COUNCIL AGENDA: 10-31-06
ITEM: 4.3

Office of the City Auditor
Gerald A. Silva, City Auditor

October 26, 2006

Honorable Mayor and Members
of the City Council
200 East Santa Clara Street
San Jose, CA 95113

Transmitted herewith is a report on *Financial Assessment of the American Musical Theatre of San Jose*. This report is in accordance with City Charter Section 805. The American Musical Theatre of San Jose will submit a response under separate cover.

I would like to thank the American Musical Theatre of San Jose staff for their cooperation, input and assistance in completing this assessment.

I will present this report to the City Council at its October 31, 2006, meeting. If you need any additional information, please let me know. The City Auditor's staff members who participated in the preparation of this report are Eduardo Luna, Gitanjali Mandrekar, Chris Constantin, and Carolyn Huynh.

Respectfully submitted,

Gerald A. Silva
City Auditor

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Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Gerald A. Silva, City Auditor

SUBJECT: *Financial Assessment of the American Musical Theatre of San Jose (AMTSJ)*

DATE: October 26, 2006

We have reviewed the AMTSJ's current financial condition and have identified several issues for the City Council's consideration. Specifically, the AMTSJ has several positive financial attributes including a strong financial team; multi-year cash flow projections; limited short-term debt; no past due accounts payable; a new business model; and reasonable and achievable fundraising goals. In addition, the AMTSJ's cash flow projections show that it will fully repay an estimated $900,000 City line of credit by April 2008. However, there are some issues that may affect the AMTSJ's financial viability. These issues include:

- From June 26, 2006 to September 11, 2006, the AMTSJ borrowed $915,000 from a Cash Reserve and Quasi-Endowment Fund held in trust at the Community Foundation. The AMTSJ does not intend to repay these loans in 2006-07, 2007-08, or 2008-09. As a result the AMTSJ's cash flow will be reduced by about $45,000 to $50,000 per year;
- The AMTSJ's audited financial statements indicate past substantial deficit spending and doubts "*about its ability to continue as a going concern*";
- The AMTSJ needs an estimated $900,000 City line of credit in 2006-07 to continue operations;
- In addition to an estimated $900,000 City line of credit, the AMTSJ is projecting to use $2,164,058 in other one-time cash infusions in 2006-07 in order to finish the year with a projected $84,289 ending cash balance;
- In 2007-08, the AMTSJ must achieve its projected $3 million reduction in operating expenses in order to avoid an operating cash deficit; and
- The AMTSJ's 2006-07 and 2007-08 cash flow projections are contingent upon its new business model working as expected.

Scope And Methodology

We have reviewed the American Musical Theatre of San Jose's (AMTSJ) current financial condition. Specifically, we reviewed the AMTSJ's projected 2006-07, 2007-08, and 2008-09 cash flow projections, admissions revenue projections, audited financial statements, budgeted

statement of activities, current year bank statements, and endowment information. We also talked with the AMTSJ's financial auditors, the Chief Financial Officer (CFO) from the Community Foundation, and current and past AMTSJ staff.

We should note that we primarily relied upon information AMTSJ staff provided us. While we conducted limited testing on the AMTSJ's admissions revenue projections and overhead expenses, we cannot attest to the accuracy of the information the AMTSJ provided us and which forms the basis for our conclusions in this report.

The AMTSJ Has Several Positive Financial Attributes Including A Strong Financial Management Team; Limited Short-Term Debt; Current Accounts Payable; New Business Model; And Achievable Fundraising Goals

We found that the AMTSJ has several positive financial attributes that indicate the organization may be able to achieve financial stability. The AMTSJ has a strong financial management team including a CFO, Accounting Manager, and a Staff Accountant. The financial management team produces complete and current financial reports, including current and future statements of activities and multi-year cash flow projections.

The AMTSJ has limited short-term debt which includes a $100,000 loan with Comerica Bank. This loan has monthly payments of about $3,300 until March 31, 2009. The AMTSJ's cash flow statement shows that the AMTSJ intends to repay this loan in full in October 2006. The AMTSJ has current accounts payable of about $457,000. None of its accounts payable are 30 days or more past due. We should note that the AMTSJ has a $350,000 line of credit with Comerica Bank. According to the AMTSJ's CFO, the AMTSJ only uses this line of credit to provide security in the form of letters of credit for touring shows. He also said that the AMTSJ does not intend to continue using the Comerica line of credit due to a change in terms. He is in discussions with other lenders to secure another line of credit.

