



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Kay Winer

**SUBJECT:** HISTORY SAN JOSÉ  
FUNDING STRATEGY

**DATE:** October 2, 2007

Approved

Date

10/5/07

**COUNCIL DISTRICT:** City-Wide  
**SNI AREA:** N/A

## RECOMMENDATION

1. Accept receipt of the History San José Audit completed by Macias Consulting Group, Inc. that recommends a baseline annual budget of \$1.6 million with a four-year financing strategy for a City subsidy of \$840,377 in year 1; \$743,796 in year 2; \$456,009 in year 3 and \$257,009 in year 4. At the end of year 4, subsidy may continue at \$257,009, revert to \$335,000 as contained in current Agreement. or the City may re-evaluate to determine future funding levels through the end of the Agreement in FY 2017-18.
2. Direct staff to work with HSJ to determine the rationale for their proposal for a \$1.2 million annual subsidy with an annual cost of living increase. HSJ to provide details on the level of service and compare this with the level of service that would be provided under the financing strategy recommended in the Macias audit. Staff to bring results of discussions with HSJ by December 2007.
3. Adopt a resolution authorizing the City Manager to negotiate and execute the Fourth Amendment to the Operations Agreement between the City of San José and the History Museums of San José (now History San José) to advance the third quarter payment for the period of January through March 2008 in the amount of \$143,705.75.

## OUTCOME

The Audit prepared by Macias Consulting Group provides independent, key information regarding History San José (HSJ) that has not been available in the past. The Audit assesses HSJ's overall financial viability, examines its current cost to operate and compares those costs with organizations of similar nature and size as a basis for determining what funding level the City should support. The Audit also recommends appropriate performance and expectation

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outcomes for HSJ and provides an evaluation of its compliance with the 1998 agreement with the City.

These were the expectations that Council established for the Audit. Though HSJ agrees with some of the recommendations of the audit, they have stated that the financing strategy recommendations are neither viable nor attainable in the current economic climate. The areas of disagreement are summarized in a letter dated September 28, 2007 (copy attached.) Specific documentation and details were not provided in the letter.

A revised Agreement between HSJ and the City will be required to reflect any changes in terms and conditions.

### **EXECUTIVE SUMMARY**

When the City Council approved a twenty-year agreement with History Museums of San José (now History San José) in 1998 to transition the museum operations to a non-profit organization, it was accompanied by a great deal of optimism that the museum's services to the community would be greatly enhanced. The non-profit organization would be able to increase support for the Museum's facilities, programs, and enhance care of the collections through its fund raising efforts and would operate at lower costs.

In the period of time that HSJ has been the operator, considerable progress has been made in engaging diverse audiences to understand and appreciate the history of San José and the Santa Clara Valley. The Macias audit confirms that HSJ has achieved noteworthy accomplishments when compared to peer history museums. The number of visitations by children is much larger; maintenance costs per square foot are much lower; and the dollars raised per visitor is higher. Support from volunteers remains strong.

Over the past six years, the City has been faced with difficult budgetary problems and still needs to grapple with its structural budget deficit. During this time, the City has honored its funding commitment to HSJ, despite reductions that have affected other operations and programs of the City. In the past two years, HSJ has approached the City for additional ongoing funding without identifying a specific amount or precisely how that money would be spent. This culminated in direction from the Council in June 2007 that a performance audit be completed to determine the appropriate size of the annual budget for HSJ and to recommend a level of funding that could reasonably be expected from the City.

HSJ has concluded that it cannot support the audit recommendations and has asked for a substantially greater subsidy with a built-in cost of living increase each year and a re-opener to the contract in three years.

Given the City's continued budgetary problems, and its policy of funding major non-profit organizations to help leverage private fund raising efforts and at the same time, to provide some level of steady to assist in maintaining the City's facilities in which the non-profit operates, the following are fundamental issues that should to be considered in evaluating HSJ's proposals:

- City services and programs have been reduced over the past years. What is the relative priority of providing additional funding to HSJ when many of the City's core programs and services have not been restored?
- City support leverages private funding and is not intended to be the primary source of the institutions' income. For example, City operating grant support to the Children's Discovery Museum, San José Art Museum, and the Tech Museum of Innovation constitutes 5 – 10% of their annual operating budgets. HSJ's request for \$1.2 million annually would be a much larger percentage, approximately 50% of its operating budget.
- Operating grant agreements to cultural institutions do not contain cost of living increases and do not provide for re-openers. If these provisions are approved for HSJ, other cultural institutions could expect the same consideration.

### **Major Findings and Recommendations of Audit**

#### **HSJ is in poor financial condition.**

- HSJ is not currently structured to have strong financial management.
- The HSJ budget shows that unrealistic revenue goals were established, i.e., HSJ continued to set fundraising, gifts, grants and in-kind revenue goals that were far beyond its current ability.
- HSJ took limited action to reduce operating expenditures, given that it has incurred operating deficits averaging \$265,000 each year for the past several years.
- Taking into account that HSJ is located in a high cost of living geographic area, personnel costs were still significantly higher than peer history museums of similar size.

#### **A four-year financing strategy is recommended with specific annual performance measures:**

The four-year strategy requires readjusting the funding levels set forth in the original Agreement that results in additional funding of \$717,113 over the four-year period. However, if the fourth year subsidy level of \$257,009 is retained for the remainder of the Agreement with HSJ that runs through FY 2017-17, the City would pay approximately \$125,000 more in operating payments to HSJ over the twenty-year period of the Agreement.

#### **HSJ's Response to Audit in September 28 Letter**

- Financing strategy is not viable and recommends approval of a subsidy of \$1.2 million annually with a built-in cost of living increase each year.

- HSJ further proposes that City staff work on a new contract that includes a set of realistic performance standards with a re-evaluation of the contract every three years. (HSJ did not identify what the changes in performance standards might be.)

### **Staff's Response to HSJ Proposal**

HSJ's proposal did not provide documentation on how the \$1.2 million subsidy was determined and what the annual base budget is upon which the subsidy is based. Staff subsequently met with HSJ and the organization presented a \$2.2 million balanced operating budget for FY 2007-08 that assumes a subsidy of \$1.2 million from the City. Staff has requested that HSJ provide detailed information on the level of service that this would provide and to provide detailed year-by-year comparison of service delivery with the funding strategy proposed by the Macias audit. Results of discussions with HSJ will be brought back to Council by December 2007.

## **BACKGROUND**

### **Twenty-Year Funding Commitment to HSJ**

#### **Annual Operating Subsidy**

A twenty-year operation agreement was executed with History San José (HSJ) in 1998 with total funding of \$12 million over the term of the agreement. An annual subsidy payment schedule was approved by Council in accordance with HSJ's preference that its twenty-year subsidy be "front loaded" with a diminishing subsidy each year. This was a compromise from HSJ's original proposal to provide all of the funding in the first ten years of the twenty-year agreement and the staff proposal for a more even distribution of funding spread out over the twenty-year period, using the costs funded for City staff to operate the complex as the baseline.

#### **Capital Improvements by City and Redevelopment Agency**

In addition to the annual operating subsidy, The City provided more than \$500,000 to HSJ during the early years of the Agreement for capital projects, replacement of the phone system, a new HVAC system at the Pacific Hotel and refurbishment of the light tower. Much of the collections have been moved to the Central Service Yard into a temperature and humidity controlled environment. The remainder of the collections will be moved from the Stockton warehouse by the end of the year. The City funded costs for shelving and continues to provide security and pays utilities for the collections at the Central Service Yard and also continues to provide landscaping and grounds maintenance.

RDA has also provided substantial support in the amount of \$4.4 million for capital improvements at the Fallon-Peralta Complex -- \$3 million for the initial renovation and \$1.4 million recently for major capital improvements.

**Maintenance and Landscaping**

HSJ is responsible for building maintenance and custodial services; however, Parks, Recreation and Neighborhood Services provides landscaping and grounds services at History Park and the Peralta Fallon complex. Security and utility costs for the collections housed at the Central Service Yard are funded by General Services. Total funds budgeted by both departments is approximately \$255,000 each year.

Maintenance responsibilities are divided between the City and HSJ. Staff has been asked in the past what the maintenance costs would be if the City were to assume full responsibility. General Services estimates the total cost at \$649,599. This includes the \$255,000 currently budgeted in General Services and Parks, Recreation and Neighborhood Services.

**Additional Funding Request from HSJ in May 2007  
Resulted in Direction to Complete an Audit**

HSJ submitted a request in May 2007 to increase annual funding on a permanent basis to meet basic annual operating costs, although a specific amount was not identified. The Council authorized proceeding with an Audit and approved funding under the subsidy schedule of \$574,823 pending any changes that might occur as a result of the Audit findings. The City Auditor's office indicated that due to workload, the Audit report would require up to six months to complete. Consequently, the City entered into an agreement with Macias Consulting Group to complete the Audit. The scope of work included:

- Assessment of HSJ's overall financial viability;
- HSJ's compliance with the 1998 operation and maintenance agreement;
- Determination of the cost to operate an organization of similar nature and size, including determining at what funding level the City should support; and
- Determine appropriate performance/outcome expectations.

**Emergency Funding Request from HSJ in August 2007**

In August 2007, HSJ requested an advance of both their second and third quarter payments (each quarterly payment is \$143,705.75). HSJ further stated that it had spent its reserve and endowment. Without emergency financial assistance, programs and other functions would be curtailed. This request was heard by the Rules and Open Government Committee on August 22, 2007 where two options were presented by staff: The first option was for the advance of one quarter only by the Council at its September 11 meeting. Since the Audit was close to completion, the second quarterly payment was not deemed to be necessary. The second option was for the City to assume responsibility for managing special events and core programs beginning September 1, 2007.

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The Rules and Open Government Committee directed staff to place an item on the September 11, 2007 agenda to advance one quarter of the annual subsidy and to continue to look at costs and a plan to assume responsibility for core operations should that be required.

On September 11, 2007, the City Council approved advancing the second quarterly payment to HSJ in the amount of \$143,705.75.

## **ANALYSIS**

Macias Consulting Group will present a summary of its findings and recommendations to the Council on October 16, 2007. (A copy of the full Audit is attached).

### **Key Findings of Audit**

- HSJ's financial stability has declined and the organization is currently fiscally unsound. Seven key indicators were used by Macias to evaluate HSJ's financial viability and all were found to have eroded in the past year, some significantly.
- HSJ has not had a predictable level of outside funding. Its success in fundraising efforts and at seeking other sources of revenue has gradually declined since FY 2002-03.
- Weaknesses in financial management at HSJ will further impair its ability to independently sustain operations. HSJ does not have an effective financial management structure or practices. The audited financial statements for FY 04-05 and FY 05-06 identified a "going concern" regarding HSJ's fiscal condition. These concerns may hinder HSJ from obtaining additional lines of credit and jeopardize grant funding from outside sources. HSJ has not designated a key full-time position of Chief Financial Officer (CFO) nor has it designated a full-time Fundraising position.
- HSJ has not met key requirements of the Agreement. The Agreement with the City provides for eight types of operational and performance requirements to assist HSJ to strengthen its operations. HSJ has never established reserves equal to 15% of the operating budget, completed only a five-year year strategic plan for the initial five years of the Agreement and has not yet received Accreditation from the American Association of Museums.
- HSJ performs well compared to peer museums in many areas. HSJ performs well with regard to the number of students served, cost per visitor, and building maintenance costs per square foot. However, HSJ's personnel expenses are high when compared to peers with similar size of operating expenditures. The Audit further states that for all history museums with operational expenses between \$750,000 and \$3,000,0000 annually, the

median cost for Personnel Expenses was \$764,694, about \$600,000 less than HSJ’s personnel costs.

- The optimal annual baseline cost analysis to operate HSJ is about \$1,663,847. Based on this baseline cost analysis, Macias developed a four-year financing strategy, which is discussed below.

**Proposed Four-Year Financing Strategy: FY 2007-08 through FY 2010-11**

The four-year strategy is presented in the Audit and summarized in this report. The funding strategy is to support the optimal annual baseline cost analysis of \$1,663,847 to cover all expenditures with funding from all sources (City subsidy, earned and contributed income raised by HSJ). Please note that the current City support from General Services and Parks, Recreation and Neighborhood Services for collections storage and landscaping and grounds maintenance, valued at approximately \$255,000 is not included in the baseline cost analysis.

**Four-Year Recommended Financial Strategy Costs**

FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	Total Cost
\$809,823	\$743,796	\$456,009	\$257,009	\$2,297,191

**Four-Year Funding Schedule Per Current Agreement**

FY 2007-08	FY2008-09	FY 2009-10	FY 2010-11	Total Cost
\$574,823	\$335,085	\$335,085	\$335,085	\$1,580,078

Over the four years, the cost to the City is \$2,297,191 compared to \$1,580,078 under the current agreement. This is an additional \$717,113 in City funding. However, if the City subsidy continues at \$257,009 for the remaining 7 years of the Agreement, the City’s total payments to HSJ would be an additional \$125,000 over the twenty-year term.

**Financing Strategy Performance Measures and Outcomes**

Macias identifies specific performance measures that must be met in order to fully implement the financing plan.

**Year 1 Performance Outcomes (FY 2007-08) to Stabilize HSJ’s Fiscal Condition**

- Develop execution plan for Year 2 through Year 5 activities;
- Establish Board Committee to oversee Execution Plan;

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- Restructure personnel staffing to hire a full time CFO and full-time Fundraising position; add 10% to marketing budget;
- At the same time, reprioritize staffing needs and reduce personnel costs by \$217,000 (17%) to achieve peer level of personnel costs;
- Recruit 5 new Board members who will raise \$17,500;
- Receive accreditation.

#### **Year 2 Performance Outcomes (FY 2008-09) to Increase Program Revenue**

- Increase Museum attendance in education and other programs by 5% to increase operating revenues by \$15,000;
- Replace non-revenue producing, non-critical positions with volunteers through attrition;
- Increase Board membership by 5 with a target that they raise an additional \$17,500;
- Increase contributions, membership and donations by 10% from FY 06-07 levels, or \$31,000.

#### **Year 3 Performance Outcomes (FY 2009-10) to Increase Grant and Contribution Level**

- Meet the 50% fund raising requirement of the Agreement with the City and raise an additional \$82,687 over prior year funds received from contributions, donations and memberships;
- Secure new grants totaling \$152,600;
- Add 5 new board members that raise an additional \$17,500.

#### **Year 4 Performance Outcomes (FY 2010-11) to Replenish Reserves and Endowment Fund**

- Develop and secure new exhibits successful at other museums to increase attendance and admissions by 10% to raise an additional \$30,000 in revenue;
- Accomplish the peer History Museum benchmark of earned income revenue levels of 32% of operational costs by raising an additional \$69,000; (HSJ's current earned income level is at 19% of total costs.)
- Increase private income from 25% to 30%;
- Expand board by another 5 members and raise an additional \$17,500;
- Any operational surpluses should begin to build a reserve and replenish the endowment.

