
OFFICE OF THE CITY AUDITOR

AUDIT OF THE MANAGEMENT AND OPERATION OF REUNION ARENA BY THE CENTER OPERATING COMPANY

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**December 13, 2002
Report No. 375**

Memorandum



CITY OF DALLAS

December 13, 2002

Honorable Mayor and Members of the City Council
City of Dallas

We have conducted an audit of the management and operation of Reunion Arena by the Center Operating Company.

The Center Operating Company's Statement of Operations present fairly, in all material aspects, Reunion Arena's revenues and expenses for the years ended December 31, 1998, December 31, 1999, and December 31, 2000. Statement of Operations for the year ended December 31, 2001, and the period ended July 31, 2002, were adjusted based on the COC's adjustments identified in May 2002. The adjusted statements match and report expenses in the proper reporting periods.

The dedicated escrow account was under-funded and some expenditures were disallowed because they were not deemed to be capital improvements. These issues are addressed in the audit findings. Final settlement of this account is pending.

The required inspections and inventory were performed; however, final determinations are pending as to whether repairs, replacements, or payments are required. These contingencies, and the settlement of the dedicated escrow account, were reported separately, in a letter dated December 13, 2002, to the Mayor and City Council.

We appreciate the cooperation of City and Center Operating Company staff during our examination.

Thomas M. Taylor

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City Auditor

c: Teodoro J. Benavides, City Manager

**AUDIT OF THE MANAGEMENT AND OPERATION OF REUNION ARENA
BY THE CENTER OPERATING COMPANY**

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EXECUTIVE SUMMARY

We have conducted an audit of the management and operation of Reunion Arena, by the Center Operating Company, LLP, (COC) for the period September 1, 1998 through July 31, 2002.

Our audit objectives were to determine whether:

- Center Operating Company's Statements of Operations properly reflected Reunion Arena's revenues and expenses
- The dedicated escrow account was properly funded and expenditures charged to this account were allowable
- The proper inspections and inventories were performed

We reviewed Reunion Arena parking revenues as related to COC. There were no material issues. We reviewed non-event parking revenues payable to the City. Non-event parking revenue is addressed in a separate audit report.

COC's Statement of Operations present fairly, in all material aspects, Reunion Arena's revenues and expenses for the year ended December 31, 1998, December 31, 1999, and December 31, 2000. Statement of Operations for year ended December 31, 2001, and the period ended July 31, 2002 were adjusted based on COC's adjustments, identified in May 2002. The adjusted statements match and report expenses in the proper reporting periods.

The dedicated escrow account was under funded and some expenditures were disallowed because they were not deemed to be capital improvements. These issues are addressed in the audit findings. COC has agreed to make additional contributions, in the amount of \$41,796 and \$26,258, to the dedicated escrow account. Final settlement of this account is pending.

The required inspections and inventory were performed; however, final determinations are pending as to whether repairs, replacements or payments are required. These contingencies, and the settlement of the dedicated escrow account, were reported separately in a letter to the Mayor and City Council dated December 13, 2002.

We also discovered that the City had not been reimbursed for insurance costs or property taxes. COC did submit payment for insurance costs in the amount of \$98,413. COC is prepared to pay its pro rata share (estimated to be \$254,407) of property taxes and has requested an invoice. These items are addressed in the audit findings.

INTRODUCTION

Authorization

We have conducted an audit of the management and operation of Reunion Arena by the Center Operating Company, LLP (COC) for September 1, 1998, through July 31, 2002. This audit was conducted under the authority of Chapter IX, Section 2 of the Dallas City Charter and the provisions of the Reunion Arena Management Agreement.

Scope and Methodology

Our audit was conducted in accordance with generally accepted auditing standards as well as generally accepted government auditing standards and, accordingly, included inquiries, tests of the accounting and related records, and other procedures that we considered necessary in the circumstances.

Our audit objectives were to determine whether:

- COC's Statements of Operations properly reflected Reunion Arena's revenues and expenses.
- The dedicated escrow account was properly funded and expenditures charged to this account were allowable.
- The proper inspections and inventories were performed.