The AMTSJ's new business model includes reducing the number of seasonal shows from nine to five, reducing costs by about $3 million in 2007-08, eliminating touring shows, producing and co-producing shows, and collaborating with other local theatre companies.

The AMTSJ Has Established Reasonable And Achievable Fundraising Goals

In 2006-07, the AMTSJ has established a fundraising target of $1.5 million from individuals, government, corporations, foundations, and events. In our opinion, this fundraising goal is reasonable and achievable based on recent past contributions. The following table shows the AMTSJ's contributions in 2005-06 and forecast for 2006-07.

Exhibit 1
Actual AMTSJ 2005-06 Contributions And Contributions Forecast For 2006-07

Donors	2005-06	Revised 2006-07	Percent Change
Individuals	$ 1,004,537	$ 1,037,892	2.18
Government	168,479	248,389	5.22
Corporate	182,899	192,668	0.64
Foundation	48,726	50,000	0.08
Events	1,882	2,500	0.04
Sub-Total	**$ 1,406,523**	**$ 1,531,449**	**8.16**

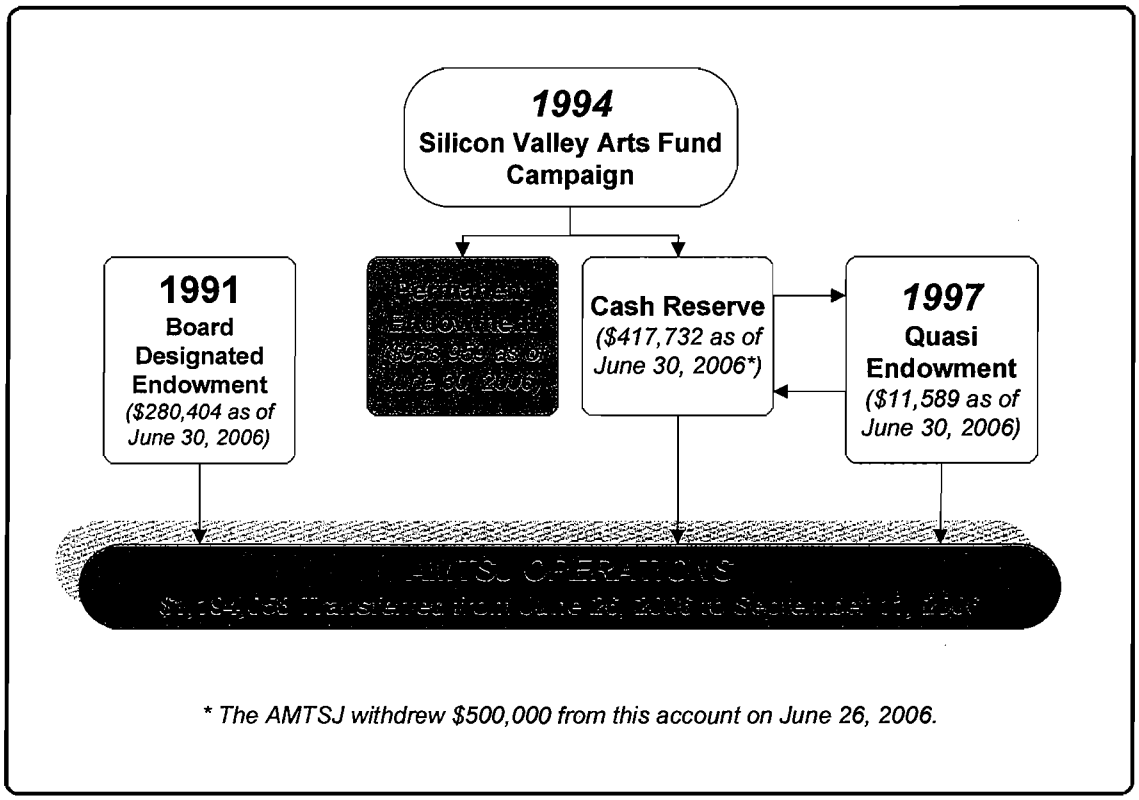
Source: AMTSJ financial data.