#### **History San José's Responses**

HSJ met with Macias Consulting during preparation of the audit and had an opportunity to review and discuss the draft audit. A number of questions and concerns were addressed to Macias in writing from HSJ and were considered prior to finalizing the audit.

HSJ sent a letter on September 28, 2007 addressed to City Manager with a copy to the Mayor and Council. Some of the major points in the letter include:

**Operating costs unknown:** The letter states that the 1998 contract recognized that the costs of operating these City facilities were unknown, but would be established after the contract was signed. As a matter of fact, the City had been operating History Park for many years and knew precisely what the costs were, given the level of services and programming provided to the community. Nothing in the contract speaks to any provision for establishing the costs of operating the facilities after the contract was signed.

**HSJ's disagreement with audit:**

- The peer benchmarks are unrealistic because they are based on institutions that do not resemble HSJ.
- The audit does not consider the Silicon Valley market in which HSJ operates.
- The audit does not outline how the City has benefited from its partnership with HSJ.
- The Audit recommendations continue with the faulty assumption that declining City support is a viable model.

These issues were referred to Macias for response and Denise Callahan, partner, submitted a written response. A copy of the letter from Macias is attached.

**HSJ's proposals:**

- "Recognize that the declining subsidy model as outlined in the Macias Audit is not viable for sustained operation of the City's historical assets and approve a realistic subsidy of \$1.2 million annually with a built in cost of living increase."
- "Direct City Staff to work with HSJ on a new contract, which includes a set of realistic performance standards and re-evaluation of the contract every three years."

**Staff's questions/issues regarding proposals:**

- The September 28 letter from HSJ did not provide any documentation on how it determined the level of the annual subsidy of \$1.2 million. Staff has since met with HSJ and was informed that the organization has approved an operating budget of \$2.2 million for FY 2007-08. In order not to run into a deficit, a subsidy of \$1.2 million is required from the City.
- More discussions need to take place with HSJ with regard to the disparity between its \$2.2 million annual budget and the \$1.6 million optimal base budget contained in the audit as a result of analysis and benchmarking efforts completed by Macias.
- Staff has requested that HSJ provide specific details on the level of service provided in its 2.2 million budget with a City subsidy of \$1.2 million and compare that with the level of service HSJ would provide under the financing strategy identified in the audit
- In the process of reducing its expenditures, HSJ will also need to identify which performance measures and outcomes it will be unable to meet under the four-year program recommended in the Macias audit.

### **Policy Questions Raised:**

As stated in the Executive Summary, HSJ's proposal raises policy issues:

- As the City continues to face budgetary problems and a structural budget deficit, how much additional funding, if any, should be considered for HSJ in light of other programmatic and service priorities?
- The City's contracts with major cultural institutions are for long periods of time and none of them include a cost of living adjustment or a provision for a re-opener of the contract. Approval of this request would likely result in other organizations to expect the same consideration.
- The subsidy from the City to major cultural institutions is a small, but important part of their budgets that they can count on receiving each year. The City's operating grants constitute 5% - 10% of their total operating budget. HSJ's proposal would be just the reverse – the City would be the major funding source.

### **RECOMMENDATION TO ADVANCE THIRD QUARTER PAYMENT**

The Council approved a second quarter advance to HSJ in September. At the time, staff did not recommend an advance of the third quarter although HSJ had made the request, believing that the long-term funding issues would be resolved by early October. Since that will not be the case and the previous cash flow information showed that HSJ would be in a deficit mode by the end of October, an advance of \$143,705.75 is recommended. This is the quarterly payment that would normally be distributed in late December for the January-March 2008 quarter.

### **EVALUATION AND FOLLOW UP**

Staff will bring back a report and recommendations to Council by December that responds to the issues and questions to be addressed by HSJ.

### **POLICY ALTERNATIVES**

Nor applicable at this time.

### **PUBLIC OUTREACH/INTEREST**

- Criterion 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

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- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

### **COORDINATION**

This report was coordinated with the City Attorney's Office, the Budget Office, Parks, Recreation and Neighborhood Services Department and General Services. The contents of this report were provided to HSJ.

### **COST SUMMARY/IMPLICATIONS**

Not applicable at this time.

### **BUDGET REFERENCE**

The third quarter payment of \$143,705.75 is already budgeted.

### **CEQA**

Exempt

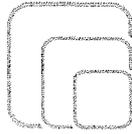


KAY WINER  
Chief Deputy City Manager

For questions please contact Kay Winer, Chief Deputy City Manager, at (408) 535-8130

Attachment: Macias Consulting Group Audit  
HSJ Letter dated September 28, 2007  
Macias Letter dated October 3, 2007

**MACIAS**  
CONSULTING GROUP



# **Performance Audit History San Jose**

**City of San Jose**

**Firm Contact  
Denise Callahan, Partner**

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**925.274.3819  
dcallahan@maciasconsulting.com**

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**September 2007**

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## EXECUTIVE SUMMARY

The City of San Jose requested Macias Consulting Group, Inc. (MCG) to review the History San Jose organization (HSJ) in response to the HSJ's request for additional funding. Our objectives were to: (1) assess HSJ's overall financial viability; (2) assess HSJ's compliance with its original 1998 contract with the City of San Jose; (3) determine the cost to operate an organization of similar nature and size, including determining at what funding level the City should support HSJ; and, (4) recommend additional appropriate performance and outcome expectations for HSJ.

Our analysis showed that the current financial viability of HSJ has eroded significantly. Fiscal strength dropped dramatically from FY 05-06 to FY 06-07. Additionally, the Museum's available reserves to fund emergency repairs, special programs or other services had deteriorated from FY 02-03 to FY 06-07. Other financial indicators that we assessed, such as net income levels, accounts payable and debt levels showed similar patterns of deterioration.

HSJ's poor fiscal health has led to operating deficits in three of the last four years, from deficits of \$189,135 in FY 03-04 to \$324,442 in FY 06-07, including the depletion of fund reserves, lines of credits and City endowments. HSJ is struggling to pay its operating expenses in spite of recent increases in revenues gained from HSJ's programs, services and other earned income sources because private income has declined.

Macias determined that HSJ is in poor financial condition for a number of reasons. First, HSJ is not currently structured to have strong financial management when key financial management positions are part-time. Second, our analysis of HSJ's budget showed that realistic revenue goals were not established. For example, HSJ has not met budgeted estimates for fundraising. In FY 06-07, the budget called for \$612,568 in private income revenues, however only \$317,625 was actually received. We found that HSJ does not have a full-time position dedicated to Fund Development, which would help meet budgeted goals. Third, HSJ was unable to reduce operating expenditures to overcome operating deficits.

In spite of its financial problems, HSJ does have noteworthy accomplishments that it can build upon. Our analysis of performance metrics shows that HSJ has exceeded Peer History benchmarks for the following:

- Number of visitations by children of about 23,700 in comparison to Peer History Museum benchmark of 1,000.
- Maintenance costs of \$1.62 per square foot in comparison to Peer History Museum benchmark of \$1.84 per square foot in 2004.
- Dollars raised per visitor of \$6.86 in comparison to Peer History Museum benchmark of \$4.73.

To assist HSJ in its financial management, it is important to know how much it costs to operate HSJ. We determined that the base level of operational costs *adjusting* for basic programming

and staffing structure is \$1.6 million per year to minimally operate HSJ. HSJ reports that to sustain current operating levels will be about \$1.8 million.

To help HSJ improve its fiscal condition, this report proposes a recommendation to the City to provide HSJ funding of \$2,297,191 over a 4-year time period. This amount is \$717,113 more than what HSJ would have received under the existing funding agreement (\$1,580,078). We offer specific performance goals to be met within this designated time period. It is expected that HSJ will cover the declining revenues from the city with increases in its own income sources from \$823,470 in Year 1 to \$1,406,238 in Year 4.

## INTRODUCTION

Macias Consulting Group reviewed the financial viability of HSJ and conducted a compliance assessment of its adherence to the Operation Agreement between the City of San José and the History Museums of San José (now HSJ). This Agreement was negotiated and agreed upon by both parties, approved by San José City Council and commenced on April 1, 1998. We conducted this review in accordance with generally accepted government auditing standards, and limited our work to that specified in the Objectives, Scope and Methodology Section of this report. We thank the HSJ staff, and Board members Margie Matthews, Joe Head, Mark Ritchie, Tom Scott, and Gerry DeYoung, and past members Steven Cox, Ann Louise Heigho and Dean Helms, for their cooperation, time, and information provided during this review. We also thank the City of San Jose for its assistance as well.

## BACKGROUND

In 1971, the San Jose Historical Museum was established in Kelley Park where 30 structures (light tower, hotel, bank, and Victorian homes) were either re-located or replicated over a period of time to become the City's focal point for the preservation and promotion of local history. The City operation developed a non-profit support organization, the San José Historical Museum Association, for the purpose of fundraising and community involvement as well as a number of affiliate partner groups to help in the development and support of the programs. The San José Historical Museum, renamed History Park, is located in Council District 7 and covers over 14.5 acres. HSJ manages these facilities with the help of private investments of individuals, groups and affiliate groups and community partnerships. In addition to structures at History Park, HSJ is also responsible for the care of the historical Fallon House and Peralta Adobe, located in downtown San Jose. Per the 20-year Operation Agreement (Agreement) with the City, HSJ is responsible for the professional care and management of facilities and the City's estimated collection of over 520,000 artifacts, the largest regional historical collection in the state of California, and is required to adhere to museum standards in the provision of care.

In 1994, the San Jose Historical Museum Association advocated to the City that a non-profit could better manage the combined San Jose Historical Museum and the Peralta Adobe and Fallon House historical sites, as a non-profit would be unencumbered by some City regulations and better suited to raising funds and other types of donations. In 1994, the City contracted with a consultant, the Wolf Organization, Inc., to conduct a study on the merits of transitioning the facility from City to non-profit operation. In March 1995 the Wolf Organization presented its report to the City that did not recommend such a transition, but a compromise scenario was developed that provided a graduated transition plan to establish HSJ as a non-profit organization. On April 1, 1998, the management and care for the City's buildings, grounds, and collection was formally transitioned to History Museums San José (now History San José).

Both the City Council and the nonprofit proponents were optimistic about the Museum becoming non-profit, with the hope that privatization would enable the museum to garner more private funding. With that in mind, the City and HSJ entered into the 20-Year Agreement, which included financial provisions for the next twenty years, with a declining payment from the City to HSJ over that time period, paid in quarterly installments. As shown in Table 1.0, the payment schedule front-loaded much of the twenty-year funding in the first ten-year period with the

assumption that it allowed HSJ to leverage increasing private donations to fund operations and become less reliant on the City. Of the \$12,084,524 to be provided over 20 years, the City has previously paid \$8,259,208 with another \$3,852,121 to be provided to HSJ over the next 11 years.<sup>1</sup>

HSJ in May 2007 requested that the City stabilize its annual operating subsidy for FY 2007-08 at the FY 2006-07 level. However, the City determined that an audit was the next course of action to assist in determining future payments to HSJ and to address its request for increased annual funding to cover a larger percentage of its operating costs.<sup>2</sup>

**Table 1.0: History San Jose Subsidy Schedule**

Year	Fiscal Year	History San Jose Annual Subsidy	Supplemental Staff Payment	History San Jose Total Annual Subsidy
1	1998-99	964,000	199,823	1,163,823
2	1999-00	750,000	199,823	949,823
3	2000-01	750,000	199,823	949,823
4	2001-02	750,000	199,823	949,823
5	2002-03	750,000	199,823	949,823
6	2003-04	712,500	199,823	912,323
7	2004-05	660,000	199,823	859,823
8	2005-06	610,000	199,823	809,823
9	2006-07	487,500	199,823	687,323 <sup>3</sup>
10	2007-08	375,000	199,823	574,823
11	2008-09	135,262	199,823	335,085
12	2009-10	135,262	199,823	335,085
13	2010-11	135,262	199,823	335,085
14	2011-12	135,262	199,823	335,085
15	2012-13	135,262	199,823	335,085
16	2013-14	135,262	199,823	335,085
17	2014-15	135,262	199,823	335,085
18	2015-16	135,262	199,823	335,085
19	2016-17	135,262	199,823	335,085
20	2017-18	61,710	199,823	261,533
<b>Total</b>		<b>\$8,088,068</b>	<b>\$3,996,460</b>	<b>\$12,084,528</b>

Source: Operation Agreement between the City of San Jose and The History Museums of San José.

<sup>1</sup>The amount paid versus the amount remaining to be paid on the Agreement do not reconcile because HSJ approached the City in 2005 regarding funding provisions and requested operational control options for Kelley Park parking lots. As a result, the City reported to City Council on June 13, 2006 and recommended a Second Amendment to the Operation Agreement with History San José that clarified parking issues and reduced the operating subsidy for the year by \$50,000 rather than the \$75,000 scheduled and reaffirmed the subsidy payment schedule for the duration of the 20-year agreement. The adjustment is reflected in the amount reported as paid by the City.

<sup>2</sup> HSJ estimated that operating costs were \$1.865 million to maintain operations at their current level.

<sup>3</sup> Actual amount paid to HSJ was \$714,124 for this period.

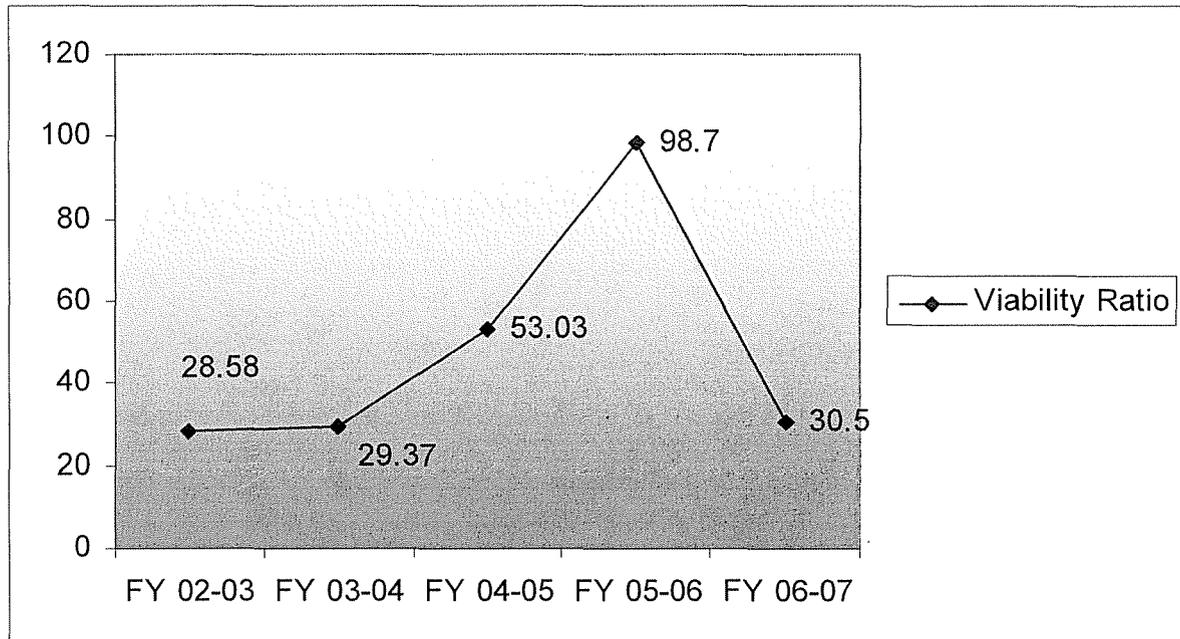
## Finding 1: HSJ's Financial Stability is Poor

Analyzing financial indicators can be a useful tool for helping boards and other stakeholders to assess financial viability and provide an in-depth understanding of an organization's financial statements. We analyzed seven key indicators, as presented below, and found that all key financial indicators, as well as other revenue and expenses that we analyzed for HSJ have eroded in the past year.

