

Office of Inspector General
U.S. House of Representatives
Washington, DC 20515-9990

MEMORANDUM

TO: Scot M. Faulkner
Chief Administrative Officer

FROM: John W. Lainhart IV 
Inspector General

DATE: July 18, 1995

SUBJECT: Audit Report - Changes In Operating Practices Could Save Office Supply Store And Gift Shop \$1.3 Million Annually (Report No. 95-CAO-07)

This is our final report on the performance audit of Office Supply Store and Gift Shop operating practices. The objective of the audit was to assess opportunities to improve efficiency and service delivery in retail operations. In this report, we identified opportunities for saving over \$1.3 million annually in Supply Store and Gift Shop operations, primarily through contracting out and/or improving various aspects of operations.

In response to our June 8, 1995 draft report, your office generally concurred with our findings and recommendations. The June 28, 1995 formal management response provided by the Director, Internal Controls and Continuous Improvement, is incorporated in this final report and included in its entirety as an appendix. The corrective actions being taken and planned by your office in response to our recommendations are appropriate and, when fully implemented, should adequately address two of the three findings in the report. With respect to your alternative strategy for closing the Supply Store, we recognize and appreciate your commitment toward achieving the thrust of our concerns. However, we strongly suggest you reconsider contracting out the Supply Store operations at this time, or at least move up your time frame for evaluating this possibility rather than waiting until March 31, 1996. In our view, this approach would not only be beneficial to House operations but also enable the House to realize significant cost-savings. With respect to this unresolved issue, we request that you provide us comments within 30 days.

We appreciate your office's prompt response and concurrence with the recommendations, and the courtesy and cooperation extended to us by your staff. If you have any questions or require additional information regarding this report, please call me or Craig W. Silverthorne at (202) 226-1250.

cc: Speaker of the House
Majority Leader of the House
Minority Leader of the House
Chairman, Committee on House Oversight
Ranking Minority Member, Committee on House Oversight
Members, Committee on House Oversight

CHANGES IN OPERATING PRACTICES COULD SAVE OFFICE SUPPLY STORE AND GIFT SHOP \$1.3 MILLION ANNUALLY

Report No. 95-CAO-07

July 18, 1995

RESULTS IN BRIEF

CONCLUSIONS

Supply Store

The House Stationery Revolving Fund was used to fund Supply Store inventory. The Supply Store was responsible for recovering costs incurred by the revolving fund. However, Supply Store operations were structured to recover the cost of goods sold only. Appropriated funds covered other operating expenses, largely labor and benefits. We estimate that operating expenses covered by appropriations in Calendar Year (CY) 1994 were over \$1 million. To recover the full cost of operations, we estimate that the Supply Store would have to markup goods sold by an average of 20 percent.

In addition, the Supply Store stocked and stored 2,114 items. More than 80 percent of the stocked items accounted for less than 5 percent of the sales. Low turnover items were stocked to support unique needs of the Members. Stocking low turnover items increased the need for storage space, retail floor space, and warehouse labor, and increased carrying costs and inventory shrinkage. In addition, a significant number of special orders were generated by Members for items that were not carried in the regular inventory. In CY 1994, special orders constituted 65 percent of all orders placed by the Supply Store. These special orders routinely took more than 24 hours and as much as three weeks for delivery.

Also, Supply Store on-hand inventory in CY 1994 was valued at \$1.3 million. Most modern retail operations that offer comparable service attempt to minimize inventory on-hand with a just-in-time inventory system. We estimate that the Office Supply Service (OSS) could save \$250,000 per year if it reduced inventory on-hand.

Moreover, contrary to a requirement of the policy directive of the Subcommittee on Administrative Oversight of the Committee on House Administration, OSS did not produce monthly financial reports for the Supply Store. As a result, OSS did not have the information necessary to facilitate the management of operations.

Further, the Supply Store sold \$1.2 million of American Flags to the general public through congressional offices. We estimate the House lost approximately 20 percent of the acquisition

price of every flag that was sold, resulting in a \$240,000 annual loss. The flags were sold at acquisition cost; therefore, the House did not recover the full costs associated with selling the flags.

Gift Shop

OSS opened the House Gift Shop on September 1, 1994. The Gift Shop operated at a \$90,000 loss from September through December 1994. If this performance trend continues, the shop will lose \$270,000 in its first 12 months of operations. Four factors contributed to this loss:

- Pricing Policy--The Gift Shop prices were marked up less than those of comparable enterprises.
- Labor Costs--The Gift Shop ratio of labor costs to annual sales was three times the average private sector ratio.
- Merchandise--Demand for most merchandise was weak in CY 1994. Of the items carried, 70 percent accounted for only 5 percent of total sales.
- Store Location--The Gift Shop location was suitable for selling to Members and staff. It was, however, less convenient to the general public.

RECOMMENDATIONS

We recommend that the Chief Administrative Office (CAO) develop proposals, for approval by the Committee on House Oversight, to: (1) close the retail Supply Store and use a contractor to implement a stockless inventory system and just-in-time inventory system; (2) price American Flags sold to the general public to recover full operating costs; and (3) modify Gift Shop operations by either contracting out the Gift Shop or continuing to operate the Gift Shop while addressing the four fundamental factors that contributed to the Gift Shop's loss (pricing policy, labor costs, merchandise, and store location).

MANAGEMENT RESPONSE

The Office of the CAO was in general agreement with the findings, conclusions, and recommendations. The CAO indicated that they intend to implement an alternative strategy to closing the Supply Store that includes performing: (1) a review of items carried; (2) reducing inventory items; (3) producing regular monthly financial reports, and adjusting staff based on workload; and (4) adjusting prices to reflect fully loaded costs. Once these actions are completed, the CAO promised to reevaluate the cost of contracting out the Supply Store by March 31, 1996. In adjusting prices, the CAO stated that the price of flags would be adjusted to reflect full costs. He further informed us that the Supply Store will discontinue purchasing and selling flags with the completion of the transfer of the responsibility for the flying and sale of flags to the Capitol Historical Society. In addition, the CAO advised us that they will continue

to operate the Gift Shop but plan to implement modifications to make the store a self-supporting and profitable operation. These modifications include adjusting prices to recover all costs, adjusting staff based on workload, stocking items that reflect the tastes of the public, and examining better means to inform the public of the shop's location.