As shown above, the AMTSJ is expecting to increase contributions about eight percent from the previous fiscal year. The AMTSJ has already received commitments for the $248,389 in government grants for 2006-07 as shown above. The AMTSJ decreased its expected foundation contributions in 2006-07 by $148,000 to the $50,000 shown above as a result of our analysis and subsequent discussions with the AMTSJ's staff.

The AMTSJ Has Four Funds At The Community Foundation Silicon Valley

The AMTSJ has four funds currently held in trust at the Community Foundation Silicon Valley. The source for three of these funds is a 1994 fund raising effort in which the AMTSJ participated along with other local arts organizations referred to as the Silicon Valley Arts Fund. The original purpose of the campaign was to raise money to: (1) retire debt, (2) have a permanent endowment to provide a source of income from its earnings, and (3) have a cash reserve. As a result of this fundraising, the AMTSJ currently has two separate deposit accounts held in trust with the Community Foundation. Of these two accounts, one is a Permanently Restricted Endowment Account and the other is a Cash Reserve Fund. In addition, the AMTSJ also has a Quasi-Endowment Account and a Board Designated Endowment Fund held in trust at the Community Foundation as shown in the following chart.

Exhibit 2
AMTSJ Sources Of Funds Held In Trust At The Community Foundation Of Silicon Valley



Source: Auditor analysis of AMTSJ and Community Foundation data.

The AMTSJ cannot borrow or use its Permanently Restricted Endowment Account shown above because its purpose is to provide the AMTSJ with a stream of investment income. Accordingly, the AMTSJ receives a two and a half percent semi-annual distribution from the corpus of this account without any restrictions. According to its agreement with the Community Foundation, the only circumstances which would allow the AMTSJ to end its arrangement with the Community Foundation are: *"(...) it may be terminated by unanimous agreement of all the parties upon resolution adopted by the Board of Directors of each of the Cultural Organizations and Board of Directors of the Community Foundation. (...) Upon termination, the proportionate share of the Cultural Organization's funds conveyed to such person or organizations must be held by that entity as reserve or permanent endowment as is required under the original gift restrictions."*

In addition to this Permanently Restricted Endowment, the AMTSJ also has a Cash Reserve Fund which is a result of the 1994 Silicon Valley Arts Fund campaign. The Cash Reserve Fund is available for operating purposes and the AMTSJ can borrow from the Cash Reserve Fund interest-free provided it repays any borrowed funds annually.

According to an official at the Community Foundation, in 1997, the AMTSJ moved some of the money from the Cash Reserve Fund and established a Quasi-Endowment Account at the Community Foundation. The AMTSJ is required to provide advance notice before it withdraws monies from this Account. The Community Foundation makes semi-annual distributions of the earnings from the corpus of this Account to the AMTSJ.

Finally, on June 30, 2006, the AMTSJ also had $279,058 in a Board Designated Endowment Fund (BDEF) held in trust with the Community Foundation. The BDEF is the AMTSJ's asset and according to its CFO the AMTSJ can withdraw the BDEF funds at the AMTSJ Board's discretion. We should note that the AMTSJ was unable to provide written documentation regarding any restrictions on the use of the BDEF.

From June 26, 2006 To September 11, 2006 The AMTSJ Borrowed $915,000 From Its Cash Reserve And Quasi-Endowment Funds And Withdrew Its $279,058 BDEF Held In Trust At The Community Foundation