We noted that independent audits were performed for the years ended December 31, 1998, 1999, 2000, and 2001 on the consolidated financial statements of the COC and its wholly owned subsidiary, Arena Operating Company. The audited Consolidated Statements of Operations for the years 1998, 1999, and 2000 reported revenues and expenses that could be exclusively linked to Reunion Arena operations. We received copies of these audit reports and have relied on the information presented in them. The audited Consolidated Statement of Operations for the year 2001 reported revenues and expenses for both Reunion Arena and the American Airline Center (AAC). We were provided access to review the 2001 Consolidated Statement of Operations, but COC would not give us a copy of the report. However, with COC cooperation and our testing and inquiries, we were able to establish reasonable assurance that the 2001 financial data provided was for Reunion Arena.

We reviewed Reunion Arena parking revenues as related to the COC and found no material issues. We also reviewed non-event parking revenues payable to the City. Non-event parking revenue is addressed in a separate audit report.

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We focused our testing of COC's Statement of Operations on the calendar years 2001 and 2002. We judgmentally selected five months. We reconciled events held at Reunion Arena to the revenues and expenses reported for the months selected. Event records, general ledger, and Statements of Operations were in general agreement. We also tested expenses, based on a judgment sample, which we deemed to be allowable.

Review of activity for the dedicated escrow account showed that there were no expenditures for 1998. Inquiries revealed that there was no documentation approving capital improvements for 2002; therefore, all 2002 expenditures charged to the dedicated escrow account were reviewed. We selected a judgmental sample of twenty-five expenditures for the calendar years 1999-2002.

The City hired a third party to perform an inspection of Reunion Arena and its related facilities. Additionally, the COC hired a third party to perform an inventory of personal property. Final determinations are pending as to whether repairs, replacements, or payments are required.

To obtain information and general understanding of the relevant activities and processes, we reviewed contracts and agreements, interviewed staff, made inquiries of City employees that had knowledge of Reunion Arena, and interviewed COC staff.

Overall Conclusion

COC's Statements of Operations present fairly, in all material aspects, Reunion Arena's revenues and expenses for the years ended December 31, 1998, December 31, 1999, and December 31, 2000. Statements of Operations for the year ended December 31, 2001, and the period ended July 31, 2002, were adjusted based on the COC's adjustments identified in May 2002. The adjusted statements match and report expenses in the proper reporting periods.

The dedicated escrow account was under-funded and some expenditures were disallowed because they were not deemed to be capital improvements. These issues are addressed in the audit findings. Final settlement of this account is pending.

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The required inspections and inventory were performed; however, final determinations are pending as to whether repairs, replacements, or payments are required. These contingencies, and the settlement of the dedicated escrow account, were reported separately, in a letter dated December 13, 2002, to the Mayor and City Council.

We also discovered that the City had not been reimbursed for insurance costs, or property taxes. These items are addressed in the audit findings.

Background

The Reunion Arena Management Agreement (Agreement) was entered into as of July 28, 1998, between the City and the Arena Group. Pursuant to the terms of the Agreement, commencing on September 1, 1998, and for a period of five years, the Arena Group is responsible for all costs of operations, repairs, and maintenance (excluding capital improvements) of Reunion Arena and all costs of the City arising under existing contractual obligations relating to the management and operation of Reunion Arena. The Arena Group was not required to make any payments to the City under the Agreement. The Arena Group was to retain all net revenues generated by Reunion Arena and related event parking. The City would retain all net revenues generated by non-event parking.

The initial term of the Agreement was five years and was renewable for successive five-year terms. The Arena Group may terminate this Agreement at any time upon sixty days' prior written notice to the City, provided that if such termination is prior to the end of any five-year term, the Arena Group shall pay to the City any pre-paid third-party use fees, rental fees, naming rights, or other material fees relating to Reunion Arena.

As part of the Agreement, the Arena Group was required to reserve 4.7% of Reunion Arena gross revenues (i.e., dedicated escrow account) to fund capital improvements. Following termination of this Agreement, monies remaining in the dedicated escrow account shall belong to the City. Upon termination of this Agreement, the Arena Group shall turn over Reunion Arena and related facilities in substantially the same condition as when the Arena Group assumed control, ordinary wear and tear accepted.

The COC, a Texas limited partnership, was formed on September 30, 1999, with operations effective October 1, 1999, by affiliates of the Dallas Mavericks, a franchise in the National Basketball Association, and the Dallas Stars, a franchise in the National Hockey League. These affiliates had previously entered into contracts with the City to participate in the acquisition and development of land in downtown Dallas for the construction, financing, and operation of the AAC, a new

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multipurpose entertainment and sports center that began operations in July 2001.