OFFICE OF INSPECTOR GENERAL COMMENTS

The CAO's actions for recommendations associated with two (i.e., Findings B & C) of the three report findings are responsive and, should when fully implemented, satisfy the intent of our recommendations. However, we strongly suggest the CAO reconsider contracting out the Supply Store operations now, or at least move up the time frame for evaluating this possibility rather than waiting until March 31, 1996. Considering the fact that special order items represented 65 percent of all orders placed by the Supply Store and orders routinely took more than 24 hours and, as much as, three weeks for delivery, the House could more effectively meet its supply needs using contractors with 24 hour delivery services. Furthermore, considering items in greater demand represented only 16 percent of items carried in inventory, this approach would eliminate unnecessary costs and make available floor space for other use. Therefore, delaying considerations for contracting out this function for eight months would, in our view, only perpetuate operational inefficiencies and preclude the House from an opportunity to immediately realize significant cost-savings.

TABLE OF CONTENTS

TRANSMITTAL MEMORANDUM

RESULTS IN BRIEF i

I. INTRODUCTION

 Background 1

 Objective, Scope, and Methodology 1

 Internal Controls 2

 Prior Audit Coverage 2

II. FINDINGS AND RECOMMENDATIONS

 Finding A: Modifications To Supply Store Inventory Practices Could
 Save The House Approximately \$810,000 In Labor Costs And
 \$250,000 In Inventory Maintenance Costs 3

 Finding B: The House Lost \$240,000 In CY 1994 On American Flag
 Sales To The General Public 9

 Finding C: The House Gift Shop Lost \$90,000 During The First Four
 Months Of Operation 11

III. APPENDIX

 Appendix: CAO Management Response To The Draft Report 18

I. INTRODUCTION

Background

Office Supply Service (OSS) serves the House of Representatives (House) by providing office supplies and related services to the Members and staff. First, OSS operates a retail supply store (Supply Store) with 2,114 items in stock to provide a convenient walk-in source for office supplies required to support the Members' official duties. Second, the Supply Store provides order processing, order fulfillment, and desktop delivery services commonly provided by office suppliers.

Based on a House decision to separate sales of personal gift items from office supplies, the House Gift Shop was established in September 1994. The Gift Shop is open to the general public. All items are subject to a 20 percent markup.

The House funds the Supply Store and the Gift Shop from two sources. Supply Store and Gift Shop inventories are paid for by the House Stationery Revolving Fund. The revolving fund is a self-sustaining fund. OSS is not required to return the balance at year-end to the Treasury. OSS maintains the fund balance through depositing Supply Store and Gift Shop receipts. Salaries and benefits for all personnel are paid with appropriated funds.

Objective, Scope, and Methodology

The purpose of the retail services audit was to assess opportunities to improve the efficiency and service delivery in retail operations. The scope of this audit was limited to the review of retail operation activities in the Supply Store and the Gift Shop located in the Longworth Building in Washington, D.C.

The retail services audit program initially focused on four entities: the Supply Store, Gift Shop, Beauty Salon, and Barber Shop. However, during the course of the audit, the House decided to privatize the Beauty Salon and the Barber Shop. These entities were, therefore, eliminated from the retail services audit scope.

This audit was conducted for the period of October 1, 1993 through December 31, 1994. We conducted our audit work during the period of March through May 1995. When data was unavailable for calendar year (CY) 1994, we relied on first quarter CY 1995 data.

We conducted our review in accordance with generally accepted government audit standards, *Government Auditing Standards*, issued by the Comptroller General of the United States. Our review included the following steps:

- Evaluated the current operations of the Supply Store to identify opportunities to improve efficiency and effectiveness of service delivery.
- Evaluated the current operations of the Gift Shop to identify opportunities to improve efficiency and effectiveness of service delivery.
- Evaluated customer satisfaction for retail services under review to identify opportunities to improve service delivery.

OSS employees provided tours of both the Supply Store and the Gift Shop. They described operational policies and ordering procedures and gave us reports on sales volume, inventory, and suppliers. We interviewed management to determine the allocation of staff positions to the Supply Store and the Gift Shop.

We reviewed selected management, reporting, and operating policies and practices for the Supply Store and the Gift Shop. We documented current operations of both entities in terms of costs, revenues, and operating performance. We conducted a market analysis of comparable entities in the office supply and gift shop industries and interviewed industry experts from national trade associations. We used results of the market analysis to evaluate Supply Store and Gift Shop operations and to identify opportunities to improve operations and reduce costs.

Internal Controls

The focus of this audit was to evaluate the cost effectiveness of operations and to identify alternative methods of fulfilling the office supply needs of Members and operating the Gift Shop. Therefore, we did not evaluate internal controls in this audit. However, internal controls in Gift Shop operations are covered in a separate audit report and the audit of financial statements.

Prior Audit Coverage

In February 1995, the General Accounting Office (GAO) published a review of the Stationery Revolving Fund Financial Statements for the year ended September 30, 1992 and three months ended September 30, 1992. GAO found:

- Internal controls provided reasonable assurance that losses, noncompliance, or material misstatements in relation to the financial statements would be prevented or detected.
- Tests for compliance with selected provisions of laws and regulations disclosed no material instances of noncompliance.