### HSJ Viability Ratio – Poor

The Viability Ratio is a basic indicator of financial strength by measuring the organization's availability of cash and assets to pay bills and other expenses as they come due, such as payroll and vendor payments. Ideally, a non-profit organization should be close to a ratio benchmark equal to 100 indicate strength. Between FY 02-03 and FY 05-06, HSJ viability ratios strengthened to very high levels, peaking at 98.70, as shown in Figure 1.0. However, HSJ's financial viability fell sharply in FY 06-07 to 30.5. This suggests that HSJ has been struggling to maintain available cash to pay large expenses as they come due.

Figure 1.0: HSJ Viability Levels, FY 02-3 to FY 06-07

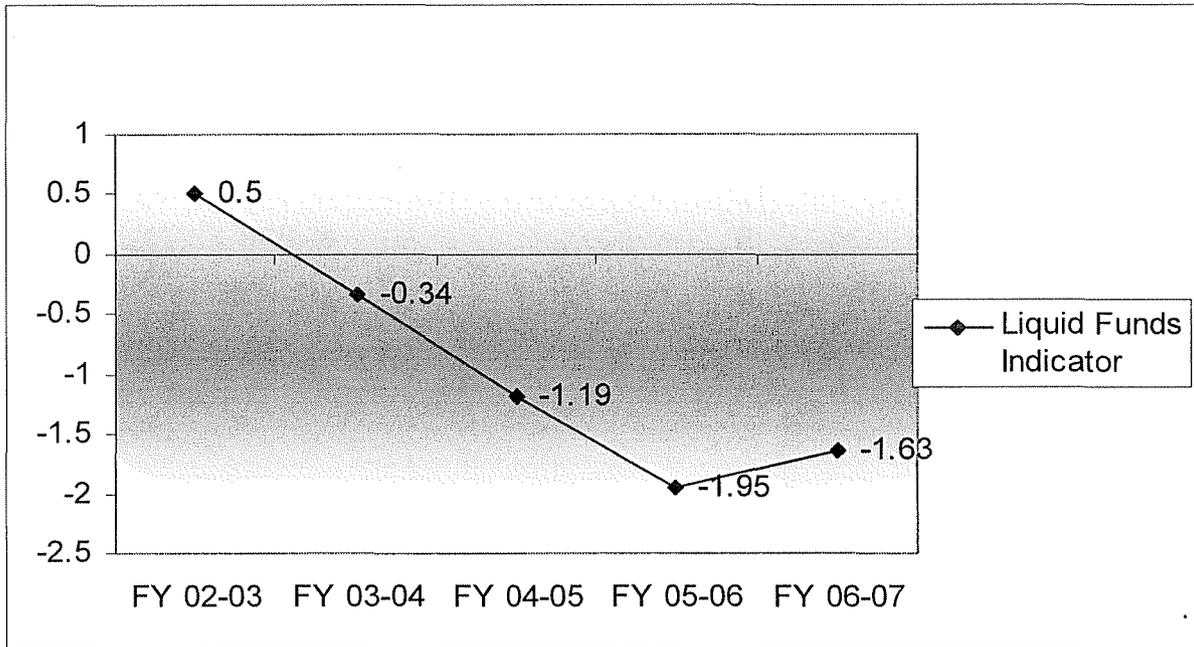


Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Available Cash – Poor

Available cash on hand (liquidity) is another basic indicator of financial strength. Metrics close to 1.0 indicate strength. As shown in Figure 2.0, HSJ had cash available in FY 02-03, but this has since deteriorated over time to -1.63. This suggests that HSJ does not have the cash that it needs to pay its bills.

**Figure 2.0: HSJ Available Cash Levels, FY 02-3 to FY 06-07**

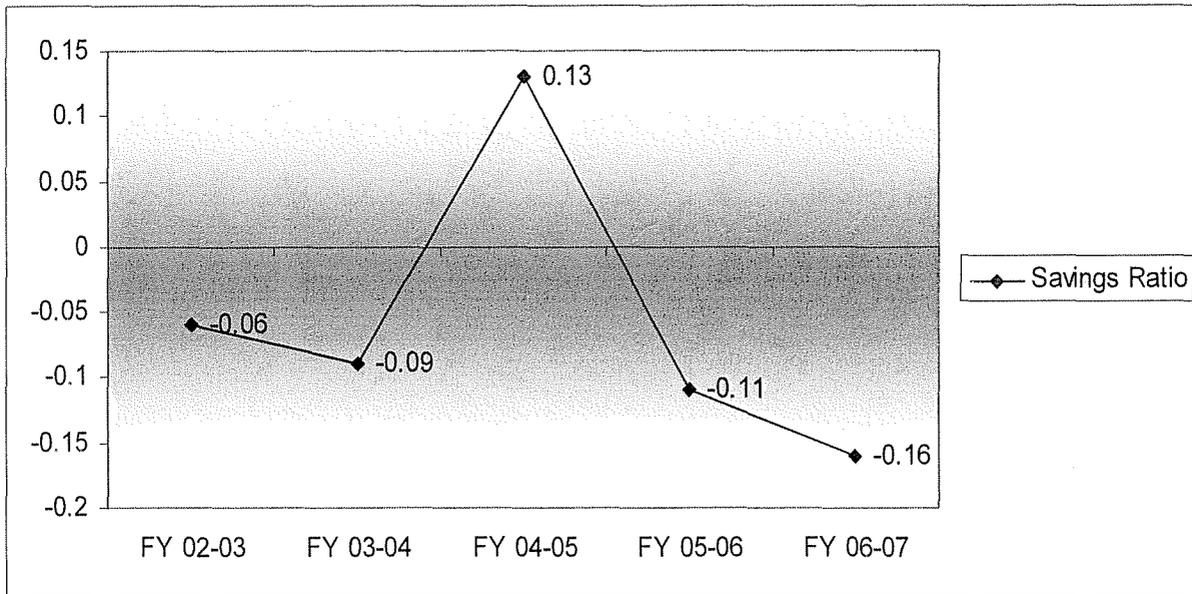


Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Savings Ratio – Poor

The Savings Ratio is an important indicator of longevity, and should be considered in combination with the liquid funds indicator. Because HSJ has poor levels of cash on hand, a higher savings ratio is desirable. As shown in Figure 3.0, HSJ has had a negative savings ratio in four of the past five fiscal years at -0.6 in FY 02-03 to -0.16 in FY 06-07, which indicates trouble for HSJ in the immediate future.

**Figure 3.0: HSJ Savings Ratio, FY 02-3 to FY 06-07**

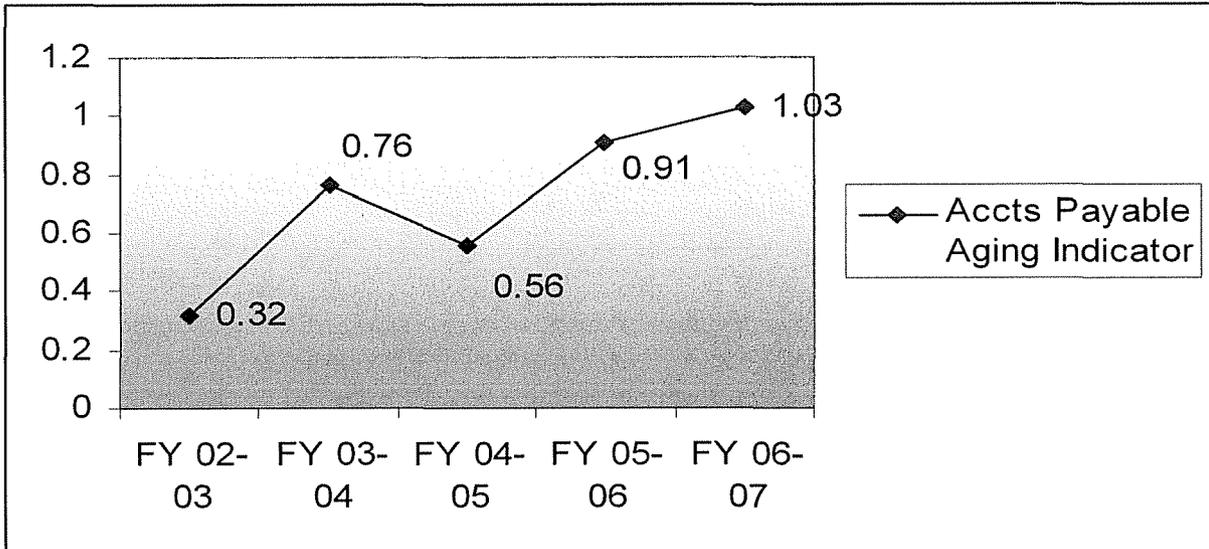


Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Accounts Payable Levels – Poor

Accounts Payable provides information on the credit strength of an organization. The lower the score at the 0 level mark, the better the ability of an organization to pay its bills. As shown in Figure 4.0, HSJ’s ability to pay its bills has steadily eroded to very weak levels from 0.32 in FY 02-03 to 1.03 in FY 06-07. The data suggests that it is taking HSJ a considerable amount of time, likely over 60 to 90 days to obtain the cash necessary to pay its bills.

**Figure 4.0: HSJ Accounts Payable Aging Levels, FY 02-03 to FY 06-07**

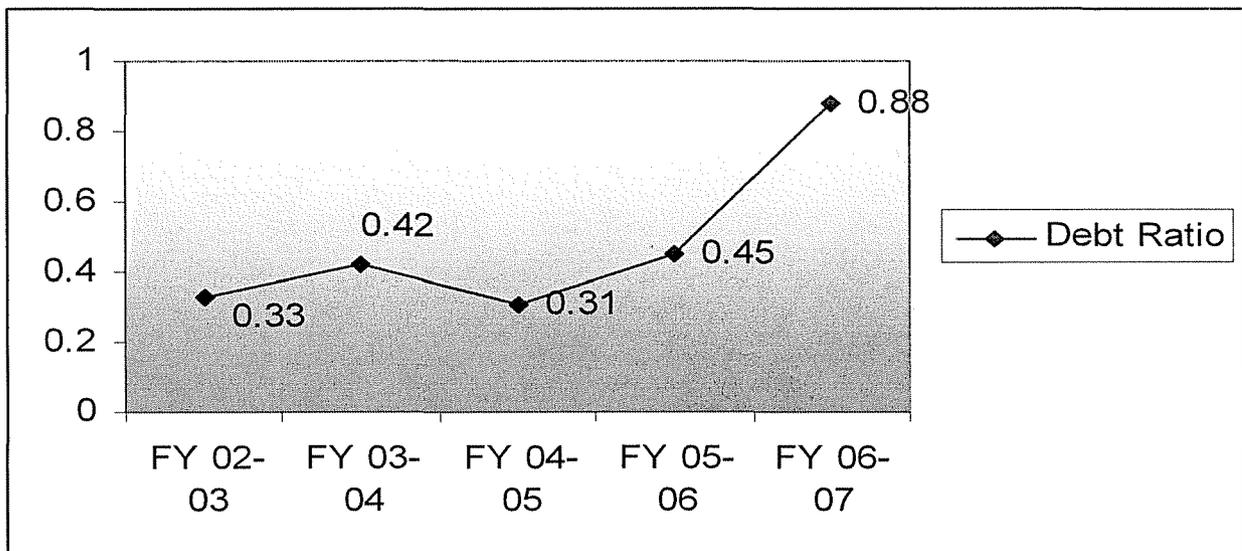


Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Debt Ratio - Eroding

A Debt Ratio measures the financial solvency of an organization. As shown in Figure 5.0, HSJ’s Debt Ratio has been on the rise from 0.33 in FY 02-03 to 0.88 in FY 06-07, which is a warning signal to HSJ that its financial condition is worsening.

**Figure 5.0: HSJ Debt Ratio, FY 02-03 to FY 06-07**



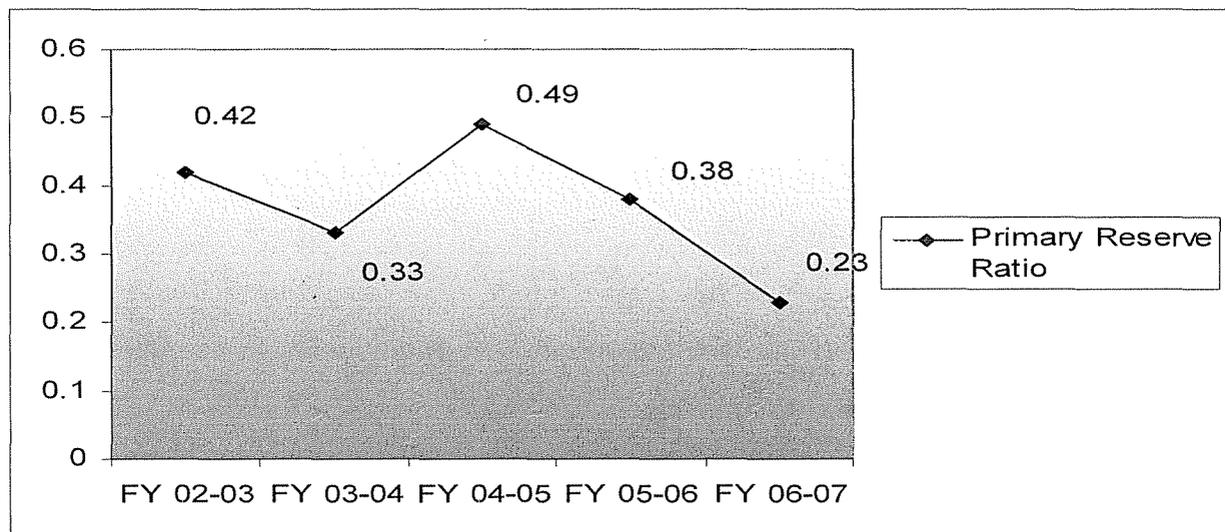
Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Primary Reserve Ratio - Poor

A primary reserve ratio provides information on an organization's ability to cover its expenses or shortfalls in revenue. Our analysis shows that HSJ's reserves are on a downward trend. As shown in Figure 6.0, the ability of HSJ to handle its operating expenses has fallen from 0.41 in FY 02-03 to nearly 0.23 by FY 06-07. This suggests that HSJ would have significant difficulty in sustaining operations since revenues were lower than anticipated and expenses were higher than what was expected.