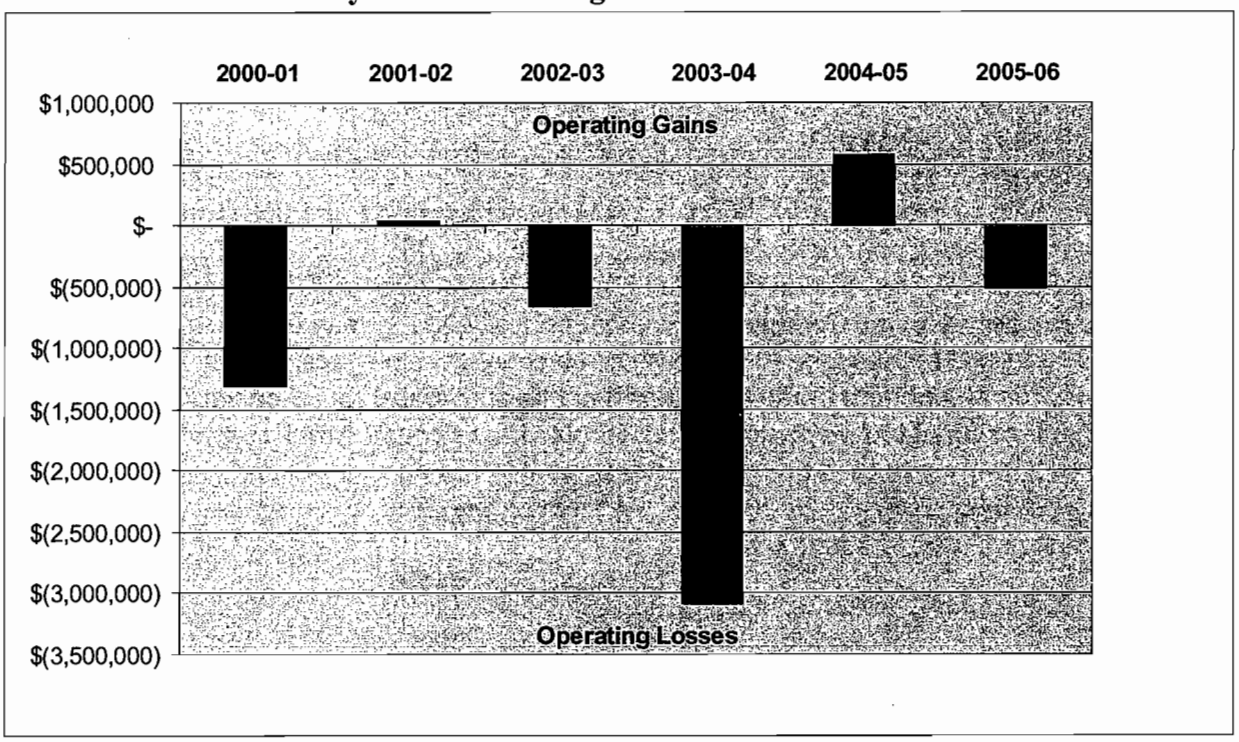
From June 26, 2006 to September 11, 2006, the AMTSJ withdrew $1,194,058 from three of its funds held in trust at the Community Foundation. This $1,194,058 includes $915,000 from its Cash Reserve Fund, its Quasi-Endowment Fund, and $279,058 from its BDEF. We should note that per its agreement with the Community Foundation, the AMTSJ may borrow monies from the Cash Reserve Fund but is required to repay the borrowings in one year. If the AMTSJ is unable to repay the full amount of the loan, it will not be able to use for its operations semi-annual distributions equal to five percent of the corpus of its Permanently Restricted Endowment Fund. According to its own cash flow projections, the AMTSJ does not intend to repay these borrowings in 2006-07, 2007-08, or 2008-09. As a result, the AMTSJ's cash flow will be reduced by about $45,000 to $50,000 per year[1].

[1] The Community Foundation distributes two and a half percent twice a year. In 2005-06, the AMTSJ received about $46,000 in interest earnings.

The AMTSJ's Audited Financial Statements Indicate Substantial Deficit Spending And Doubts "About Its Ability To Continue As A Going Concern"

The AMTSJ's current financial situation is the result of several years of deficit spending. In the AMTSJ's 2005-06 audited financial statement, the auditors state "*the Organization has a net deficiency in net assets that raise substantial doubt about its ability to continue as a going concern.*" The AMTSJ posted losses during four of the past six years as shown in the following chart.

Exhibit 3
Summary Of AMTSJ Budget Deficits 2000-01 To 2005-06



Source: AMTSJ Audited Financial Statements.

ATMSJ's officials attribute its financial difficulties to several factors including a less than favorable business arrangement with a national production company, a new subscription campaign that did not achieve its target, three shows that did not meet financial expectations, and declining support from major foundations.

AMTSJ Needs An Estimated $900,000 City Line Of Credit In 2006-07 To Continue Operations

According to the AMTSJ's 2006-07 cash flow projections, the AMTSJ requires an estimated $900,000 to continue operating in 2006-07. The AMTSJ projects it will run out of cash in December 2006 without additional money from the City or another source. In February 2007, the AMTSJ's peak cash flow need will be almost $900,000.

