifts/Novelties/Souvenirs
- Heating and Air Conditioning Repair
- IT Services
- Landscaping Services
- Laundry
- Locksmiths
- Marketing Advertising
- Minor Renovations
- Office Furniture and Supplies
- Photography/Video Services
- Plumbing
- Power Washing
- Printing Services
- Security Guards and Patrol Services
Prepared by:

April M. Jordan, CFE, CLEA
Staff Auditor II

Approved by:

Leanis L. Steward, CPA, CIA
City Internal Auditor

aj:nd

c: City Council
   Clerk of Council
   Mayor
   General Manager, Shreveport Convention Center Hotel
   Chief Administrative Officer
   External Auditor