HSJ has depleted its reserve funds. Also, the City provided an original Endowment Fund for \$105,340 for the museum prior to the transition to HSJ, to be used to offset operating expenses with the interest earned. However, HSJ has had to use all of the Endowment Fund even though the City had prohibited HSJ from doing so. Currently, \$138,425 is now payable to the Fund. Further, two years of negative cash flows caused HSJ to deplete both its endowment and reserves because of HSJ's limited ability to meet budgeted revenue projections.<sup>4</sup>

**Figure 6.0: HSJ Primary Reserve Ratio Trend, FY 02-03 to FY 05-06.**



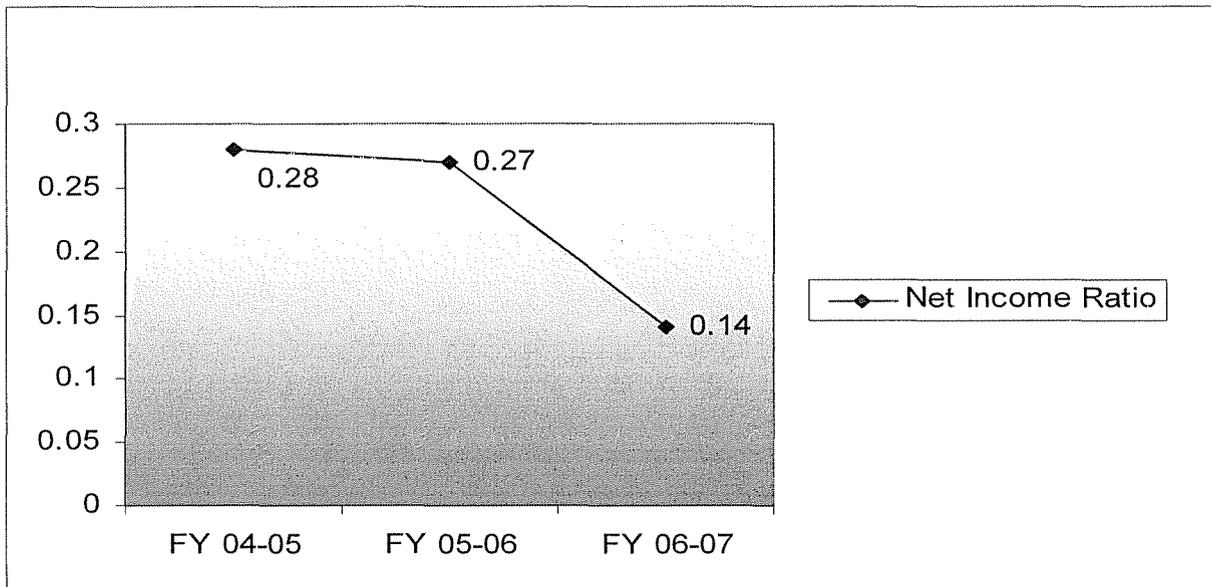
Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

<sup>4</sup> As of June 30, 2007, HSJ had \$138,425 payable to the endowment. Past audited financial statements cited this in Note H from FY 2005-06 Audited Financial Statements, that these permanently restricted net assets were to be maintained and the principal held and not distributed and that the income generated was to be distributed annually to Board Designated Unrestricted Net Assets. During the years ended June 30, 2006 and 2005, HSJ used permanently restricted net assets for purposes other than those prescribed by the donor imposed restrictions. HSJ recorded an interfund receivable reflecting the use of the permanently restricted net assets.

### Net Income Ratio

The Net Income Ratio shows how well an organization has operated within its means. As shown in Figure 7.0, the net income ratio has declined over time for HSJ from .28 in FY 04-05 to 0.14 in FY 06-07. This data suggests that HSJ has been increasingly unable to operate within its means because of declines in both unrestricted net assets and unrestricted income.

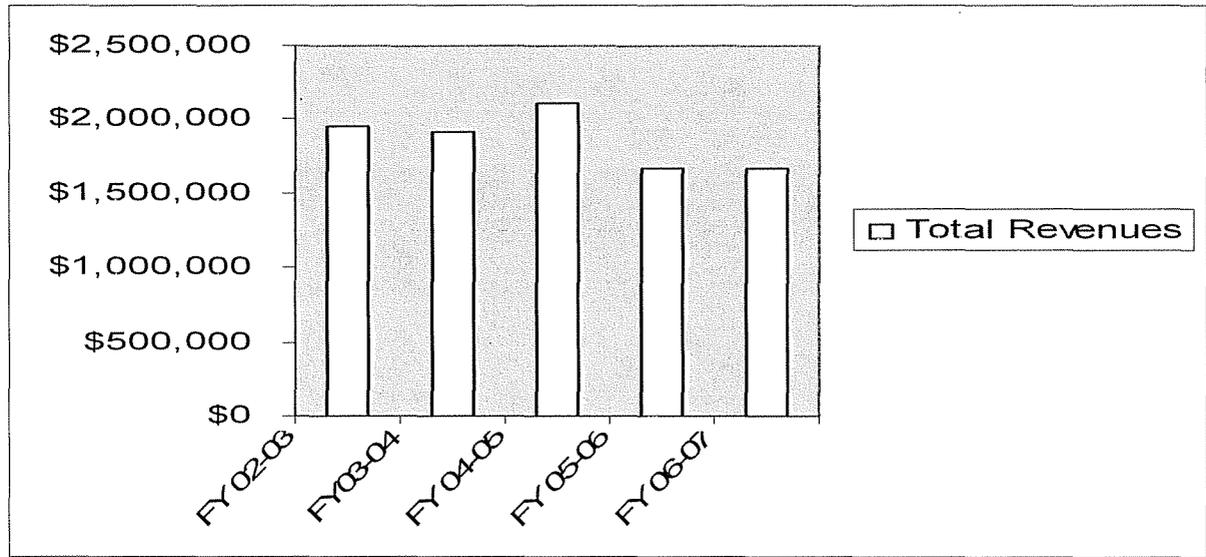
**Figure 7.0: HSJ Net Income Ratio Trend, FY 04-05 to FY 06-07**



Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 04-05 through FY 05-06. FY 06-07 source – trial balance. Audited financial statements for FY 02-03 and 03-04 were not available.

Our further analysis on eroding net income levels shows that total revenues have declined and are insufficient to support its current mission and level of services. As shown in Figure 8.0, HSJ revenues reached a high in FY 04-05 at about \$2.1 million but then declined in FY 06-07 to nearly \$1.7 million. Most revenue sources have fallen because of declining private income comprising of contributions, membership donations, and other in-kind support, in addition to the decline in the subsidy HSJ receives from the City. It is important to note that earned income revenues have increased from \$92,650 to \$139,438 annually from Student Programs even though school attendance has remained relatively stable, as shown in Table 2.0 and Figure 9.0. Also, event revenues have increased from \$59,564 to \$113,132 as shown in Figure 10.0.

**Figure 8.0: HSJ Revenue Trends FY 02-03 through FY 06-07**

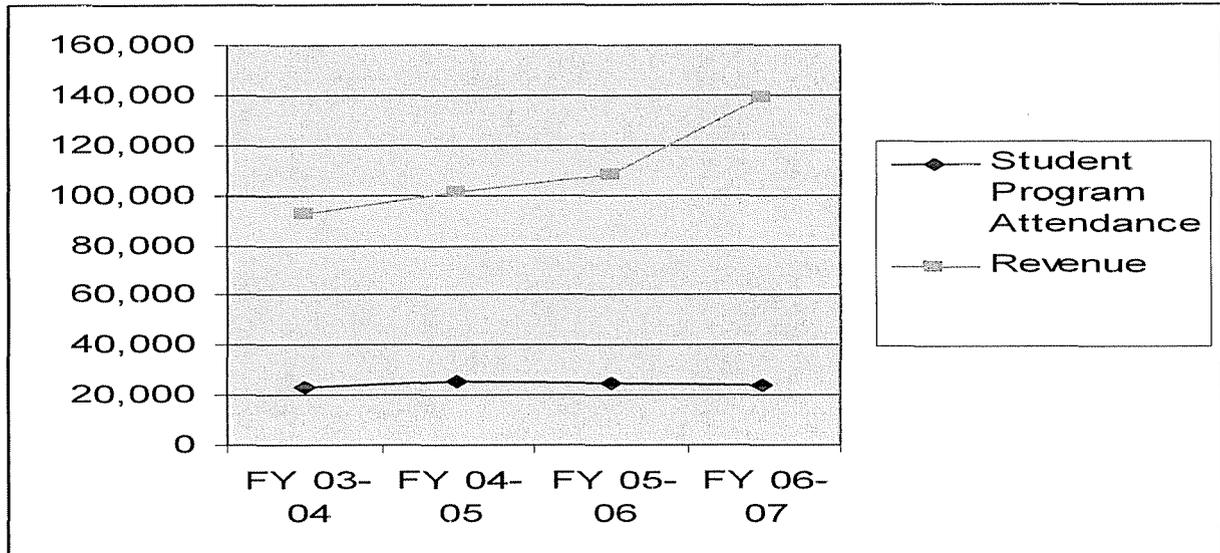


\*FY 06-07 is based on HSJ unaudited trial balance report.

**Table 2.0: Student Attendance and Revenue, FY 03-04 to FY 06-07**

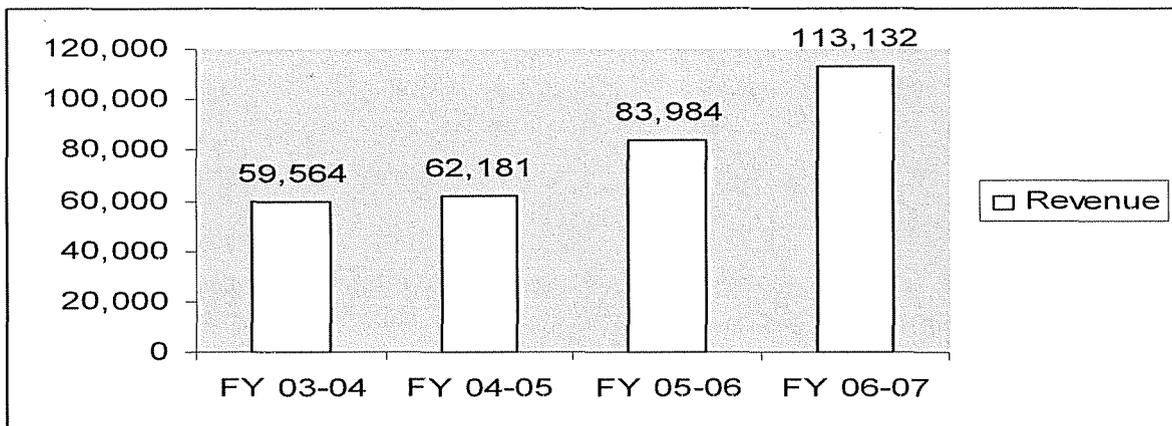
	FY 03-04	FY 04-05	FY 05-06	FY 06-07
Student Program Attendance	23,099	25,170	24,918	23,721
Revenue	\$92,650	\$101,173	\$107,863	\$139,438

**Figure 9.0: HSJ Student Attendance and Revenue generated for FY 03-04 through FY 06-07**



Source: FY 03-04 – FY 06-07 Program Attendance and Revenue by Pricing Category

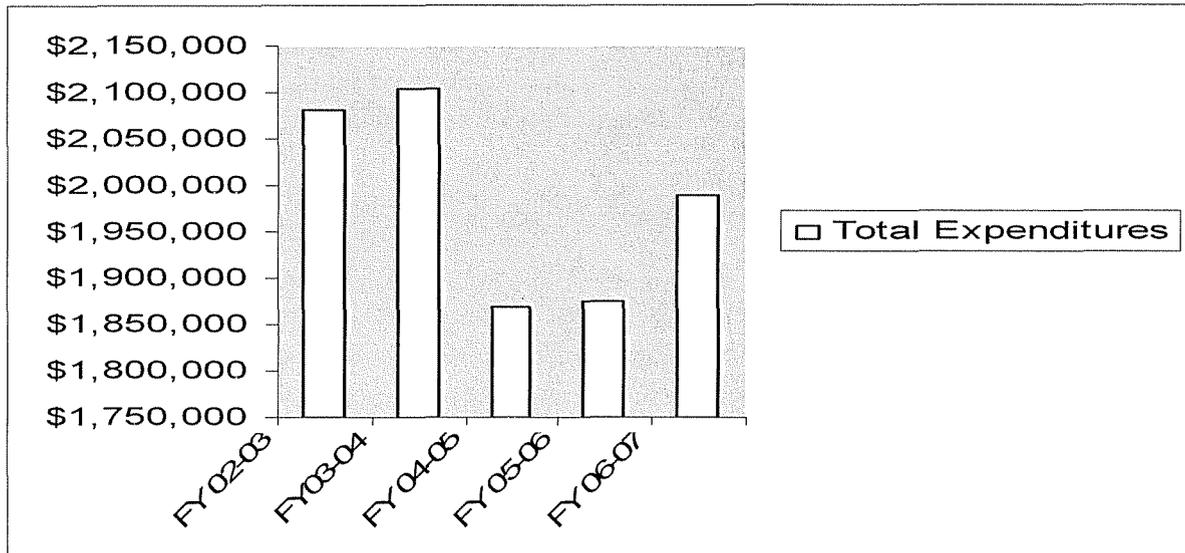
**Figure 10.0: HSJ Event Fee Revenue generated for FY 03-04 through FY 06-07**



Source: FY 03-04 – FY 06-07 Program Attendance and Revenue by Pricing Category

HSJ has not been able to reduce expenditures sufficiently to adjust to declining revenues from all sources. As shown in Figure 11.0, expenditures declined and then remained somewhat stable between FY 02-03 and FY 06-07. Major increases in expenditures occurred in professional support due to increases in contract labor costs, but were somewhat offset by a decline in total employee-related expenses. Other expenditure amounts were relatively stable during this period.