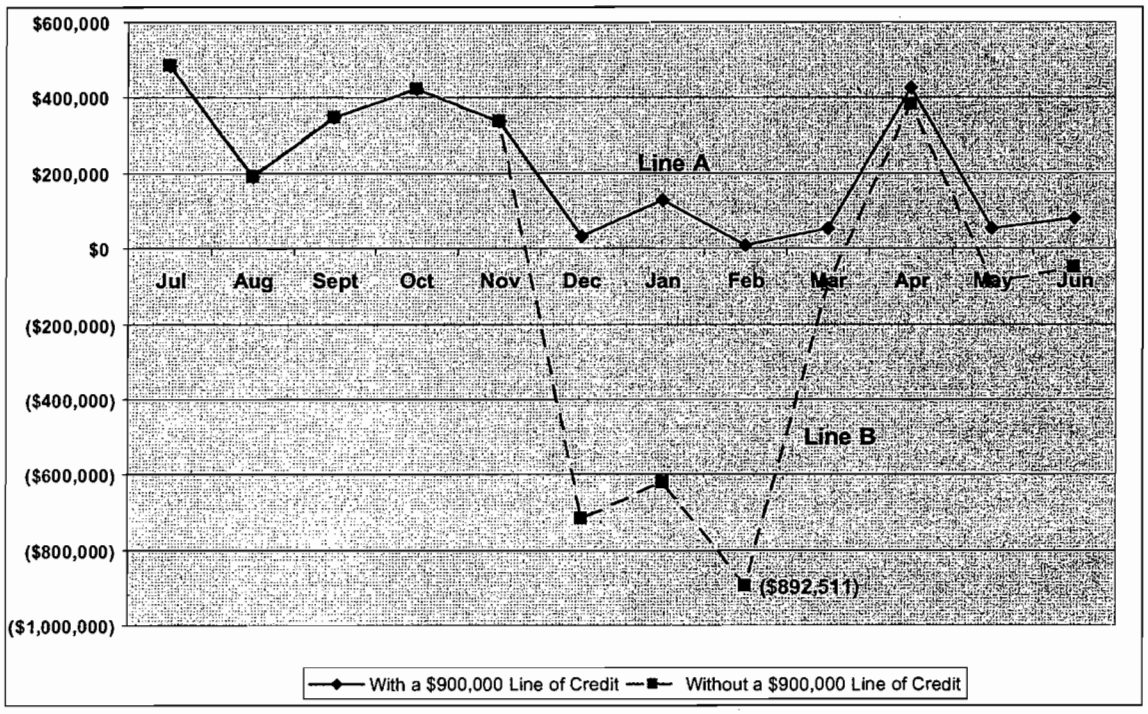
In Addition To An Estimated $900,000 City Line Of Credit, The AMTSJ Is Projecting To Use $2,164,058 In Other One-Time Cash Infusions In 2006-07 In Order To Finish The Year With A Projected $84,289 Ending Cash Balance

In 2006-07, a critical component of the AMTSJ's 2006-07 projected cash flow is the reliance on one-time cash infusions of $2,164,058, not including an estimated $900,000 City line of credit. The AMTSJ is relying on the following one-time cash infusions:

- Using $1,194,058 in cash reserve funds for operating expenses as described above;
- Receiving $470,000 from the City for a sound system; and
- Receiving $500,000 from the sale of certain assets.

These one-time actions represent 18 percent of the AMTSJ's total income for 2006-07 and will allow the AMTSJ to end the fiscal year with a projected $84,289 ending balance. Exhibit 4 highlights AMTSJ's projected monthly ending cash balances for 2006-07 with and without an estimated $900,000 City line of credit.

Exhibit 4
AMTSJ's Projected 2006-07 Monthly Ending Cash Balances With And Without An Estimated $900,000 City Line Of Credit



Source: AMTSJ financial data.