II. FINDINGS AND RECOMMENDATIONS

Finding A: Modifications To Supply Store Inventory Practices Could Save The House Approximately \$810,000 In Labor Costs And \$250,000 In Inventory Maintenance Costs

The Supply Store did not recover operating expenses through sales in CY 1994. As a result, costs exceeded revenues by \$1 million. The policy directive from the Subcommittee on Administrative Oversight of the Committee on House Administration (Subcommittee) did not state clearly which store costs must be recovered.

In addition, the Supply Store stocked 2,114 items in its 2,400 square foot retail store. Eighty-four percent of the items (1,770 items) accounted for less than 5 percent of the sales. Stocking low turnover items increased the need for storage space, retail floor space, and warehouse labor, and increased carrying costs and inventory shrinkage expenses. In addition, a significant number of special orders were generated for items that were not carried in regular inventory. In CY 1994, special orders were 65 percent of all orders placed by the Supply Store.

Also, on average, the Supply Store had an on-hand inventory valued at \$1.3 million. The Supply Store incurred \$250,000 in labor to maintain this inventory in CY 1994. OSS is not held accountable for minimizing the costs of its on-hand inventory.

Further, contrary to the requirement of the policy directive of the Subcommittee, OSS did not produce monthly financial reports. As a result, OSS did not have the information necessary to facilitate the management of Supply Store operations.

Supply Store costs exceeded revenues by \$1 million in CY 1994

The House funded OSS from two sources: the House Stationery Revolving Fund and appropriations. The revolving fund covered the cost of inventory. When Members bought office supplies, their supply accounts were charged. These charges replenished the revolving fund. Appropriated funds were used to pay salaries and benefits for Supply Store personnel.

OSS management did not count salary and benefit costs or inventory shrinkage expenses against store operations. We estimated that, on a full-cost basis, Supply Store expenses exceeded revenues by over \$1 million in CY 1994. (Costs of space, depreciation, and maintenance are excluded.)

\$5,674,050	Revenues (sales) ¹
-1,100,226	Less Operating Expenses ²
<u>-\$5,604,226</u>	Less Cost of Goods Sold ¹
-\$1,030,402	Total Loss

Policy guidance from the Subcommittee did not state clearly whether acquisition costs or operating costs should be recovered from store revenues. OSS management interpreted at cost to mean only the revolving fund costs. As a result, they implemented policies charging acquisition cost rounded up to the nearest nickel for all sales.

The Subcommittee's policy directive of July 20, 1994 states, "All items will be sold at cost rounded up to the nearest nickel." OSS interpreted this policy to mean that only the acquisition cost of an item was to be recovered. According to OSS pricing policy, Members were charged the acquisition cost of an item, rounded to the nearest nickel. As a result, there was no markup applied to merchandise.

We interviewed senior management of the General Services Administration (GSA) to collect operational and procedural data for comparison with the Supply Store. The GSA fulfills the office supply needs of many Federal agencies. GSA is required to provide Federal government customers office and industrial supplies at the lowest prices, while accounting for and recovering all operating costs. An eight percent markup is applied to all GSA merchandise.

We interviewed four commercial vendors in the office supply industry. All the vendors suggested implementing a stockless inventory system. A stockless inventory is one that stocks top selling items on-site and orders other items when needed. Vendors place their own people on-site and recover operating costs from sales. One office supply superstore estimates a staff of six is needed to meet the office supply needs of an organization the size of the House. The Office of Management and Budget approved rate for fringe benefits is 29.55 percent.³ Including direct labor costs and fringe benefits of 29.55 percent, the House paid \$1.09 million to Supply Store employees in CY 1994. By closing the retail store and transitioning to a stockless supply

¹Source: Office Supply Service Register History Report

²Source: House Payroll Records and Inventory Disposal Report

³A fringe benefit rate of 29.55 percent is used, as prescribed by the Office of Management and Budget Circular A-76 for the Executive Branch cost-benefit calculations. This Circular sets governmentwide standards for comparing government costs to those of private vendors. All labor costs and rates in this report include salary and fringe benefits.

system, which could be operated with six employees, OSS could save approximately \$810,000 in salary and benefit costs. This savings was calculated by multiplying the average salary (including benefits) paid to OSS employees from House payroll data (\$46,999 x 6 employees).

In the Supply Store, over 80 percent of the items accounted for less than 5 percent of the sales

The Supply Store stocked 2,114 items. Supply Store management categorized these items based on sales volume into three categories (A, B, and C) and generated a report of this analysis entitled "ABC Analysis Report." The categories are defined as follows:

- A Items in the top 80 percent of sales.
- B Items in the next 15 percent of sales.
- C Items in the bottom 5 percent of sales.

The Supply Store overstocked low turnover items. For example, in the first quarter of CY 1995, Category C included 1,700 (80 percent) of the items in inventory, and represented less than 5 percent of the sales (see Figure 1). Similar information was unavailable for CY1994;