**Figure 11.0: HSJ Expenditure Trends FY 02-03 to FY 06-07**



Although HSJ accelerated revenue-generating efforts, such as increasing event fees, educational program fees, and selective admission charges, these efforts were not enough to prevent another deficit in FY 06-07 because projected revenues from private income sources were not realized. HSJ also ran a deficit during two of the other three previous fiscal years. FY 04-05 was the HSJ’s only deficit-free year due to a one-time donation of \$100,000 from Cisco Systems, which HSJ designated to ensure ongoing free admission to History Park. As shown in Table 3.0, deficits ranged from \$189,135 to \$324,442.

**Table 3.0: HSJ Deficits**

	FY 03-04	FY 04-05	FY 05-06	FY 06-07
HSJ Revenues	\$1,914,005	\$2,103,811	\$1,668,618	\$1,663,531
HSJ Operating Exp	\$2,103,140	\$1,868,075	\$1,875,285	\$1,987,973
Deficit/Surplus	(\$189,135)	\$235,736	(\$206,667)	(\$324,442)

We noted that running a deficit of any kind (planned or involuntary) is common among many nonprofits, including museums surveyed in benchmark studies. Based on nationwide benchmark data from 809 museums surveyed, the percentage of those that ran a deficit in one year ranged from a high of 33.9 percent in FY 03-04 to a low of 24.9 percent in FY 04-05. In its 2006 Financial Report, the American Association of Museums reported that:

- Over 20 percent of museums ran deficits in two consecutive years,
- 22 percent ran a deficit of in one of three years,

- 12.7 percent ran deficits for two of three years,
- 11.5 percent ran deficits in three of three years,
- 55 percent never ran a deficit.

No other information was provided in benchmark studies on whether Museums that had operating deficits had Reserve or Endowment funds to help offset the shortfall.

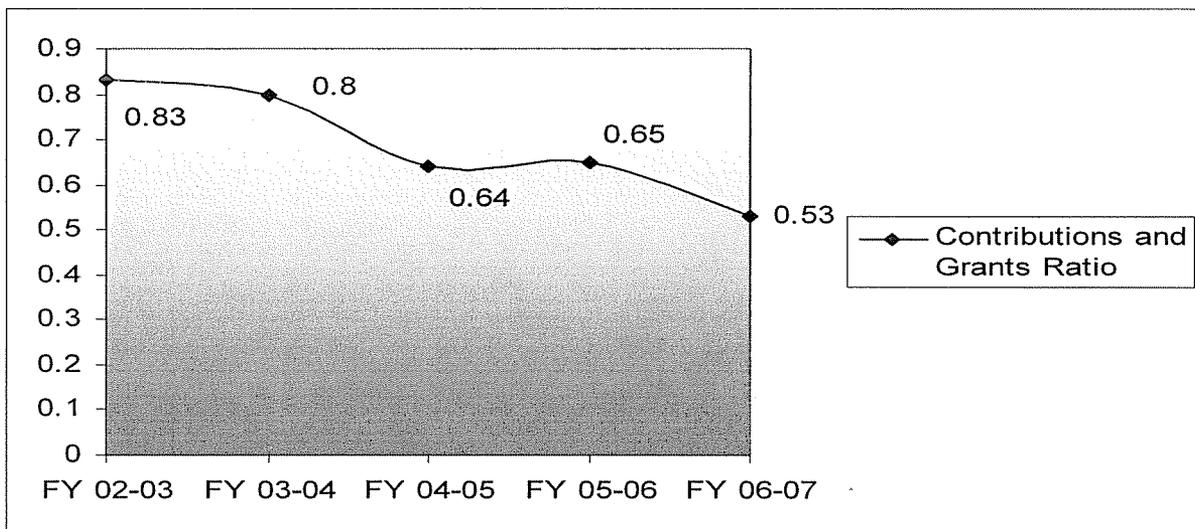
To help determine if HSJ can overcome operating deficits, we studied the possibility of HSJ enhancing revenues by adopting general admission fees. Among 266 peer History/Historical Society museums, 57 percent had a general admission fee versus 41 percent without fees charged. The remaining two percent did not respond to the survey.

Similarly, when compared to peer museums of similar operational sizes, and for those museums with operating budgets between \$750,000 and \$3,000,000, 70 percent of those museums charged general admission fees, and among those that were designated as private/non-profit, 67 percent charged a fee. HSJ charges admission fees for various educational programs, custom tours of History Park and Peralta-Adobe Fallon House and for special programs and events held at History Park throughout the year, but does not charge a general admission fee. HSJ officials explained that HSJ officials reported that charging a fee at History Park has not been considered a feasible option because it was not cost-effective to staff a booth at the entrance.

## Finding 2: HSJ Has Not Had a Predictable Level of Private Funding

Our review of past revenue and expense details from audited financial statements and fundraising documents found that HSJ has not had a consistent, predictable level of private income. As shown in Figure 12.0, HSJ's Contributions and Grants Ratio, which measures the success at fundraising efforts and seeking other sources of revenue, has gradually declined since FY 02-03 at .83 to .53 in FY 06-07.

**Figure 12.0: Contributions and Grants Ratio**



Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

HSJ officials acknowledged that revenue issues have been exacerbated due to difficulties in fundraising. Fundraising dollars come in several forms: memberships, sponsorships of events, individual and corporate donations, foundation grants, and events. Also, the HSJ Board is charged with procuring outside funds, including the requirement that each board member “give or get” \$3,500 per year. However, some board members explained that fund raising abilities vary within the Board, which affects the success in that area. Other board members explained that the HSJ’s relationship with the City has impaired its ability to receive contributions from external sources because it is a City Park and the City’s collection. Yet, others cited that many potential contributors would rather give to other types of museums, noting competition in the area, such as the Children’s Museum. Fundraising difficulties are not new to HSJ. In 1995, the Wolf Report stated that it may take a very long time for HSJ to become independent from the City until it can prove that it can successfully perform fundraising.<sup>5</sup> HSJ’s fundraising capability is limited because its Fundraising Consultant works on a part-time basis, which is further discussed in this report.

<sup>5</sup> The Wolf report also stated the need for the new nonprofit organization to obtain two key positions outside of the CEO position; a CFO with a non-profit background and Fundraising personnel. At HSJ, the CFO position has experienced nearly annual turnover, and has been staffed with part-time independent contractors, currently for three days per week.

We examined the effectiveness of HSJ in fundraising and found that HSJ is not as efficient as it should be in raising funds. Evaluating fundraising efficiency is a key indicator used by funders and non-profit organizations to assess whether an organization is making good use of its fundraising resources. The median fundraising expenses for history museums nationwide were \$2,020 in 2004 with \$0.05 spent for every dollar raised. In comparison, fundraising expenses were \$132,550 in 2004 for HSJ with a fundraising efficiency indicator of 16 cents to raise every one dollar of funds. For FY 04-05, a total of \$835,552 was earned through fundraising efforts. As shown below in Table 4.0, HSJ's fundraising efficiency decline in FY 05-06 when its efficiency ratio more than doubled to \$0.37 spent for every dollar raised, and funds raised fell to \$275,203.

**Table 4.0: HSJ Fundraising Efficiency Indicators FY 03-04 through FY 05-06**

Fiscal Year (FY)	Fundraising Expenditures	Funds Raised	Cents spent to raise \$1
FY 03-04	\$198,667	\$475,865	\$0.42
FY 04-05	\$132,550	\$835,522	\$0.16
FY 05-06	\$101,412	\$275,203	\$0.37

Source: American Association of Museums 2006 Museum Financial Information and HSJ's IRS 990 Forms 2003, 2004, 2005.

HSJ has had to rely on the City's subsidy to help maintain operations. Per existing agreements, the City has provided from about 40 to 50 percent of HSJ's total revenues, as shown in Table 5.0. In recent years, the City has continued supporting HSJ by providing other subsidies totaling another \$90,000.

**Table 5.0: Percent of HSJ Revenues from City Subsidy, FY 02-03 to FY 06-07**

	FY 02-03	FY 03-04	FY 04-05	FY 05-06	FY 06-07
HSJ Revenues	\$1,948,788	\$1,914,005	\$2,103,811	\$1,668,618	\$1,663,531
City Funding	\$974,348	\$917,323	\$859,863	\$809,823	\$714,124
% of Total Revenue from City	50.00%	48.0%	40.9%	48.5%	43.0%

Source: MCG analysis based on audited financial statements, FY 02-03 to FY 05-06, Unaudited trial balance report, FY 06-07.

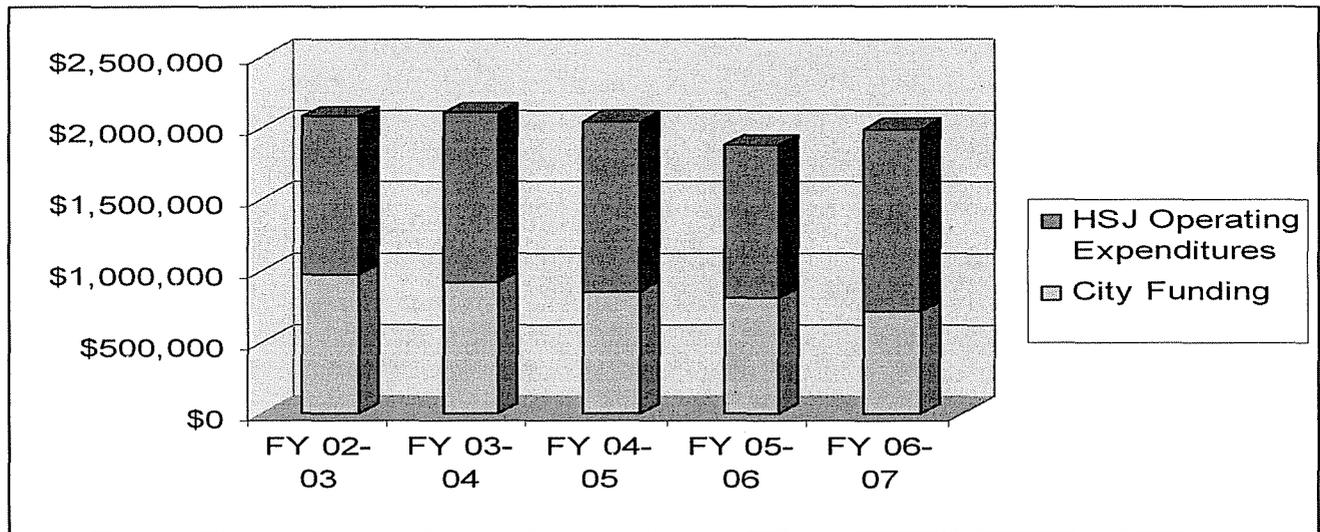
Upon further analysis, the total funding received from the City has allowed HSJ to cover from a low of 35 percent to a high of 46 percent of total expenditures, as shown below in Table 6.0 and in Figure 13.0. In FY 06-07, the City's funding subsidies covered 35.9 percent of total HSJ operating expenditures of about \$2 million.

**Table 6.0: Operating expenditures FY 02-03 through FY 06-07**

	FY 02-03	FY 03-04	FY 04-05	FY 05-06	FY 06-07
HSJ Operating Expenditures (Total)	\$2,080,412	\$2,103,140	\$1,868,075	\$1,875,285	\$1,989,794
% of Expenditures covered by City	46.8%	43.6%	46.0%	43.2%	35.9%

Source: MCG Analysis of Audited Financial Statements.

**Figure 13.0: City funding and HSJ operating expenditures, FY 02-03 to FY 06-07.**



The new CEO has taken steps to address fundraising issues. First, the CEO is working on board development by attempting to recruit new members. The CEO explained that the current financial situation of the Museum has made recruitment difficult. Second, the CEO has allocated more hours to the contracted fundraising personnel, though still not at full-time levels. The CEO has also instructed development staff to work on a membership and audience campaign with the board to enhance memberships and sponsorships. Finally, the CEO has targeted community groups to raise awareness of HSJ and to identify possible funding opportunities by networking.

The CEO has become involved on other approaches to obtain external funding, such as working to obtain additional funding for structural improvements for the Peralta Adobe and Fallon House from the City's Redevelopment Agency. HSJ is interested in improving some of the facilities and its surroundings. To further assist with the modernization, the CEO reported that contacts were made with developers who work in the area to allocate funds to historic preservation, but efforts so far have been unsuccessful although negotiations continue. The CEO also reported success in partnering with corporate donors for specific exhibits, such as with Summerhill Homes, KB Homes, and Cinnabar Commons, Ltd. for online exhibits.

### **Finding 3: Financial Management Concerns Identified at HSJ**

Sound financial management comprises many components of the structure of non-profit organizations from effective leadership to providing monthly financial reports. We examined HSJ's financial structure and the services that it provides and determined that HSJ needs to have more effective financial management. HSJ's external auditors found in FY 04-05 and FY 05-06 a "going concern" regarding HSJ's fiscal condition. This has far-reaching ramifications because these concerns may hinder the museum from obtaining additional lines of credit and jeopardize grant funding from outside sources.

We found that HSJ has not designated the key position of Chief Financial Officer (CFO) as full-time. Other nonprofit organizations of HSJ's size have full-time CFOs. HSJ also has not authorized the CFO to make difficult financial decisions because of the contracted nature of the position. Presently, the senior accountant and administers the day-to-day financial transactions of the Museum. The CFO works with the CEO on strategic financial planning for HSJ. Similarly, HSJ has not designated its fundraising position as full-time. Presently, a contractor works part-time and day-to-day activities, such as researching fundable programs, seeking out available grants and assembling proposals for grants. Without permanent positions in place, it will difficult for HSJ to have long-term strategic planning and execution.

Other concerns include HSJ's over projection of its revenues presented in its annual budget. HSJ overestimated revenues for Contract Services, Licensing and Curation Fees, Gifts and Grants, and Fundraising Events in the amount of \$472,215. HSJ recognized the shortfalls in revenue projections and took steps to reduce FY 06-07 projected operating expenditures of \$2.4 million. HSJ ended the year with actual expenditures of \$1.9 million that suggests that even though HSJ recognized the need to reduce its expenditures, the reductions did not go far enough to include reductions in other expenditure areas, including their staffing levels to cover year-to-year budget deficits.

During the past year, HSJ has made some improvements to financial reporting and administrative infrastructure, such as:

- Developing financial policies and procedures,
- Requiring monthly budget meetings with Program Directors,
- Preparing cash flow projections, and
- Presenting more detailed financial reports to the HSJ Board.

Although an intangible, but equally noteworthy, HSJ has a strong volunteer base to assist in providing services and in operations. HSJ volunteers logged a total of 24,732 hours in FY 06-07. According to the U.S. Bureau of Labor Statistics, the hourly rate attributed to work performed by volunteers in the United States is \$18.77 per hour, totaling a labor value, or cost savings of \$464,222 for HSJ.