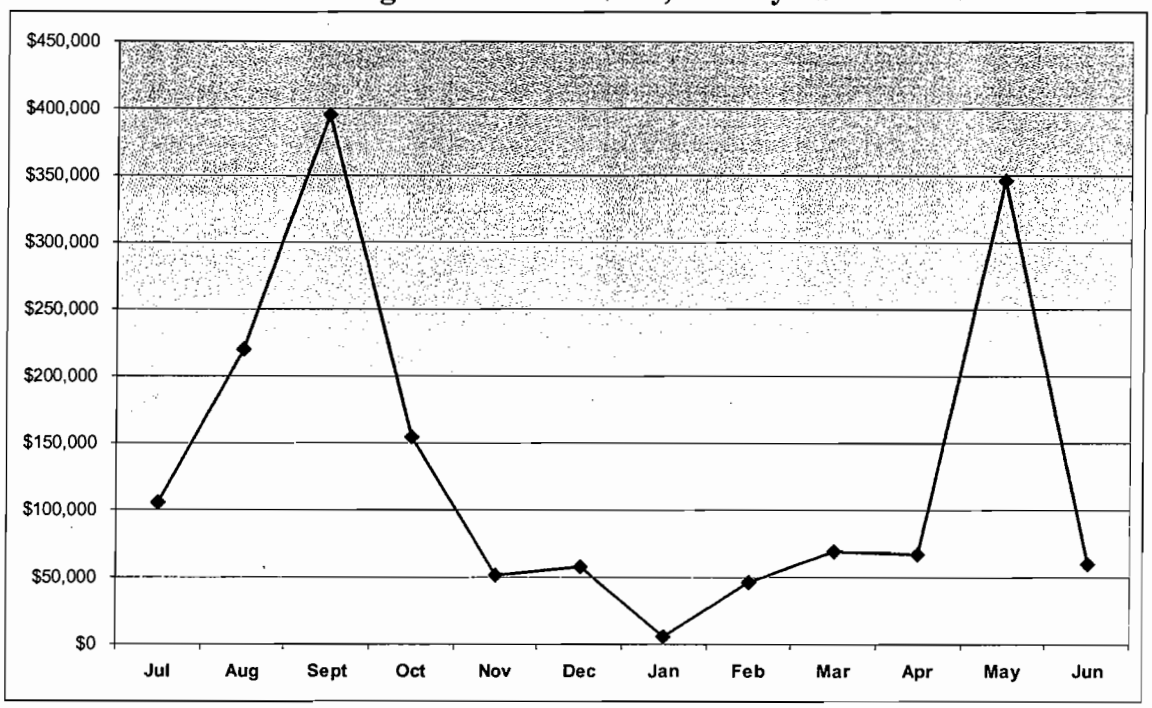
Line A in Exhibit 4 shows that in December 2006, February 2007, and May 2007, the AMTSJ will draw down $750,000, $150,000, and $100,000, respectively, from an estimated $900,000 City line of credit. Line A in Exhibit 4 also shows that the AMTSJ will repay the City $750,000 in March 2007 and $110,000 in April 2007. At the end of 2006-07, the AMTSJ projects it will have repaid the City all but $140,000 of its estimated $900,000 City line of credit.

In 2007-08, The AMTSJ Must Achieve Its Projected $3 Million Reduction In Operating Expenses In Order To Avoid A Cash Deficit

The AMTSJ is aggressively downsizing its operational budget as part of its new business model. In 2006-07, the AMTSJ's new business model includes reducing the number of seasonal shows from nine to five, reducing costs, and collaborating with other local theatre companies. Overall, the AMTSJ is projecting it will reduce its total income and expenses by 31 percent and 33 percent, respectively. In 2007-08, the AMTSJ is projecting it will reduce its operating expenses

by 24 percent, or $3 million, to avoid a cash deficit. Exhibit 5 highlights the AMTSJ's monthly ending cash balances assuming an estimated $900,000 City line of credit in 2007-08.