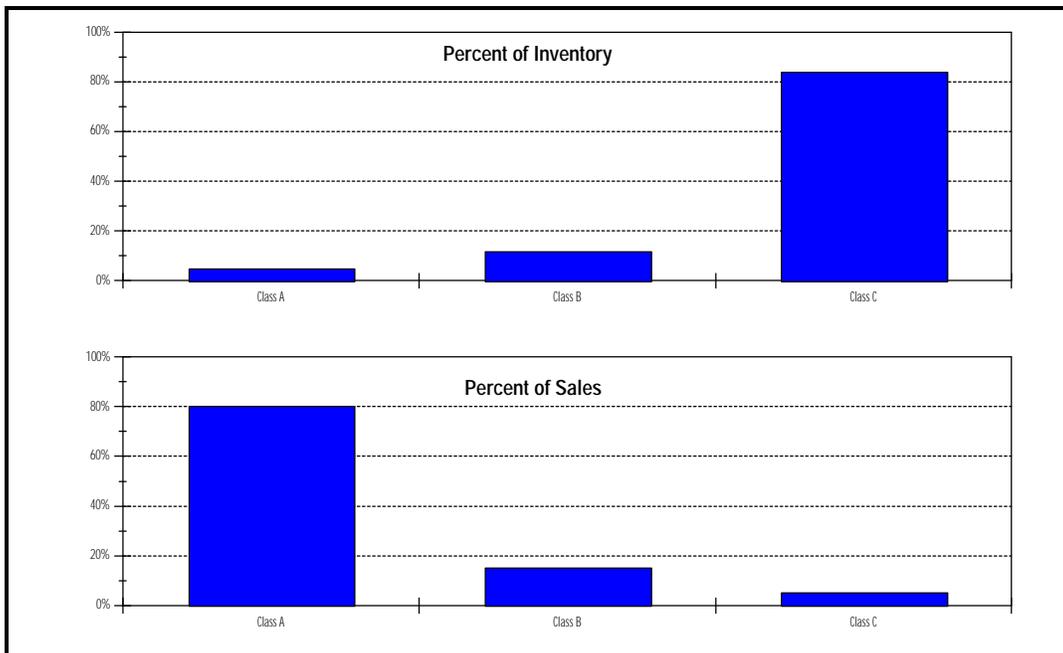


Figure 1 -Percent of Inventory and Sales by Supply Class

however, we believe that the same situation existed in CY 1994. While we did not calculate the effects of stocking low turnover items, this practice increased the need for storage space, retail floor space, and warehouse labor and allowed for inventory shrinkage. OSS decisions regarding items to stock in the Supply Store were not based on statistical criteria such as actual sales history. Supply Store management strived to ensure that all Members' needs were met. They ordered items that were used infrequently but were occasionally needed by Members. Management was uncertain of the demand for these products so they stocked higher quantities to ensure they would have them in stock if the Members needed them.

In addition, a significant number of special orders were generated by Members for items that were not carried in Supply Store inventory. Most special orders were for computer accessories or software. In CY 1994, special orders constituted 65 percent of all orders placed by OSS. These special orders routinely took more than 24 hours and, as much as, three weeks for delivery.

As previously mentioned, we interviewed four commercial vendors in the office supply industry who suggested implementing a stockless inventory system. Typically, these vendors carry about 12,000 items in their regular inventory and have access to about another 28,000 items. Vendors guarantee any item ordered will be delivered within 24 hours. This would include orders from Members' Washington, D.C. and district offices. Same day delivery service is available for an additional fee. A primary benefit of a stockless inventory system is to eliminate the need to buy and stock items that do not sell quickly. Such a system reduces the number of items in inventory, storage space, retail floor space, and carrying and labor costs.

Supply Store inventory on-hand was twice the industry standard and resulted in \$250,000 in inventory maintenance costs

The Business Products Industry Association (BPIA) is a national trade association of wholesalers, dealers, manufacturers and representatives of the office products industry. BPIA published a study, "The 1995 Dealer Financial Comparison and Performance Benchmarking Guide." This study presents financial and operating performance benchmarks. In this study, the average net sales to inventory ratio, a performance ratio used to evaluate stock level, was 10.75. A low ratio indicates the inventory is overstocked. We estimate the Supply Store net sales to inventory ratio to be 4.2.

The Supply Store had an average of \$1.3 million of inventory on-hand in CY 1994. According to CY 1994 House payroll records, OSS employed seven people who received, maintained, and stored inventory. The House paid \$193,000 in direct labor and \$57,000 in fringe benefit costs to employees who managed inventory.

\$193,000	Salaries
<u>57,000</u>	Fringe Benefits (29.55 percent x \$193,000)
\$250,000	Total Costs

OSS was not held accountable for minimizing the costs of its on-hand inventory. The costs of carrying this inventory and storage space fees were not charged to the Supply Store and not accounted for in operating reports.

According to the BPIA, the current industry trend is to reduce or eliminate inventory through implementing a just-in-time inventory system. A just-in-time inventory system allows the user to order merchandise when it is needed, instead of having to forecast user demand. A just-in-time inventory system significantly reduces or eliminates the labor associated with maintaining inventory because it is not necessary to have an inventory.

OSS lacked information to facilitate the management of Supply Store operations

OSS did not have the information necessary to facilitate the management of Supply Store operations in CY 1994. Complete and accurate information would help OSS manage Supply Store operations by providing a baseline from which to determine whether control objectives are adequate. For example, the balance sheet provides an indication of fundamental soundness and strength at a given point in time. By generating this report on a monthly basis, OSS would be able to see where the business is strong, average, and weak.

The accounting system, ProVar, used by OSS, can generate these reports. OSS management, however, did not generate these reports on a regular basis. This is in spite of the intent of a July 20, 1994 policy directive from the Subcommittee which required that an accounting system be established to produce monthly financial reports (including statements of cash flows, income, and balance sheet).

Recommendation

We recommend that the Chief Administrative Officer prepare a proposal, for approval by the Committee on House Oversight, for closing the Supply Store and replacing it with a contractor.

Management Response

The Office of the CAO was in general agreement with the findings, conclusions, and recommendations (see appendix). According to the CAO, they are implementing an alternative strategy to accomplish the objective in the report. The strategy includes conducting a review of the items carried, reducing inventory, producing regular monthly financial reports, and adjusting

staff based on workload. The CAO also indicated that prices would be adjusted to reflect fully loaded costs. Upon completion of these actions, the CAO promised to compare Supply Store prices to those of private vendors and reevaluate the option of contracting out the office supply function by March 31, 1996.