COC operations included the development and management of AAC and the management of Reunion Arena, pursuant to the agreements originally entered into in the name of the Arena Group and the City.

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CENTER OPERATING COMPANY STATEMENT OF OPERATIONS

	Sept - Dec 1998 Total	1999 Totals	2000 Totals	2001* Totals	Jan-Jul 2002 Totals
Reunion Arena Revenue:					
Event Income	\$ 959,467	\$ 4,699,986	\$ 5,107,399	\$ 3,116,989	\$ 803,423
Food and beverage	777,019	3,404,858	4,394,673	2,704,650	290,075
Novelty	112,204	401,762	486,752	251,675	200,230
Parking	535,234	3,328,521	3,268,441	1,971,342	405,089
Other	92,006	853,676	951,050	913,264	269,631
Total Revenues:	\$ 2,475,930	\$ 12,688,803	\$ 14,208,315	\$ 8,957,920	\$ 1,968,448
Reunion Arena Expenses:					
Event Services	\$ (262,134)	\$ (2,004,922)	\$ (1,918,005)	\$ (1,330,737)	\$ (318,481)
Building Operations	(737,257)	(2,863,018)	(3,135,581)	(2,202,225)	(656,798)
General and administrative	(1,085,127)	(4,579,262)	(5,311,780)	(4,527,397)	(2,012,583)
Total Expenses:	\$ (2,084,518)	\$ (9,447,202)	\$ (10,365,366)	\$ (8,060,359)	\$ (2,987,862)
Reunion Arena Net Operating Income:	\$ 391,412	\$ 3,241,601	\$ 3,842,949	\$ 897,561	\$ (1,019,414)
Other:					
Depreciation	(2,791)	(31,193)	(119,695)	(198,174)	(108,205)
Net Income (Loss):	\$ 388,621	\$ 3,210,408	\$ 3,962,644	\$ 699,387	\$ 1,127,619

*AAC began holding events July 2001.

AUDIT FINDINGS

Our audit was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the audit findings presented in this report may not be comprehensive of the areas where improvements may be needed.

1. Gross revenue was not used for computing the 4.7% contribution to the dedicated escrow account.

COC deducted event expenses to arrive at gross income and used this amount as its basis for computing the 4.7% contribution. The Reunion Arena Management Agreement identifies the requirements for the dedicated escrow account to be 4.7% of total annual Reunion Arena facility gross revenues. Gross revenues should be all revenues before any deductions, allowances, credits, or adjustments. We noted that COC was accounting for gross parking revenues and parking expenses to ascertain the costs of events. However, the parking expenses were actually incurred by the parking lot operator, and the revenue received by COC from the parking lot operator was net of expenses. This payment method by the parking lot operator was the same method previously used for payments to the City. Therefore, we determined gross revenues to be revenues from all sources less parking expenses to arrive at the proper basis for computing the 4.7% contribution to the dedicated escrow account.

The Reunion Arena Lease Agreement Between the City of Dallas and Dallas Basketball Limited, Section 15.4 set up the initial 4.7% contribution requirement and states, "...City agrees to invest each year an amount equal to a minimum of four and seven tenths percent (4.7%) of total annual Arena facility gross revenues received by City each fiscal year for the use of the Arena from tenants and all other sources derived from the use of the Arena...."

The dedicated escrow account was under-funded by \$41,796. See Schedule 1 (page 13) for details.

Year	Amount Funded per COC Schedule	Amount required to be funded	Difference
1998	88,948	88,948	0
1999	313,608	322,600	(8,992)
2000	462,532	483,588	(21,056)
2001	554,068	562,240	(8,172)
2002	<u>354,390¹</u>	<u>357,966²</u>	<u>(3,576)</u>
	1,773,546	1,815,342	(41,796)

We recommend that the COC contribute an additional \$41,796 to the dedicated escrow account.

¹ This amount funded is for the period Jan – Sept 2002

² This is for the period Jan – Sept 2002

AUDIT FINDINGS

COC's Response:

COC adopted accounting practices consistent with those employed by the City. COC did, however, implement new business practices that enabled us to contribute hundreds of thousands of dollars more to the escrow account (or the CapX fund.) That was possible because COC could take risk on events, promotions, retail items and ticket management. The City, of course, cannot take those kinds of risks when operating Reunion Arena because it would involve risks of taxpayer dollars. The truth is that privatizing some of Reunion Arena's operations allowed substantial taxpayer benefit due to greater contributions to the escrow account.