## Finding 4: HSJ Has Not Met Key Requirements of the Agreement

The 1998 Agreement between the HSJ and the City provides for eight<sup>6</sup> types of operational and performance requirements designed to assist HSJ in strengthening its operations. The requirements, as shown in Appendix I, include developing and implementing a strategic plan, stipulating funding requirements, and meeting performance benchmarks. Our analysis determined that between 1998 and 2003, HSJ generally met or partially accomplished six of the eight requirements. After 2003, HSJ's compliance with the requirements of the Agreement has diminished. Our analysis shows that of the eight types of requirements, four were no longer applicable, three were partially met, and the remaining one was not met, as shown in Table 7.0. HSJ explained that it had not completed an annual report last year, but at the time of our review, preparation of an annual report and a strategic plan were in process.

The City, which monitors HSJ compliance with the Agreement requirements, has alerted HSJ about the compliance issues in the past, particularly the lack of maintaining the Reserve requirement and the lack of annual report submissions. HSJ acknowledged this, and current management is aware of these issues and addressed them in its draft Strategic Plan for 2008-13. Although the Agreement does grant the City authority to redirect future funding to paying back the Reserve, as well as the authority to take over the Museum, the City has not considered these actions as viable in the past. However, without imposing consequences for inaction, the City has limited ability to ensure that HSJ moves toward seeking other supplemental income sources.<sup>7</sup>

**Table 7.0: Agreement Compliance Matrix**

Agreement Requirement	Compliant between 1999 to 2003	Compliance between 2003 and 2007
Submit first Strategic Plan that provides goals, measurable performance standards and strategies	Yes	N/A
Strategic Plan in 5 year intervals FY 04-05 to 08-09 FY 07-08 to 11-12	Yes	N/A  Partially: Draft is in the works for FY 07-08 to FY 11-12.
Apply for and Receive/ Maintain Accreditation	Yes	Partially – In progress

<sup>6</sup> The Agreement outlines 11 compliance components though many are the same. For purposes of clarity, we combined elements where necessary, such as in the strategic plan and accreditation requirements. See Appendix for full listing and analysis.

<sup>7</sup> Source: Notes to Audited Financial Statements FY 2003, 2004.

Agreement Requirement	Compliant between 1999 to 2003	Compliance between 2003 and 2007
Operating Reserve equal to 15% of the HSJ operating budget	No	No
Average funds raised per year equivalent to at least 50% of the city's annual operating subsidy.	Yes	Partially
Annual Reports to show progress against strategic plan.	Yes	No. Annual reports documenting progress per the Strategic Plan were not prepared or submitted after 2004. Annual report for 06-07 in progress.
Conservation Workplan	No	N/A
Institutional growth evidenced by membership and audience increase by at least 10% from year 1.	Yes	N/A

Source: MCG Analysis.

## Finding 5: In Other Areas, HSJ Performs Well Compared to Peer Museums

While HSJ collects performance data, HSJ does not currently track performance metrics from year-to-year. We determined how HSJ compared to other museums of similar type and nature for:

- Building maintenance costs
- Facility size and staffing levels
- Personnel costs
- Students served
- Cost per visitor
- Personnel costs<sup>8</sup>
- Income Sources

Overall, HSJ performed well in nearly all areas, as further described below, when compared to other peer museums nationwide, which suggests HSJ has noteworthy characteristics from which to build.

### HSJ's building and maintenance costs are lower

Average maintenance costs for history museums nationwide were \$1.84 per square foot in 2004. In comparison, HSJ was below the peer average at \$1.62 per square foot. As shown in Table 8.0 below, costs of building maintenance are below other peer museums because of other types of costs that HSJ does not incur for some building, such as some landscaping, utilities, security and storage. General Services estimated a total of \$649,599<sup>9</sup>, which represents the value of grounds maintenance, storage, landscape, and utilities that are currently not incurred by HSJ at History Park and Peralta-Adobe Fallon House. We did not assess the accuracy of the data provided by the City.

**Table 8.0: HSJ Building Maintenance Costs Per Square Foot, FY 03 - 04 through FY 05 - 06**

Fiscal Year (FY)	Building Maintenance	Total Expenditures	Ratio of Building Maintenance To Total Expenditures
Peer Benchmark			11%
FY 03-04	\$72,332	\$2,103,140	3%
FY 04-05	\$81,298	\$1,868,075	4%
FY 05-06	\$83,630	\$1,875,285	5%

Source: American Association of Museums 2006 Museum Financial Information

<sup>8</sup>The publication listed financial data for 2004 only for this specific type of museum (History Museum/Historical Society).

<sup>9</sup> General Services estimates of \$394,701 for Grounds Maintenance as budgeted by the Department of Parks Recreation and Neighborhood services (PRNS) for History Park; \$56,176 for Grounds Maintenance at Peralta Adobe-Fallon House Complex; and \$108,722 for utilities, and security costs at the Collection Center.

**HSJ size is one of the largest surveyed**

Physical Size

Average physical size for peer history museums nationwide was 7.5 acres in 2004. In comparison, HSJ exceeded the median size by almost double, at 14 acres.

Staffing Size

The median for staffing levels for history museums nationwide was two for full-time and two for part-time personnel in 2004. In comparison, HSJ exceeded peer benchmarks with levels of 15 for full-time personnel and 14 for part-time personnel. The median for volunteer staff for history museums nationwide was at 40 in 2004. In comparison, HSJ exceeded the benchmark with about 200 volunteers. The data suggests that HSJ may not have difficulty attracting staff.

**HSJ has school attendance that far surpasses its peers**

The median number of students served in museums nationwide was about 1,000 students in 2004. In comparison, HSJ in 2004 served over 25,000 students, as shown in Table 9.0 or 25 times the median. When compared to all types of museums that had operating budgets within the budget size of HSJ (\$750,000 and \$3,000,000) the median of 6,126 students is still well below HSJ performance levels. Educational programs highlight the area of HSJ’s positive financial growth in earned income.

**Table 9.0: HSJ Student Program and Tour Attendance and Associated Revenue**

	FY 03-04	FY 04-05	FY 05-06	FY 06-07
Student Program Attendance	23,099	25,170	24,918	23,721
Revenue	\$92,650	\$101,173	\$107,863	\$139,438

**Dollars raised and costs per visitor are favorable for HSJ when compared to peers**

Dollars raised per visitor among peer museums nationwide was \$4.73 in 2004. In comparison, HSJ raised more dollars per visits at \$6.86 in 2004.

The median cost per visit for history museums nationwide was \$21.05 in 2005. In comparison, the cost per visitor was \$18.43 for HSJ in 2004.

**HSJ’s personnel expenses are higher when compared to peers with similar size of operating expenditures**

Median personnel expenses for peer history museums nationwide were \$86,600 including taxes and employee benefits in 2004. In comparison, HSJ exceeded the peer median in 2004 at \$1.3

million because of its considerably larger staff and size. It is important to note HSJ is located in a high cost-of-living area.

For all museums with operational expense between \$750,000 and \$3,000,000, the median cost for Personnel Expenses was \$764,694, about \$600,000 less than HSJ's personnel costs. All Museums with this budget size allocated a median of 52 percent of their operating income to personnel costs in 2004. As shown in Table 10.0, HSJ was close to this peer median at 56 percent for FY 04-05. HSJ was above the median at 60 percent for FY 06-07. When including the contract labor into the personnel cost category, HSJ was again above the median at 71 percent for FY 06-07.

However, among museums with a government "parent" organization, the median average of personnel costs was 63 percent, similar to HSJ with 60 percent, as shown below in Table 10.0. This suggests that personnel costs would likely be same if the City operated HSJ (excluding benefit costs).

**Table 10.0: HSJ Total Personnel Cost Ratios (as a percentage of Total Operating Expenditures), FY 02-03 to FY 06-07.**

	FY 02-03	FY 03-04	FY 04-05	FY 05-06	FY 06-07
Personnel Cost Ratio	68%	71%	56%	64%	60%
Personnel Cost Ratio (plus contract labor )	74%	80%	63%	79%	71%

Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06. FY 06-07 source – trial balance reports.

Although peer information was not available, we examined HSJ's success at devoting as much of its resources as possible to program activities - a goal for many non-profit organizations. Over time, non-profit organizations should strive to achieve ever-higher program ratios, typically around 80 percent. As shown in Table 11.0, HSJ's program ratio has held steady in the past two years at 73 and 72 percent of operating expenses, respectively.

**Table 11.0: HSJ Program Ratios, FY 02-03 to FY 06-07.**

	FY 02-03	FY 03-04	FY 04-05	FY 05-06	FY 06-07
<b>Program Ratio</b>	na	0.79	0.81	0.73	0.72

Source: MCG Analysis of HSJ Audited financial statements for corresponding years FY 02-03 through FY 05-06 of Program Operations, as stated in the Statement of Functional Expenses. FY 06-07 source – trial balance estimates.

**HSJ's Earned Income sources are like that of peers, but other income sources are sub-par due to heavy reliance on the City subsidy**

Museums typically obtain operating income from four main income sources: (1) private income; such as contributions and donations, (2) earned income; from event fees, exhibit and program fees, (3) government sources, like grants or subsidies from a government agency, and (4) from

investment income. Total income amounts vary widely by the institution's size, but comparing the median income amounts for each of these sources can be expressed as a percentage to total operating income for comparison purposes. For Peer History museums, we examined three key income sources – private income, earned income and government sources. The peer median percentages are shown in the tables and analysis provided below.

### Earned Income

Earned income comes from events, exhibits, program fees and retail sales. Peer History Museums generate about 31 percent of their total operating income from this source. HSJ is slightly below the peer median at 29 and 28 percent in FY 05-06 and FY 06-07, as shown in Table 12.0.

**Table 12.0: HSJ Earned Income as a percentage of Total Operating Income, FY 03-04 to FY 06-07**

	FY 03-04	FY 04-05	FY 05-06	FY 06-07	Median
Earned Income	\$259,937	\$247,124	\$488,971	\$428,156	\$35,716
Percentage of Total Operating Costs	14%	12%	29%	28%	31%

### Private Income

Private income comes in the form of contributions, donations, membership and general fundraising. Peer Museums derive an average of 32 percent of their total operating income from these sources. HSJ obtained income from private sources at levels about 10 percent lower than those of Peer Museums. As shown in Table 13.0, HSJ's private income levels were at 21 percent of total operating income for FY 06-07.

**Table 13.0: HSJ Private Income (as a percentage of Total Operating Income) FY 03-04 to FY 06-07**

	FY 03-04	FY 04-05	FY 05-06	FY 06-07	Median
Private Income	\$605,018	\$949,400	\$367,045	\$317,625	\$34,609
Percentage of Total Operating Costs	32%	45%	22%	21%	32%

### Income from Government Agency

Some museums receive funds from government agencies to assist with operations. Monies allocated to Museums in the form of subsidies or grants from Government agencies averages about 30 percent of total operating income for Peer History Museums. As previously noted, the City subsidy has been HSJ's main income source, where this income source has been upwards of 20 percent higher than Peer averages. As shown in Table 14.0, City subsidy level comprised 50 percent of total operating income in FY 06-07.

**Table 14.0: HSJ Government Income (as a percentage of Total Operating Income, FY 03-04 to FY 06-07)**

	FY 03-04	FY 04-05	FY 05-06	FY 06-07	Median
Government Income	\$1,047,293	\$905,126	\$809,823	\$762,124	\$25,080
Percentage of Total Operating Costs	55%	43%	49%	50%	30%

**HSJ does accomplish its mission**

HSJ has made considerable progress toward accomplishing its mission of engaging diverse audiences in exploring the varieties of human experience that contribute to the continuing history of San José and the Santa Clara Valley. We determined there are a variety of cultural organizations that share History Park with HSJ: the affiliate groups of the Portuguese, Chinese, Vietnamese and Hellenic Society – all on site at History Park, as well as the Pioneers exhibit homes. These offerings portray the history of those groups as they made their way to San Jose and Santa Clara Valley. Additionally, HSJ offers many cultural and ethnic exhibits online and at City Hall that appeal to a variety of audiences. For instance, the Speed City Road Trip exhibits focused on the African American experience in San Jose in the 1950's. Another measure is the number of educational programs and persons attending them. As previously reported, HSJ excels in presenting educational programs to the local community. Sixteen different types of school programs were designed by HSJ to match California history curriculums for primary grades.

## Finding 6: Minimum Baseline Cost Analysis to Operate HSJ is \$1,663,847

We provided below three cost estimates to show (1) what it would cost to operate HSJ solely as an independent non-profit organization, (2) HSJ operating expenditures if it were to have personnel costs on par with Peer History Museums median benchmarks of 52 percent of total operating costs, and (3) HSJ operating expenditures if it were to restructure personnel and professional support staffing levels.

As illustrated in Table 15.0, total operating expenses for HSJ are \$2,517,058.

**Table 15: Total Operating Expenses if HSJ Operated as a Single Entity**

<b>Total Operating Expenses <sup>10</sup></b>	<b>Current Expenses - FY 06-07</b>
Personnel costs (salaries, wages, benefits)	\$991,090
Professional support (contract labor)	\$190,589 <sup>11</sup>
Occupancy costs (building maintenance, custodian services, utilities, insurance)	\$218,282
Business cost (payroll processing fees, bank fees)	\$45,629
Communications (telephone, Internet)	\$35,114
Equipment and repair (equipment rentals, non capital equipment purchases)	\$34,381
Programming (educational programs)	\$352,374
Operations and Maintenance <sup>12</sup> (grounds maintenance, utilities, security, storage)	\$649,599
<b>Total Costs</b>	<b>\$2,517,058</b>

As illustrated in Table 16.0, HSJ baseline expenditures to operate with personnel costs more aligned with Peer History Museum's personnel cost benchmark ratios of 52 percent and excluding the grounds maintenance, utilities, security, and storage costs that are not currently incurred by HSJ, would be \$1,847,477.

<sup>10</sup> Line items shown are consistent with the types of expenses illustrated in Audited Financial Statements (section on Functional Operating Expenses).

<sup>11</sup> HSJ has reported that they sought additional contract labor support in the temporary hiring of archivists as part of conservation work done as part of a National Endowment of the Humanities (NEH) grant.

<sup>12</sup> Based on General Services estimates of \$394,701 for Grounds Maintenance as budgeted by the Department of Parks Recreation and Neighborhood services (PRNS) for History Park, \$56,176 for Grounds Maintenance at Peralta Adobe-Fallon House Complex and Central Services estimates of \$108,722 for utilities, and security costs at the Collection Center.