Office of Inspector General Comments

While the CAO's actions are generally responsive, we strongly suggest that the CAO reconsider contracting out the Supply Store operations now, or at least move up the time frame for evaluating this possibility rather than waiting until March 31, 1996. Special order items represented 65 percent of all orders place by the Supply Store for Members and their offices, and orders routinely took more than 24 hours and, as much as, three weeks for delivery. Consequently, the House could more effectively meet its supply needs using contractors with 24 hour delivery services. According to the vendors we interviewed, they typically carry about 12,000 items in their regular inventory and have access to about another 28,000 items. Vendors guarantee any item ordered will be delivered within 24 hours. This includes all order from Members' Washington, D.C. and district offices. Furthermore, considering items in greater demand represent only 16 percent of items carried in inventory, this approach would eliminate unnecessary costs and make available floor space for other use. Therefore, delaying considerations for contracting out this function for eight months would, in our view, only perpetuate operational inefficiencies and defer an opportunity to more immediately realize significant cost-savings.

Finding B: The House Lost \$240,000 In CY 1994 On American Flag Sales To The General Public

The Supply Store sold \$1.2 million of American Flags to the general public through congressional offices. We estimate the House lost approximately 20 percent⁴ of the acquisition price of every flag that was sold, resulting in a \$240,000 annual loss. The flags were sold at acquisition cost; therefore, the House did not recover the costs associated with selling the flags.

In CY 1994, the Supply Store sold \$1.2 million worth of American Flags. Flag prices ranged from \$6.80 to \$17.57. Members bought flags at acquisition cost from the store for their constituents with funds from their supply accounts. Constituents reimbursed the Member's supply account for the acquisition cost.

Flags sold to the public were subsidized by the markup required to recover operating costs. We estimate that markup to be 20 percent. According to OSS, American Flag sales in CY 1994 amounted to \$1.2 million. We estimated the loss in CY 1994 by multiplying total sales by the estimated markup.

\$1,200,000	Total Flag Sales
<u>20%</u>	Markup required to recover costs
\$240,000	Annual Loss

The House, therefore, did not recover labor, storage, and delivery costs related to selling American flags.

Recommendation

We recommend that the Chief Administrative Officer prepare a proposal, for approval by the Committee on House Oversight, to modify the pricing policy to recover the full cost of flags sold to the public.

Management Response

The Office of the CAO was in general agreement with the findings, conclusions, and recommendations (see appendix). The CAO stated that the price of flags would be adjusted to reflect full costs of flags sold. He further informed us that the Legislative Branch Appropriations Bill transfers responsibility for the flying and sale of flags to the Capitol

⁴Operating Expenses/Cost of Goods Sold (1,100,226/5,604,226 = 19.63%)

Historical Society who will recover the full cost of the flags. Consequently, he advised us that the Supply Store will discontinue purchasing and selling flags upon completion of the transfer of that responsibility.

Office of Inspector General Comments

The CAO's actions are responsive and fully satisfy the intent of this recommendation.

Finding C: The House Gift Shop Lost \$90,000 During The First Four Months Of Operation

The House Gift Shop operated at a \$90,000 loss from September through December 1994. If this performance trend continues, the shop will lose \$270,000 in its first 12 months of operation. Pricing policy, labor costs, selection of merchandise, and shop location all contributed to the operating loss.

Gift Shop prices were marked up less than those of comparable enterprises

The Subcommittee issued a policy directive on July 20, 1994 related, in part, to Gift Shop pricing. It stated that "pricing shall be established consistent with the operation of the Gift Shop as a retail store and according to sound business practices." In response, OSS implemented a policy which set prices at 20 percent above acquisition cost. The memo also directed that "gift shop expenses should be paid with revolving fund monies."

The Gift Shop pricing policy was insufficient to recover all shop expenses. A 36 percent markup was needed to recover the acquisition cost of merchandise and labor. As a result, the pricing policy contributed to store losses of \$90,000 during the period of September through December 1994. The established 20 percent markup did maintain the revolving fund balance, but did not recover salary and benefit costs which were paid with appropriated funds. In fact, in the first four months of operation, the Gift Shop realized an 8.5 percent margin on sales instead of a 20 percent margin.

\$356,000	CY 1994 Sales
<u>328,000</u>	Less Cost of Goods Sold
\$ 28,000	Difference
\$ 28,000	Difference
<u>\$328,000</u>	Divided by Acquisition Cost of Goods
8.5 Percent	Margin Realized

A possible cause was inventory shrinkage including shrinkage due to obsolescence, damaged merchandise, or theft.

Former OSS management reviewed Senate pricing policy which requires an average markup of 22-25 percent. The House Gift Shop's markup was intended, according to former OSS management, to approximate the markup applied by the Senate. However, prices were less than

those of other similar gift shops (see Figure 2). House Gift Shop markups were also five to six times less than the average for the retail gift shop industry.