In order to resolve the interpretation of the manner in which the contribution is computed, we will agree to contribute an additional \$41,796 to the dedicated escrow account.

2. Expenditures were not capital improvements.

Testing of expenditures charged to the dedicated escrow account revealed that:

- COC acknowledged that two expenditures (totaling \$21,411) were misclassified and should not have been charged to the dedicated escrow account.
- Two expenditures (totaling \$37,905) were disallowed because they were not deemed to be capital improvements, major maintenance, or refurbishing, and there was no City approval for the expenditures. These expenditures were:
 - A payment of \$26,815 for banners.
 - A reimbursement to the Mavericks of \$11,090 for photographs.

These expenditures, totaling \$59,316, should not have been charged to the dedicated escrow account. The COC charged these amounts to the escrow account because it believed that if the expenditure was for the benefit of the teams (Mavericks or Stars), then it was an allowable cost. At the same time, the COC over-funded the signage portion of the dedicated escrow account by an amount of \$33,058. Therefore, the disallowed expenditures should be offset by this over-funded amount.

The Agreement, Section 23 (b) states, "Reunion Arena capital improvements, major maintenance or refurbishment (beyond maintenance and repairs otherwise required of Arena Group under this Agreement) may be accomplished by Arena Group using monies to be paid by the Arena Group into the dedicated escrow account and such monies shall be spent on projects at Reunion Arena selected by mutual agreement of Arena Group and the City."

We recommend that the COC contribute an additional \$26,258 to the dedicated escrow account.

AUDIT FINDINGS

COC's Response:

This is in reference to banners and pictures added in the concourses and hallways to improve the ambience in the public areas. We believe the expenditures were capital improvements, especially since the banners are still in place. However, given the City's position, we agree to provide an additional \$26,258 to the escrow account and we respectfully request the return of the decorative banners.

3. The City was not reimbursed for property insurance costs.

The City did not receive complete reimbursement for property insurance costs for Reunion Arena from COC for FYs 1998-2002.

Convention and Event Services (CES) did not invoice the COC for property insurance pursuant to Section 9e of the Agreement for FYs 1999-2002. Risk Management did not provide CES with the property insurance cost for FY2001-2002.

The Agreement, Section 9e, Reimbursement of Property Insurance Costs, states, "During the Term, Arena Group shall reimburse the City for all costs of property insurance on Reunion Arena and the RPC (Reunion Parking Center) in accordance with Subsection 12c."

The Agreement, Section 12c, Property Insurance, states, "The City shall pay the cost for this insurance, and shall be promptly reimbursed by the Arena Group following receipt from the City of an invoice for such cost."

Based on the amounts that Risk Management communicated to CES for FY1999-00 and FY 2000-01 and the amounts that were not communicated to CES for FY1998-99 and FY2001-02, CES has not invoiced the COC for \$98,413 for property insurance at Reunion Arena. The following table shows the unbilled amounts:

UNBILLED INSURANCE COSTS	
TERM	COSTS
09/01/98 to 05/14/99	\$19,728
05/14/99 to 10/01/99	\$10,749
10/01/99 to 10/01/00	\$15,181
10/01/00 to 10/01/01	\$36,314
10/01/01 to 10/01/02	\$46,856
Amounts paid to date	(\$30,415)
TOTAL	\$98,413

We recommend that CES immediately invoice the COC for the reimbursement of property insurance costs for previously unbilled amounts. (CES invoiced COC on October 2, 2002 and received payment on October 22, 2002.)

AUDIT FINDINGS

COC's Response:

The City has been paid for property insurance costs. The issue here is that the City did not submit an invoice for the 10/01/99 – 10/01/02 property insurance until October 2002. Upon receipt, the bill was immediately paid.

4. COC owes the City for pro rata property taxes.

COC is responsible for paying property taxes through September 30, 2002, for property leased for use as parking lots at Reunion Arena.

Property taxes to be reimbursed to the City are:

Description	2002 Estimate	COC's Pro Rata Share for Jan. 1 through Sept. 30, 2002
Property Taxes	\$339,342	\$254,507

We recommend that CES immediately bill the COC for its pro-rated shared of property taxes.