**Table 16.0: Baseline HSJ Expenses Project to Have Comparable Personnel Costs to Peer History Museums**

Baseline Operating Expenses - less programming cost	Peer Median of History Museums with Operating Expenses Greater than \$750k: (52% personnel cost ratio)
Personnel costs (salaries, wages, benefits)	\$971,078
Professional support (contract labor)	\$190,589
Occupancy costs (building maintenance, custodian services, utilities, insurance)	\$218,282
Business cost (payroll processing fees, bank fees)	\$45,629
Communications (telephone, Internet)	\$35,114
Equipment and repair (equipment rentals, non capital equipment purchases)	\$34,381
Programming (educational programs)	\$352,374
Operations and Maintenance (grounds maintenance, utilities, security, storage)	\$0 <sup>13</sup>
<b>Total Costs</b>	<b>\$1,847,477<sup>14</sup></b>

As illustrated in Table 17.0, HSJ baseline expenditures provided that HSJ restructure its staffing allocations to accommodate a full time CFO and Development personnel would be \$1,663,847. The goal of the staff restructuring is to overcome year-to-year operating deficits.

<sup>13</sup> We excluded Operations and Maintenance costs not incurred by HSJ which include General Services estimates of \$394,701 for Grounds Maintenance as budgeted by the Department of Parks Recreation and Neighborhood services (PRNS) for History Park, \$56,176 for Grounds Maintenance at Peralta Adobe-Fallon House Complex and Central Services estimates of \$108,722 for utilities, and security costs at the Collection Center.

<sup>14</sup> HSJ is located in a higher cost of living area.

**Table 17.0: Adjusted Operating Cost Targets That Would Require Staff Restructuring**

Baseline Operating Expenses	Operating Cost Targets (Staffing Restructure to Lower Professional Support Expenses)
Personnel costs (salaries, wages, benefits)	\$971,078
Professional support (contract labor)	\$6,988
Occupancy costs (building maintenance, custodian services, utilities, insurance)	\$218,282
Business cost (payroll processing fees, bank fees)	\$45,629
Communications (telephone, Internet)	\$35,114
Equipment and repair (equipment rentals, non capital equipment purchases)	\$34,381
Programming (educational programs)	\$352,374
Operations and Maintenance (grounds maintenance, utilities, security, storage)	\$0
<b>Total Costs</b>	<b>\$1,663,847</b>

Source: HSJ Audited Financial Statements, FY 06-07, MCG Fiscal Analysis.

## CONCLUSIONS

HSJ has provided the community with diverse exhibits, an extensive permanent collection, and comprehensive educational programs to schools around the region. Although HSJ has operated as a non-profit entity since 1998, it has encountered significant financial problems and has not sufficiently adjusted its operating levels to reduce the impact of the planned reduction in the City subsidy over time. Today, HSJ does not have revenues to continue to provide its current level of services without ongoing financial assistance from an external entity, whether through public or private funding. As a result of its ongoing financial shortcomings, the HSJ has perpetually drawn down its endowment and reserves and has operated with multi-year deficits.

Despite the efforts of the current CEO and new management practices implemented by the CFO, more needs to be done to implement stronger financial management. Tools and processes must be developed to ensure that HSJ Program Directors strictly adhere to their budgets, monitor cash flow closely and that HSJ takes action when cash flows are not favorable. If negative cash flow persists into future years, the financial condition could continue to spiral downward. During a time of financial crisis, strong financial management should be the top priority for HSJ, in addition to obtaining private funding and allocating the staff necessary to accomplish these goals.

In our opinion, the City should continue to fund HSJ because it has strengths of dedicated staff and a foundation that it can build upon, such as its educational programming, facility size and the diversity of its collection. Subsidies should be continued if HSJ, in return, can develop and execute a financial management strategy so that it can utilize the City's subsidy to supplement its operations, as intended by the original Agreement, and meet other specific performance goals and objectives that we have presented below.

## RECOMMENDATIONS

The recommendations that are presented below are predicated on our opinion that the City should continue its assistance in funding of HSJ operations because HSJ provides strong educational and cultural programs to the community. The subsequent funding allocation was developed as an independent analysis.

**Recommendation 1:** The City should consider and adopt the following four-year funding levels for HSJ, as shown in Table 18.0. The information presented below does not include cost-of-living or salary increases because of the current fiscal health of HSJ.

We outline the performance measures that HSJ should follow to improve its financial condition and strengthen accountability.

**Table 18: City Funding Levels for HSJ Subsidy**

Year 1	Year 2	Year 3	Year 4	Total
\$840,377	\$743,796	\$456,009	\$257,009	\$ 2,297,191

### Year 1: Stabilize HSJ Fiscal Condition - \$840,377 in City Funding

The City should increase HSJ’s subsidy to a levels of \$840,377 to stabilize and improve its current financial condition<sup>15</sup>. Providing this funding level would allow HSJ to maintain basic operations, and/or continue with most of their programming.

HSJ in return must perform the following activities:

- Develop Execution Plan for Year 2 through Year 5 activities.
- Establish a Board Committee to oversee the Execution Plan.
- Restructure personnel staffing to hire a full-time CFO and Development Director, and add ten percent to FY 06-07 marketing budget of \$74,541 for direct marketing activities.
- Reduce personnel costs to median levels for history museums of a similar size and reduce by two to four FTEs (depending on salary level) to accomplish peer level personnel costs (52 percent of total operational costs). This would require a reduction of \$217,000, or 17 percent in personnel costs (including contract labor), plus associated benefits.
- Recruit five board members who will “give or get” \$17,500.
- Receive Accreditation.
- Seek professional assistance from the City in budget development and prepare monthly versus actual reports to take managerial action to eliminate deficit spending.

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<sup>15</sup> Based on the original funding agreement of \$574,823 plus \$265,554 to cover prior year deficits (average).

- Accomplish zero net income.
- Continue fundraising efforts, in a combination of contributions, donations and membership by five percent, resulting in additional revenues of \$15,881 respectively.
- Review and evaluate current programming efforts and streamline where appropriate, i.e., discontinue those that are not cost effective

**Year 2: HSJ Increase Program Revenue - \$743,796 in City funding.**

The City should slightly decrease funding levels to \$743,796. Funding levels can be reduced in Year 2 because, based on our review of operations, HSJ could realistically accomplish the following outcomes.

- Increase HSJ attendance by five percent that will increase operating revenues by \$15,000. Attendance can increase at HSJ because it has noteworthy programs and education activities that it could build upon.
- Eliminate non-critical positions from the budget as employees leave because of normal attrition and replace with volunteer staff.
- Increase board membership by additional five and “give or get” \$17,500. (\$35,000 cumulative total from Year 1)
- Increase contributions, membership and donations (private income) by ten percent from FY 06-07 levels, or \$31,000, to reach benchmarks for Peer Museums, as previously discussed on page 25. (\$46,881 cumulative total from Year 1)
- Seek professional assistance from the City in budget development and prepare monthly versus actual reports to take managerial action to eliminate deficit spending.

**Year 3: Increase Grant and Contribution Level – \$456,009.**

The City should decrease funding levels to \$456,009. HSJ would be expected to cover the decline in funding by accomplishing the following:

- Meet the 50 percent fund raising requirement of the Agreement and raise an additional \$82,687 over prior year funds raised from contributions, donations and memberships.
- Hire a full-time development coordinator who can realistically secure new grant sources totaling \$152,600.
- Add five new board members and “give or get” \$17,500, cumulating to \$52,500 in board member donations over the next three years.
- Seek professional assistance from the City in budget development and prepare monthly versus actual reports to take managerial action to eliminate deficit spending.

**Year 4: Replenish Endowment Fund - \$257,009.**

The City should provide funding levels of \$257,009 HSJ would be expected to accomplish the following activities:

- Develop and secure new exhibits successful at other museums to increase attendance and admissions by ten percent that would raise \$30,000 in revenue – through additional exhibit admission fees or increased custom tour fees. (\$45,000 cumulative total).
- Accomplish the peer History Museum benchmark of establishing earned income revenue levels at 32 percent of operational costs raising an additional \$69,000. (HSJ's current earned income level is at 19 percent of total costs).
- Increase private income from 25 percent to 30 percent (median) for an additional \$15,000.
- Add another five members to the board and raise \$17,500 (cumulative total of \$70,000 from base)
- Replenish the Endowment and Reserves with any operational surpluses.

The City should continue to fund the HSJ only if the organization meets mutually-agreed upon financial and performance measures. The City, to ensure appropriate accountability, should perform an annual fiscal review of HSJ's health. As part of this funding agreement, the City should state its intention to withdraw its support at any time should HSJ fail to meet the agreed-upon measures.

At the end of Year 4, the City should consider the following three options:

- Option 1: Continue funding at Year 4 Levels -- \$257,009.
- Option 2: Revert back to scheduled funding of \$335,085, per the former agreement for FY 11-12.
- Option 3: Re-evaluate HSJ's progress at meeting key goals and its fiscal condition to determine further funding levels.

As shown in Table 18.0, HSJ should receive \$2,297,191 over the next four years. The financial impact to the City is an additional \$717,113, as shown in Table 19.0. The City previously authorized funding of \$1,580,078 for the same time period. According to the benchmarks, Peer History Museums receive a median of 30 percent of operating income from government sources. Assuming a base operating level of \$1,663,847, total funding averages 34 percent of government provided income over the four-year period.

**Table 19.0: Financial Impact to the City**

Fiscal Year	Original Funding Amount Per Agreement (total)	Additional Funding	Total
2007-08	\$574,823	\$265,554	\$840,377
2008-09	\$335,085	\$408,711	\$743,796
2009-10	\$335,085	\$120,924	\$456,009
2010-11	\$335,085	-\$78,076	\$257,009
	\$1,580,078	\$717,113	\$2,297,191

**Recommendation 2:** The HSJ CEO should implement the following activities to enhance financial management:

- Change its budgeting process to ensure that program directors adhere to budgets and that corrective action is taken when prior month reports are unfavorable.
- Ensure Strategic plan, Annual Report, monthly budget versus actual reports, and Audited Financial Statements are presented to the City's Administrative Officer as required by the Agreement. The monthly versus actual reports and audited financial statements must accompany a memo that provides an analysis of HSJ's fiscal condition.

**Recommendation 3:** The HSJ Board should immediately coordinate budget development and ensure the following:

- Development of up-to-date income and expense forecasts.
- Establishment of expense limitations and income targets for department directors.

**Recommendation 4:** HSJ should provide semi-annual reports to the City on the following metrics:

- Change in corporate sponsorship at events
- Change in overall contributions each month
- Change in financial viability trends, including
  - Viability Ratio
  - Liquid Funds Ratio
  - Net Income Ratio
  - Contributions and Grants Ratio
  - Debt Ratio
- Change in overall Museum performance trends, including:
  - Fundraising Efficiency Ratio
  - Cost Per Visitor
  - Dollars Earned Per Visitor
  - Dollars Raised Per Visitor
  - Income from private sources as a percentage of total operating income
  - Collections Care Expenses as a percent of total operating expenses
  - Personnel expenses as a percent of total operating expenses
  - Ratio of volunteers to full-time staff

## Other Issues

We estimated the financial impact to HSJ if the City were to continue its implementation of the current financing schedule, per the Agreement. According to the Agreement, City revenues are scheduled to decline by 19.6 percent from FY 06-07 to FY 07-08. That situation creates significant funding gaps for HSJ if it does not take any corrective action to improve its fiscal condition given its current operating costs and expenditures, especially in the short term. Regressing the level of non-city operating income, we found that if they continue to decline, coupled with the City's scheduled funding decline over the next three years (FY 07-08 through FY 09-10), funding gaps will almost double between FY 07-08 and FY 08-09. (This is based on our estimate of the HSJ operating budget of \$1,663,841 required to maintain basic operations.<sup>16</sup>) To illustrate the deficit that HSJ will incur in FY 07-08, see Table 20.0.

**Table 20.0: Impact of Current Agreement on HSJ**

Possible Financial Impact to HSJ Based on Status Quo Agreement and HSJ Operating Income Trends	FY 07-08	FY 08-09	FY 09-10
HSJ (Non-City) Operating Income (trend over time-declines)	\$791,214	\$745,167	\$699,119
Additional City Funds Per Agreement (decline)	\$574,823	\$335,085	\$335,085
Total Operating Income (projected)	\$1,366,037	\$1,080,252	\$1,034,204
Operating Expenditures	\$1,663,841	\$1,663,841	\$1,663,841
Revenue Less Expenditures	(\$297,804)	(\$583,589)	(\$629,637)

<sup>16</sup> Per Memo dated May 8, 2007 – Manager's Budget Addendum #4.

## Agency Comments

The City and HSJ were provided the opportunity to comment on our draft report. Items that were technical in nature were incorporated into this report for added clarity. The City generally agreed with our recommendations contained within this report. HSJ stated that we had good ideas within the recommendations, but had disagreed with the recommendation pertaining reducing staff sizes as suggested within our proposed recommendation. HSJ proposed that staff cuts would have to come from critical key management positions and as a result, HSJ would no longer have the staff need to carry out educational programs or exhibits, or would not be able to comply with the city contract in terms of professional care of the collections. However, as reflected in this report, we suggested that HSJ restructure staffing at the lowest staff support levels (non-critical positions) where there would be minimal impact.

HSJ further commented on their need for additional guidance and expertise to help them implement our suggestions related to raising attendance and operating revenues. The city should consider this comment in its ongoing monitoring.

HSJ also stated that if it were to dissolve, then any additions to the collection HSJ has obtained since 1998 would become the property of the City.

## Appendix I: Compliance with Current Funding Agreement

### Agreement Requirements:

#### **Item: By the End of Fiscal Year One (FY 1999-98):**

**1. Submit strategic plan that provides goals, measurable performance standards and strategies that address, but are not limited to the following areas:**

- a. Income Development**
- b. Interpretive exhibitions and programs**
- c. Educational programs including school programs**
- d. Community Outreach and Public Service programs**
- e. Collections Management, conservation and care**
- f. Accreditation by the AAM**
- g. Audience Development**
- h. Volunteer Recruitment and retention**
- i. Board Development**

Status: Compliant. HSJ's 1999-2004 Strategic Plan, *A Plan to Serve*, is comprised of goals specifically related to all areas required by the Agreement.

**2. HSJ should submit a separate plan and timetable for applying for accreditation by the end of fiscal year 5 (FY 2002-03) if the Strategic Plan does not contain these points.**

Status: Compliant. The Strategic Plan listed a plan for Accreditation.

**3. Fiscal Years 2-5 (1999-00 through 2002-03): HSJ shall submit annual activity/progress report on the performance measures set forth in the strategic plan.**

Status: Compliant. For Fiscal years 99-00 through FY 02-03, annual progress reports were submitted by the former HSJ CEO.