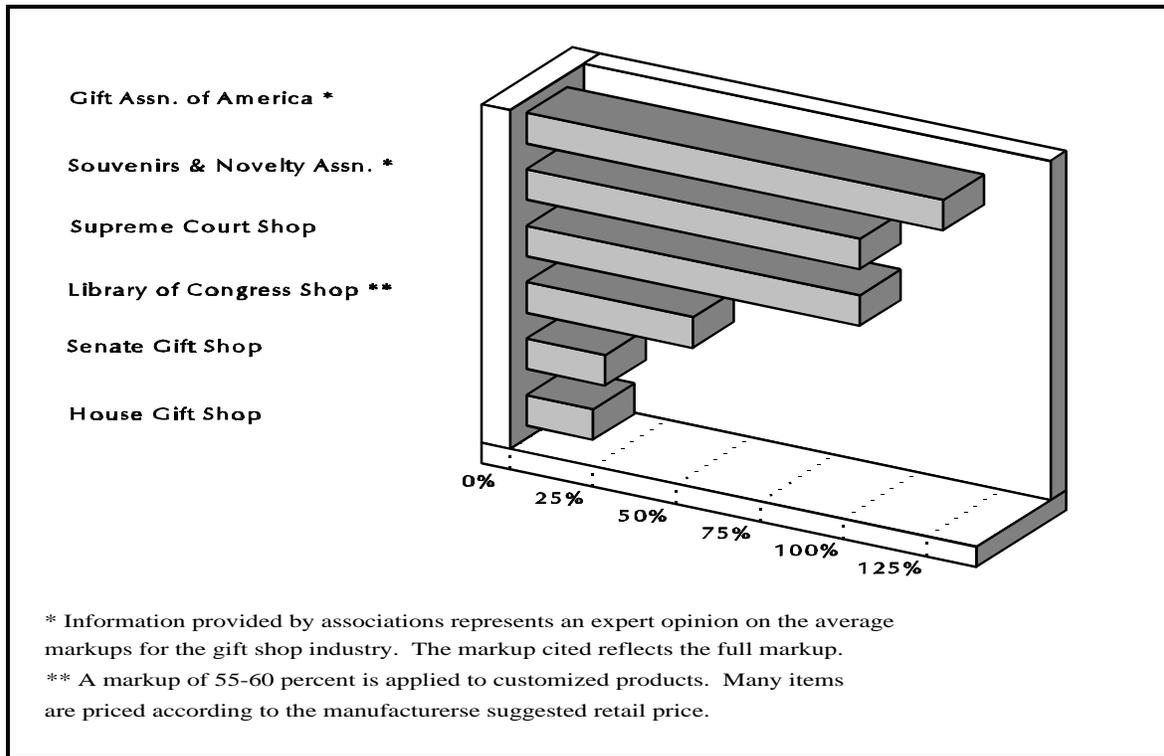


Figure 2 - Markup Applied by Various Gift Shops

Gift Shop labor costs were higher than those of comparable enterprises

The House Gift Shop did not have a staff separate from the Supply Store during the first four months of operation. The Subcommittee policy directive required the Director to select, to the extent possible, OSS employees when establishing a staff to manage and operate the Gift Shop. OSS implemented this guidance by running both stores with a single staff.

The Gift Shop incurred salary and benefit costs of \$118,000 and generated \$356,000 in sales during the first four months of operation. Based on these figures, we estimate that on an annualized basis, salary and benefit costs would be \$354,000 and annual sales would be \$1.07 million.

Based on the projected annual labor costs for the Gift Shop, labor costs are \$157,000 too high.

Average Labor Ratio ¹	18.5 percent
x Projected House Annual Sales	<u>\$1,070,000</u>
Target Labor Costs ²	\$198,000
Projected Annual Labor Costs	\$355,000
Less Target Labor Costs	<u>\$198,000</u>
Excess Labor Costs	\$157,000

Calculated by averaging labor ratios for the Supreme Court gift shop (16 percent) and Library of Congress gift shop (21 percent). We used these shops because they are located on Capitol Hill and we were able to obtain data from them.

²House labor costs if labor was aligned with Supreme Court and Library of Congress average.

We used the ratio of labor costs to total sales, a common performance measure in the retail industry, to evaluate labor costs. The ratio is higher for the Gift Shop than for any of the other gift shops we reviewed. Comparative labor costs are shown in Figure 3. The average ratio of labor costs to sales for the Library of Congress and Supreme Court gift shops was 18.5 percent in

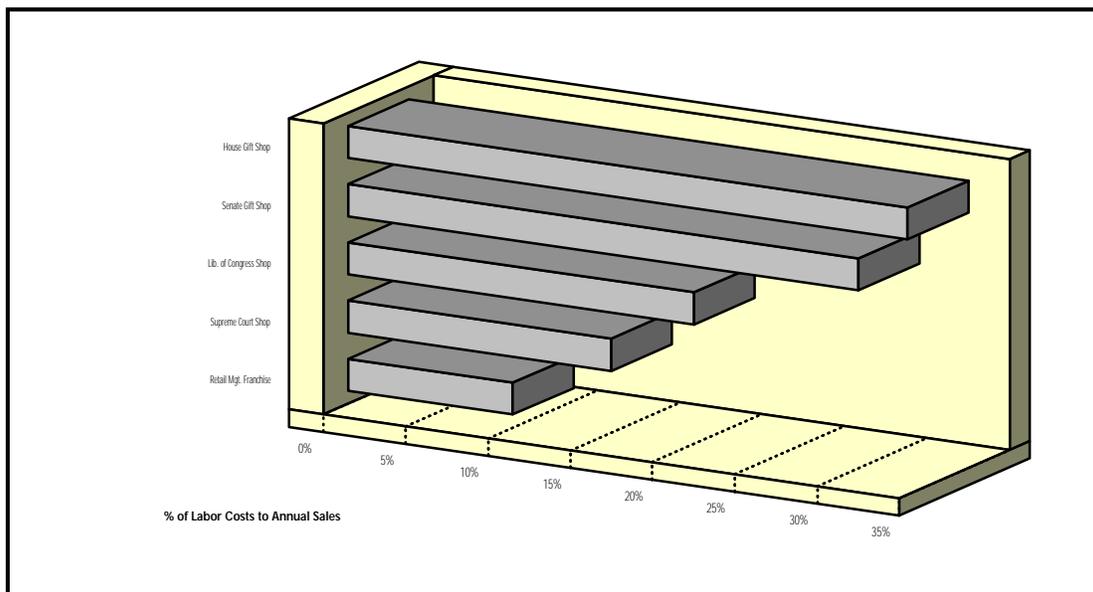


Figure 3 -The House Gift Shop Ratio of Labor to Annual Sales

CY 1994. Both the Library of Congress and Supreme Court gift shops are operated as retail stores, and are required to pay all operating costs, including labor, and to make a profit.

The primary cause for the House Gift Shop's high labor costs as a percentage of sales was that the environment provided few incentives for controlling labor costs since these costs were paid with appropriated funds.

In the Gift Shop, 16 percent of the items stocked accounted for 80 percent of the sales

The Subcommittee directed the Gift Shop to sell items such as souvenirs and mementos to the general public, and Members and staff. The Gift Shop sold merchandise such as china and crystal in addition to those items categorized as souvenirs and mementos. A diverse mix of merchandise is carried to appeal to both the general public and Members and staff.