COC's Response:

COC's share of the property taxes for 2002 will be paid. As of today, we have not received an invoice for those taxes. We do not understand why this is included in the audit report. In the past, the City has not sent a bill for those taxes until approximately seven months after the end of the taxable year. We respectfully request an invoice for the property taxes due for 2002.

AUDITOR'S RESPONSE:

This item was reported to disclose that a liability exists for COC and that action is required by CES to collect these taxes.

NOTES

Fiscal Year Information

- COC's fiscal year for financial reporting is the calendar year end December 31.
- COC's fiscal year for reporting its operations is June 30. This schedule is necessary to meet its lenders' requirements and was implemented in 2001.
- COC's fiscal year for computing its 4.7% requirement for the dedicated escrow account is the 12 months ending August 31. The Arena Group took control of Reunion Arena on September 1; therefore, this twelve month period was adopted for purposes of the dedicated escrow account.

Revenue Recognition

Event revenue is recognized as the events occur. Event-related revenue was comprised of rental income, parking, sale of novelties, and food and beverages depending on the contract negotiated for each event.

Expense Recognition

Expenses are recognized as incurred. Event services represents expenses for the specific event and is net of reimbursements received from the promoter. Building operations represents expenses for operations and box office. General and administrative represents expenses for executives, finance, marketing, and overhead.

Property and Equipment

Computers, machinery and equipment, and furniture and fixtures are depreciated using the straight-line method over the estimated useful life of thirty-six months.

Schedule 1

Description of 4.7% Contributions to Dedicated Escrow Account

Center Operating Company (COC) assumed management control on September 1, 1998, and, therefore, uses the 12-month period ending on August 31st for computing its 4.7% contribution. COC's initial computations were based on the City's Reunion Arena revenues (\$5,677,532) for FY97-98. In subsequent computations, COC deducted event expenses (a.k.a. service income) to arrive at an adjusted gross income for its basis to compute the 4.7% contribution.

We used the same 12 month period and revenues from all sources, less parking expenses (since these expenses were actually incurred by the parking lot operator), to arrive at the proper basis for computations. We used this basis to compute the 4.7% contribution to the dedicated escrow account.

Computations and comparison are detailed as follows:

	1998 amount funded per COC records	Computation per Auditor
Sept 98 - Dec 98	<u>\$88,948</u> (\$22,237 x 4 months)	<u>\$88,948</u>
	1999 amount funded per COC records	Computation per Auditor
Jan 99 - Aug 99	\$177,896 (\$22,237 x 8 months)	\$177,896
Sept 99 - Dec 99	<u>135,712</u> (\$33,928 x 4 months)	<u>144,704</u> (36,176 x 4 months)
	<u>\$313,608</u>	\$322,600
	2000 amount funded per COC records	Computation per Auditor
Jan 00 - Aug 00	\$271,424 (33,928 x 8 months)	\$289,408 (36,176 x 8 months)
Sept 00 - Dec 00	<u>191,108</u> (47,777 x 4 months)	<u>194,180</u> (\$48,545 x 4 months)
	<u>\$462,532</u>	\$483,588
	2001 amount funded per COC records	Computation per Auditor
Jan 02 - Aug 01	\$382,216 (\$47,777 x 8 months)	\$388,360 (\$48,545 x 8 months)
Sept 02	<u>171,852</u> (42,963 x 4 months)	<u>173,880</u>
	<u>\$554,068</u>	<u>\$562,240</u>
	2002 amount funded per COC records	Computation per Auditor
Jan 02 - Aug 02	\$343,704 (\$42,963 x 8 months)	\$347,760 (43,470 x 8 months)
Sept 02	<u>10,686</u>	<u>10,206</u> (1 month - Sept 02)
	<u>\$354,390</u>	<u>\$357,966</u>

Summary

Year	Amount Funded per COC records	Amount required to be funded	Difference
1998	\$ 88,948	\$ 88,948	\$ 0
1999	313,608	322,600	(8,992)
2000	462,532	483,588	(21,056)
2001	554,068	562,240	(8,172)
2002	<u>354,390³</u>	<u>357,966⁴</u>	<u>(3,576)</u>
	<u>\$1,773,546</u>	<u>\$1,815,342</u>	<u>\$(41,796)</u>

Conclusion: Dedicated escrow account was under-funded by \$41,796.

1 This amount funded for Jan – Sept 2002

2 This amount is for Jan –Sept 02

³ This amount funded for Jan – Sept 2002

⁴ This amount is for Jan – Sept 02