**4. By the end of Fiscal Year 5 (FY 2002-03): HSJ must substantially meet the performance measures set forth in the Strategic Plan. At a minimum HSJ must achieve the following objectives in addition to the Accreditation objective:**

- a. Operating Reserve equal to 15% of the HSJ operating budget**

Status: Non-Compliant. Upon review of correspondence between HSJ and the City, and audited financial statements for FY 03-04 through FY 05-06, we found no evidence of the maintenance of the Reserve. Letters from the former HSJ CEO cited the depressed economy as reasons HSJ was unable to comply with the Agreement. Even in FY 04-05, when HSJ had a positive cash balance, it was unable to replenish the Reserve. Although the Agreement permits the utilization of the Reserve from time to time for cash-flow purposes with 30 days notice to the city, it requires that the Reserve must be repaid by the end of the following fiscal year. We reviewed annual financial statements and found there was no replacement of the reserve funds and after three years they were depleted.

Additionally, we reviewed the City's and HSJ's correspondence to verify that HSJ continually alerted the City of the situation, as required, and had a plan and commitment to replenish the Reserve each time HSJ requested its use. We also noted that within the Agreement, the City may require that all or part of the annual Operations payment be utilized to replenish the Reserve account, if the HSJ failed to repay the account by the end of the following fiscal year. However, the City opted not to resort to this action, because it would have had a further impact on HSJ's financial situation and chose to continue regular funding.

HSJ's draft strategic plan for FY 07-08 through FY 10-11 demonstrates its awareness of this issue and has a plan to replenish the Reserve by budgeting a monthly sum for this purpose over the next three years.

**b. Average funds raised per year equivalent to at least 50% of the city's annual operating subsidy.**

Status: Partially Compliant. The contract states that HSJ must raise funds equivalent to 50 percent of the annual operating subsidy provided by the City. HSJ was for the most part, in compliance. The exception was in FY 05-06, when funds raised totaled about 34 percent of the operating subsidy, as shown in the table below.

Fundraising Requirement 50 percent of City Subsidy

	FY 03-04	FY 04-05	FY 05-06	FY 06-07
Actual HSJ Funds Raised	\$475,865	\$835,522	\$275,203	\$409,502*
City Funding	\$917,323	\$859,863	\$809,823	\$714,124
Percent of City Subsidy	51.88%	97.17%	33.98%	57.34%

\*un-audited amount

**c. Institutional growth evidenced by membership and audience increase by at least 10% from year 1 (1998-99).**

Status: Compliant. We found that between 1998 and 2005, that public use had increased 200 percent from 51,000 to 150,000 annually, and that general admission attendance increased 58 percent. This did not include web-site hits.

**d. Permanent Collection identified by the survey conducted by the Museum Consultant has been re-mediated (Appendix 2).**

Status: Partially-Compliant. The City had supplied the funding for the Conservation Workplan in 1999 in the amounts of \$50,000 as required by the contract, and requested that the plan be produced. HSJ did not submit one to City, as required by the Agreement. HSJ officials explained that they had expended equal and possibly more funds to evaluate the collection and plan for proper care and treatment, which they believe would satisfy the original intent of the Conservation Workplan. About nine years ago when the City allocated funding for the plan, the HSJ CEO explained that she worked with another museum professional to combine their expertise to develop an informal plan for

conservation efforts, which were followed. We documented that HSJ had spent over \$71,080, not including materials, since 2001 on conservation assessment and treatment of the collection. We also noted that HSJ acquired a grant totaling \$89,467 in 2007 to provide further resources to the evaluation, assessment and treatment of the collection.

We also noted that since 1998 HSJ has collected items that have become its property and that while it is caring for the City-owned collections in the City-provided Collection Center, HSJ is providing for its own collections as well.

**5. HSJ shall create a new Strategic Plan for the next five years (FY 2007-08 through 2011-12) in conformance with Section A, with annual progress reports to be submitted to the City.**

Status: Partially Compliant. (In progress). A new strategic plan was created at the end of Year 5 (FY 2002-03), as outlined in the contract for FY 02-03; however no annual reports were generated to substantiate progress pertinent to any performance measures within the strategic plan. A general 1998-2005 document was submitted summarizing achievements of HSJ, but it was not as comprehensive or detailed as annual reports provided to the City in past years.

**6. Fiscal Years 6-20 (2003-04 through 2017-18) a. HSJ shall maintain Accreditation:**

Status: Partially Compliant (In Progress). When museums receive professional accreditation, they can (1) increase fundraising ability 2) enhance prestige and 3) acquire more collection/exhibition loans from other institutions.

We reviewed the accreditation application and the subsequent review that was conducted in 2005 by the national accreditation body, the American Association of Museums (AAM). Although HSJ was granted a conditional accreditation, full accreditation was withheld due to its financial standing at the time. Within the last year, HSJ has had to report on its progress regarding its financial status, but the AAM has not yet granted full accreditation. In a July 2007 AAM meeting, AAM deferred its decision granting HSJ accreditation until issuance of our report.

**b. HSJ shall create new strategic plans in 5-year intervals.**

Status: Partially Compliant. The former CEO had not prepared a Strategic Plan for 2006. The new CEO has plans and is in the process of completing a Strategic Plan for years FY 07-08 to be presented to the board and to the City with the annual report.

1650 Senter Road  
San José, CA 95112-2599  
408-287-2290  
Fax 408-287-2291  
www.historysanjose.org

September 28, 2007

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Debra Figone, City Manager  
City of San Jose  
San Jose City Hall  
200 East Santa Clara Street  
San José, California 95113

Dear City Manager:

On behalf of the staff and Board of Directors, this letter is in response to the Macias Draft Audit dated September 18, 2007. HSJ has previously submitted more specific comments and corrections concerning the Audit on Friday 21 and Saturday 22 to meet the Monday 24 deadline as requested. We have not heard anything since then, nor have we seen a Final Audit— never the less we are submitting this letter to you as requested in advance of your staff report.

The City's support for these facilities has been steadily declining over the years. In 2005, HSJ CEO and Board began meeting with City Staff to request that the contract be amended to stop the further decline of City financial support. While the City Council did approve a one-time \$25,000 "reduction of the reduction" in 2006, the continuing decline has resulted in a deficit situation for the institution.

As you know, the original contract was established in the midst of an economic boom in Silicon Valley. The contract itself recognized that the costs of operating these City facilities were unknown, but would be established after the contract was signed. Also, assumptions were made about future private funding that did not bear out. The subsequent economic decline has negatively affected all sectors in the region, including business, non-profits, and the City itself. Therefore, History San José must inform you that the recommendations in the recent Draft Audit

by the Macias Consulting Group are neither viable nor attainable in the current economic climate.

We do agree that HSJ's financial condition has deteriorated. The Board has already directed HSJ staff to immediately implement many of the recommendations contained in the report. We must point out, however, several fundamental flaws in the Audit:

1. **The proposed peer benchmarks presented in the Audit are unrealistic for HSJ because they are based on other institutions that do not resemble HSJ in any respect.** The "national peer benchmark" in the report is defined as having a physical size of 7.5 acres, 40 volunteers, school attendance of 1,000, general attendance of 7,000 with 2 full-time employees and 2 part-time employees. In fact, HSJ is responsible for managing four different sites: the Collection Center at the CSY, the Stockton Warehouse, the Peralta-Fallon Historic Site, and History Park, which is 14 acres alone; 200 volunteers; school attendance of 25,000; general attendance of over 100,000, and 15 full time and 14 part time employees. The criteria used to select institutions making up the "peer benchmark" are unknown.
  
2. **The Audit does not consider the Silicon Valley market in which History San José operates.** Comparing HSJ to other institutions across the nation from a 2004 study, does not take into account that Silicon Valley has the highest cost of living in country, and thus the corresponding need for higher employee salaries and benefits. In fact, HSJ's financial difficulties are very similar to San Jose's other institutions serving a municipal function.
  
3. **The Audit does not outline how the City has benefited from its partnership with History San José, namely in HSJ's ability to raise private funds and in-kind contributions to the City's facilities.** Although the amount of cash contributions has not met the objectives set forth in 1998, HSJ's audited financial statement by Petrinovich Pugh &

Co., LLP for FY05-06 shows HSJ raised an average of \$858,795, which is not insignificant. The Audit lists volunteer labor equal to \$464,222 as “intangible.” In addition, the Audit does not recognize the hundreds of thousands of dollars worth of capital improvements secured and managed by HSJ and its affiliates that have been gifted to the City in the last nine years.

4. **The Audit recommendations continue with the faulty assumption that declining City support is a viable model.** This model was proposed in 1998 when, as stated in the City contract itself, the costs of operating the Museum were unknown. After nine years of successful operation of the City’s History Museums, Archives, and Collection Center, HSJ’s audited financial statement by Petrinovich Pugh & Co., LLP for FY05-06 lists the operating costs at \$1,875,285.

The Audit’s proposed four year declining *City Financing Strategy for HSJ Subsidy*, starting with an annual payment of \$840,377 and ending at \$239,409 simply turns the clock back to FY2005-06 on the original *HSJ City Subsidy Schedule*. \$859,823 was not enough money to sustain these facilities in 2005, and it is certainly not enough money to sustain them in 2007.

HSJ has been successful in raising money for the many and diverse programs it now offers; but it remains extremely difficult to raise private funds to operate and maintain City facilities. We acknowledge that HSJ must greatly improve its fund raising capacity by strengthening the Board and hiring a full-time development officer. We plan to immediately implement these Audit recommendations along with many other good suggestions. However, we must respectfully propose the following alternative recommendations:

1. Recognize that the declining subsidy model as outlined in the Macias Audit is not viable for sustained operation of the City’s historical assets

and approve a realistic subsidy of \$1.2 million annually with a built in cost of living increase.

2. Direct City Staff to work with HSJ on a new contract, which includes a set of realistic performance standards and re-evaluation of the contract every three years.

The History San José Board of Directors, Staff, and Volunteers represent a large and diverse community. Each person is passionate about the mission of HSJ

*History San José aspires to provide innovative national leadership in preserving and sharing regional history by engaging diverse audiences in exploring the varieties of human experience that contribute to the continuing history of San José and the Santa Clara Valley.*

As an institution, we are confident that HSJ can continue to preserve San Jose's unique heritage and provide education, enrichment, and enjoyment to the San Jose community at a very high level. We sincerely ask that the City of San Jose make the same kind of commitment to this endeavor.

Sincerely,



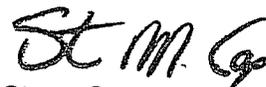
Alida Bray  
President & CEO



Margie Matthews  
Board Chair



Mark Ritchie  
Board Chair  
2001 – 2005



Steve Cox  
Board Chair  
1997 – 2001

Cc: Mayor and City Council, Kay Winer, Lee Price, CA Pioneers of Santa Clara County, CA Trolley and Railroad Corp., Chinese Historical & Cultural Project, Connie L. Lurie College of Education Assoc., Digital Clubhouse Network, Hellenic Heritage Institute, Immigrant Resettlement & Cultural Center, Poetry Center San José, Portraits of the Past, Portuguese Heritage Society of CA, Printers Guild, Rotary Club of SJ, A Schmahl Science Workshop, Victorian Preservation Assoc.



**MACIAS GINI & O'CONNELL** LLP  
CERTIFIED PUBLIC ACCOUNTANTS & MANAGEMENT CONSULTANTS

3000 S Street, Suite 300  
Sacramento, CA 95816

2175 N. California Boulevard, Suite 645  
Walnut Creek, CA 94596

515 S. Figueroa Street, Suite 325  
Los Angeles, CA 90071

402 West Broadway, Suite 400  
San Diego, CA 92101

October 3, 2007

Ms. Debra Figone, City Manager  
City of San Jose  
San Jose City Hall  
200 East Santa Clara Street  
San José, California 95113

Dear City Manager:

On behalf of our firm, this letter is in response to the HSJ Letter dated September 28, 2007 by Alida Bray and Board of Directors. In that letter, several points were raised that merit some additional information for your consideration.

The HSJ Letter states that HSJ has not heard from our firm about HSJ staff-specific comments about the draft report. Prior to our issuance of the draft report, our staff met with the HSJ staff and various Board Members on a pro bono basis to discuss the results of the draft report. We held this meeting as a courtesy and to promote transparency in our communication with the City and the HSJ. Also, prior to our issuance of the draft report to the City, I personally contacted Ms. Bray and one of the Board members to discuss changes in the draft report that occurred since that initial meeting. We accepted comments from the City and from HSJ about the draft reports, and we handled each set of the comments in the same fashion. Those comments were incorporated into the final report and others were addressed in the final section of the report. Please note that our firm went beyond what is normally carried out in ensuring that HSJ had the opportunity to comment on the draft report.

The HSJ Letter also stated the proposed peer benchmarks presented in the Audit are unrealistic for HSJ because they are based on other institutions that do not resemble HSJ in any respect. However, in our report we compared HSJ in multiple ways: (1) against all Museums, (2) against History Museums, and then (3) against government sponsored Museums. We outlined in the report that HSJ is larger, both in physical size, and in staffing, volunteers, and number of people served. As stated in our report, the benchmarks were obtained from the American Association of Museums 2006 Financial Data, which compiled data of 266 Historical Museums. In the case where we outlined benchmarks for personnel costs, we used a median percentage of personnel costs to total

operational costs, which made it an “apples to apples” comparison and offered a good basis for outlining where HSJ’s personnel costs should fall. Again, this is stated in the report.

The HSJ Letter further stated that the Audit does not consider the Silicon Valley market in which History San José operates when our report states that the Silicon Valley has a high cost of living and that it was a factor in high personnel costs at HSJ.

The HSJ Letter states that the Audit does not outline how the City has benefited from its partnership with History San José, namely in HSJ’s ability to raise private funds and in-kind contributions to the City’s facilities. Our contract with the City does not include this analysis in the scope of the work that was requested. We do highlight in the report the performance of HSJ in raising private funds which has gradually declined over time. We also state in the report, in contrast to that stated in the HSJ Letter, about the notable efforts by HSJ of cost savings derived from its volunteer staff. We included in the report a table specifically describing HSJ efforts in this area. We also described in the report, in contrast to that reported in the HSJ Letter, the efforts by HSJ to partner with corporate sponsors to support HSJ.

The HSJ Letter takes issue with the declining City support over time as a viable model. We respectfully disagree. We discuss in the report that HSJ has not had effective financial management nor the types of staff positions needed to effectively run the Museum. Our recommendations are aimed at helping HSJ establish the organizational structure it needs to have so that the declining City support can indeed work. The City needs to carefully consider HSJ’s current position on the proposed funding levels because of its far-reaching implications about the handling of HSJ by the City.

Finally, our evaluation was based on information provided by HSJ. We followed our professional standards and our analysis was beyond what is typically required for this type of evaluation. This evaluation was performed with the goal of helping HSJ strengthen their operations and determine the best funding level from the City so that HSJ can continue serve the citizens of San Jose and the Silicon Valley.

Sincerely,

*Denise Denise Callahan*

Denise Callahan  
Partner  
Macias Gini & O’Connell, LLP