The Gift Shop stocked 950 items. Gift Shop management categorized these items according to sales volume into three categories (A, B, and C) and generated a report of this analysis entitled "ABC Analysis Report." The categories are defined as follows:

- A Items in the top 80 percent of sales
- B Items in next 15 percent of sales
- C Items in the bottom 5 percent of sales

The Gift Shop stocked low turnover items. For example, in the first quarter of CY 1995, Category C included 658 (69 percent) of all Gift Shop items stocked, and represented 5 percent of the sales (see Figure 4). Furthermore, 257 of the items in Category C, or 27 percent of the total inventory, generated no sales. Comparable information was unavailable for CY 1994, however, we believe that the same situation existed in CY 1994.

Shop productivity was adversely affected by holding 658 (Category C) items in inventory that generated 5 percent of the total sales. Operating costs were increased because such a large number of low turnover merchandise was stocked. These items increased the need for storage space, retail floor space, and warehouse labor.

We used sales per square foot, a common performance measure in the retail industry, to evaluate shop productivity. We conducted interviews to determine the sales per square foot of retail space for each of the organizations cited. House Gift Shop productivity in terms of sales per square foot was \$191 to \$428 less than comparable shops in CY 1994 (see Figure 5). The ratio is lower for the House Gift Shop than for any of the other gift shops we reviewed.

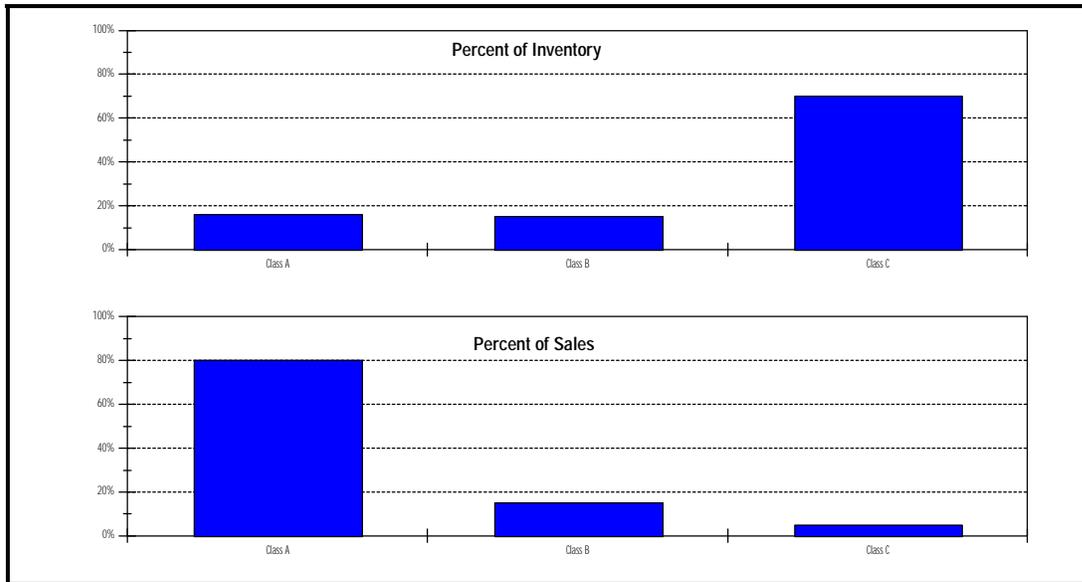


Figure 4 -Percent of Inventory and Sales by Gift Shop Item Class

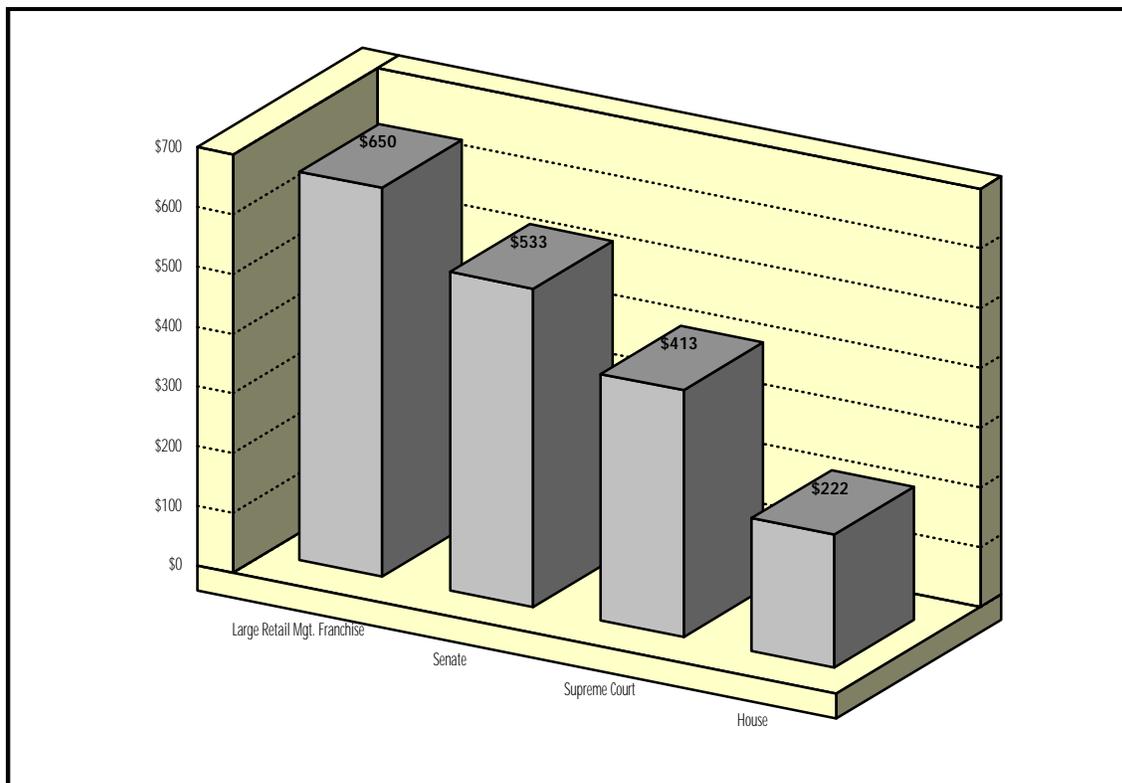


Figure 5 - Gift Shop Sales per Square Foot in CY 1994

The Gift Shop attracts fewer visitors than other Capitol Hill shops due to location