Exhibit 5
AMTSJ's Projected 2007-08 Monthly Ending Cash Balances
Assuming An Estimated $900,000 City Line Of Credit

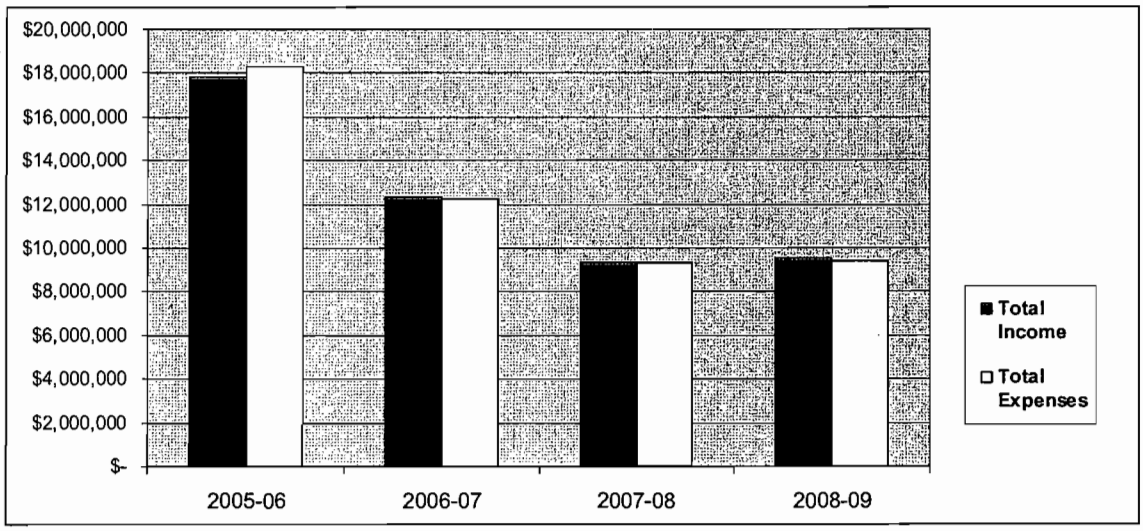


Source: AMTSJ financial data

The AMTSJ's 2007-08 cash flow projection shows that in July 2007, it will repay the remaining $140,000 it borrowed against an estimated $900,000 City line of credit. However, the AMTSJ's cash flow projection also shows that in November 2007 and December 2007, it will borrow $200,000 and $300,000, respectively, against an estimated $900,000 City line of credit. In addition, AMTSJ's cash flow projection shows that it will repay these amounts between February 2008 and April 2008. At the end of 2007-08, the AMTSJ projects it will have repaid the entire estimated $900,000 City line of credit.

As shown below, in 2007-08, the AMTSJ expects to have total income and expenses of about $9.3 million, or a 48 percent decrease, from 2005-06.

Exhibit 6
AMTSJ Total Income And Total Expenses For 2005-06 To 2008-09



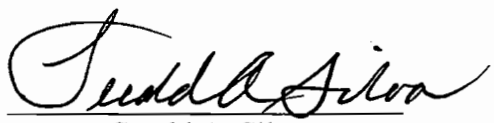
Source: Analysis of AMTSJ financial data.

The AMTSJ's 2006-07 And 2007-08 Cash Flow Projections Are Contingent Upon Its New Business Model Working As Expected

The AMTSJ's 2006-07 and 2007-08 cash flow projections, including the $900,000 City line of credit, show ending cash balances of $84,289 and $59,341, respectively. In order for the AMTSJ to meet these projections, the AMTSJ's new business model will need to work as expected. The AMTSJ's new business model includes reducing the number of seasonal shows from nine to five, reducing costs by about $3 million in 2007-08, eliminating touring shows, producing and co-producing shows, and collaborating with other local theatre companies. AMTSJ officials are optimistic about achieving the AMTSJ's revenue and expense targets.

Conclusion

The AMTSJ has several positive financial attributes including a strong financial team; multi-year cash flow projections; limited short-term debt; no past due accounts payable; a new business model; and reasonable and achievable fundraising goals. In addition, the AMTSJ's cash flow projections show that it will fully repay an estimated $900,000 City line of credit by April 2008. However, there are some issues that may affect the AMTSJ's financial viability. The AMTSJ's audited financial statements show significant past deficit spending and doubts "about its ability to continue as a going concern." In addition, the AMTSJ needs an estimated $900,000 City line of credit in 2006-07 to continue operations. Additionally, AMTSJ's financial projections show it is using $2,164,058 in one-time cash infusions to sustain operations in 2006-07. As a result, the AMTSJ will not have these one-time cash infusions available for 2007-08. Additionally, as part of its new business model, the AMTSJ must achieve its projected $3 million reduction in operating expenses in order to avoid a cash deficit in 2007-08.



Gerald A. Silva
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