Industry experts identify location and traffic flow as the best predictors of profit potential and a critical issue affecting privatization potential. The Tour Guide Service estimates that one million people toured Capitol Hill buildings in CY 1994. According to unofficial estimates by various congressional offices, the number of visitors to the Capitol Hill area was 5 to 10 million.

OSS management estimated that the Gift Shop received an average of 200 visitors a day or 16,400 visitors (200 visitors/day x 82 days) during the first four months of operation. Similar shops on Capitol Hill averaged 20,067 visitors during a 4-month period. Based on this average, the Gift Shop had 3,667 less visitors than the other shops. As a result, we estimated that \$80,700 of sales was not realized from September to December 1994.

Projected on a full year basis, lost opportunity costs equaled \$242,000, as shown below:

20,067	Avg. No. of Visitors to Shops for a 4-Month period
<u>16,400</u>	House Gift Shop Visitors (Sept. - Dec.)
3,667	
\$22	Average Sales Per Customer During First Four Months of Operation (\$356,000/16,400 visitors)

Unrealized Revenues:

\$80,700	CY 1994 Sept. - Dec.
\$242,100	Projected 12 months

The Gift Shop is co-located with the Supply Store in the basement of the Longworth Building. While the location is suitable for selling to Members and staff, it is less convenient to the general public.

In contrast to the problems cited above, minimal amount of risk is involved with contracting out the Gift Shop. This approach would eliminate current projected losses of \$270,000 and generate a marginal profit for OSS. A gift shop industry expert stated that rent is commonly five to eight percent of annual sales. House Gift Shop annual sales projected on a yearly basis for CY 1994 would have been \$1 million. Assuming a rent of five percent, OSS could expect to receive an estimated \$50,000 in revenues.

It would be advisable under this arrangement for OSS to maintain some level of control over the merchandise sold and the markup applied. By maintaining approval authority over merchandise sold, OSS can ensure that items preserve the integrity of the House.

Recommendation

We recommend that the Chief Administrative Officer develop a proposal, for approval by the Committee on House Oversight, to implement one of the following options:

Option 1: Contract out the Gift Shop.

Option 2: Continue to operate the Gift Shop and address the four fundamental problems. The shop's charter would need to be revised to require the store to be a self-supporting and profitable operation. This means the shop would operate on a full-cost basis, paying all fixed and variable costs with revenues generated by the Gift Shop. The following four issues also must be addressed:

- Pricing Policy--An increase in the markup from 20 percent to 36 percent would have been sufficient to cover labor costs in CY 1994.
- Labor Costs--Labor costs need to be bought in line with private sector costs.
- Merchandise--Continue efforts to stock store merchandise that appeals to the public, specifically tourists.
- Location--Locating the shop in a higher traffic flow area would increase the number of customers and increase shop revenues.

Management Response

The Office of the CAO concurred with this finding and associated recommendations (see appendix). The CAO advised us that they will continue to operate the Gift Shop but plan to implement modifications to make the store a self-supporting and profitable operation. According to the response, they plan to increase prices to recover all costs, adjust staff requirements based on workload, stock items that reflect the tastes of the public, and examine better means to inform the public of the shop's location.

Office of Inspector General Comments

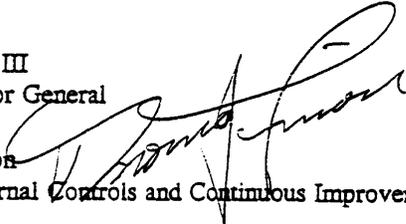
The CAO's actions are responsive and fully satisfy the intent of this recommendation.

APPENDIX

Office of the
Chief Administrative Officer
U.S. House of Representatives
Washington, DC 20515-6860

MEMORANDUM

TO: Robert B. Frey III
Deputy Inspector General

FROM: Thomas J. Simon 
Director of Internal Controls and Continuous Improvement

DATE: July 5, 1995

SUBJECT: Draft Audit Report - Office Supply Store and Gift Shop

We appreciate the opportunity to comment on your draft report. We deeply appreciate your efforts and are in general agreement with the findings and recommendations. Specific comments on each recommendation follow. If there are any questions or additional information required regarding this reply, please contact me at (202) 226-1854.

Finding A

Recommendation : We agree with the findings and are implementing an alternative strategy to obtain the objective of the report. A review is being conducted of the items carried, inventories are being reduced, regular monthly financial reports are being initiated and staffing are being adjusted based on workload. Prices will be adjusted to reflect fully loaded costs. When these actions are completed, prices will be compared to private vendors and the option of contracting out will be reevaluated by March 31, 1996.

Finding B

Recommendation: The price of flags will be adjusted as noted in the response to Finding A. In addition the Legislative Branch Appropriations Bill transfers responsibility for the flying and sale of flags to the Capitol Historical Society who will recover full cost. Upon implementation of the transfer, we will cease to purchase and sell flags.

described above. A review will be done of the procedures for maintaining and accounting for supplies will be completed by October 1, 1995. Performance indicators are under development.

Recommendation 2: The Committee on House Oversight on June 14, 1995 approved actions consistent with Option 1. The annualized savings in operating costs from these actions and those taken in response to Recommendation 1 will exceed \$325,000.