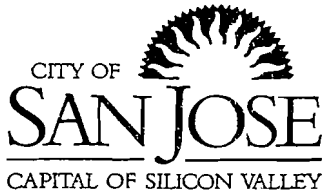
RULES COMMITTEE: 04-04-07
ITEM: G1



Office of the City Auditor

Report to the City Council
City of San José

A REVIEW OF THE MEXICAN HERITAGE CORPORATION' S ABILITY TO OPERATE AND MAINTAIN THE MEXICAN HERITAGE PLAZA

PREFACE

Presented herein are the City Auditor's Executive Summary and the Mexican Heritage Corporation's response to *A Review Of The Mexican Heritage Corporation's Ability To Operate And Maintain The Mexican Heritage Plaza.* This summary is intended to reduce the City's cost of printing and distributing audit reports. If you would like a copy of the full report, please call the City Auditor's Office at (408) 535-1250; we will be happy to send you a complete report.

Executive Summary

In accordance with San Jose City Council (City Council) direction we have reviewed the Mexican Heritage Corporation's (MHC) current financial condition and have identified several issues regarding the MHC's ability to operate and maintain the Mexican Heritage Plaza (MHP). We conducted this audit in accordance with Generally Accepted Government Auditing Standards and limited our work to those areas specified in the Scope and Methodology section of this report.

Finding I — The Mexican Heritage Corporation (MHC) Is Facing Significant Financial Challenges

We found that the Mexican Heritage Corporation (MHC) has struggled financially since the Mexican Heritage Plaza (MHP) opened in 1999 and in 2000-01 and 2001-02 the City provided the MHC with substantial cash infusions. Since 1996, the City and the RDA has provided the MHC with about $7.10 million in direct and indirect financial assistance, including an annual $413,783 operating subsidy and $814,766 in financial assistance in 2006-07, as well as free use of the MHP. In 2004, the MHC scaled back programming and embarked on a "quiet period." Despite the MHC's recent efforts it still faces significant financial challenges including:

- The MHC's cash flow projections show that the MHC lacks sufficient funds to complete its fiscal year which ends June 30, 2007;
- The MHC's 2006-07 budget is a planning document and not an operating budget in the traditional sense;
- The MHC owes the City $500,000; and
- The MHC has nearly $236,000 in accounts payable that are over 90 days past due and other liabilities.

Finally, in our opinion the RDA needs to amend its agreement with the MHC.

RECOMMENDATION

We recommend that the San Jose Redevelopment Agency:

Recommendation #1 **Amend its agreement with the MHC and work with the MHC to use State funding for the $530,000 HVAC work at the MHP. (Priority 2)**

Finding II The MHC Needs To Revisit Its Agreement With Its Resident Art Partners (RAPs)

We found that the MHC's existing financial relationship with its Resident Art Partners (RAPs) limits the MHC's ability to maximize its use of the MHP. Specifically, the MHC charges significantly below market rents and provides prime programming dates to the RAPs. In addition, the MHC is overestimating the demand for its theater and charging non-competitive rates.

RECOMMENDATION

We recommend that the Mexican Heritage Corporation:

Recommendation #2 **Revisit its agreement with the RAPs to maximize the MHC's use of the MHP. (Priority 2)**

Finding III The MHC Has Significant Operational And Administrative Challenges

The MHC has significant operational and administrative challenges. These challenges include the MHC's 1) limited in-house professional financial capacity; 2) limited fund-raising ability; 3) relationship with the Neighborhood Development Center; 4) failure to comply with terms of its $650,000 City loan agreement as well as the MHP's inherent physical limitations.

RECOMMENDATIONS

We recommend that the City Administration:

Recommendation #3 **Revisit its agreement with the MHC and review whether it should revise or cancel its agreement regarding the NDC's use of space at the MHC's facility. (Priority 2)**

Recommendation #4 **Monitor and ensure compliance with the terms of the $650,000 loan agreement. (Priority 2)**

Finding IV Absent A Strategic, Measurable, Attainable, Realistic, And Timely Business Model Or Plan, The MHC's Ability To Operate And Maintain The MHP Is Highly Questionable

The MHC has not developed a strategic business plan or business model that articulates what programs, services, and events it would deliver with increased City funding. Absent a strategic, measurable, achievable, realistic, and timely business model or plan to address the aforementioned challenges, the MHC's ability to operate and maintain the MHP is highly questionable.

The City Council currently has a number of different policy options regarding the MHC. These options include but are not limited to the City:

1. Providing the MHC with its requested subsidy and financial support;

2. Providing one-time financial relief to the MHC to allow it time to develop a strategic plan or business model for City review and approval;

3. Assuming responsibility for the operation and maintenance of the MHP while allowing the MHC to remain at the MHP as a tenant; and

4. Hiring a consultant to do an in-depth organizational and structural assessment of the MHP and report back to the City Council with recommendations regarding the highest and best use of the MHP.

RECOMMENDATION

We recommend that the City Council:

Recommendation #5

Consider the following options regarding the MHC and operation and maintenance of the MHP. These options include but are not limited to the City:

1. **Providing the MHC with its requested subsidy and financial support;**
2. **Providing one-time financial relief to the MHC to allow it time to develop a strategic plan or business model for City review and approval;**
3. **Assuming responsibility for the operation and maintenance of the MHP while allowing the MHC to remain at the MHP as a tenant; and**
4. **Hiring a consultant to do an in-depth organizational and structural assessment of the MHP and report back to the City Council with recommendations regarding the highest and best use of the facility. (Priority 2)**

Memorandum

To: Gerald Silva, City Auditor, City of San Jose

Subject: Response by MHC to City Audit report

Date: March 28, 2007

Introduction

This memorandum sets forth the response of the Mexican Heritage Corporation ("MHC") to the report of the City Auditor, received on March 25, 2007 (the "Audit Report"). This response references exhibits which MHC will provide directly to the City Council if they are not attached to the copy of this reponse provided to Council by the City Auditor.

MHC expresses its appreciation to the Office of the Auditor for its time and effort in conducting a review of MHC's funding sources. We appreciate that the issues relative to MHC's operating model as described under the terms of the Operating and Maintenance Agreement entered into between MHC and the City of San Jose (the O&M Agreement") are complex and require diligent review in order to understand the business issues surrounding an analysis of the sustainability of the current model, many of which are industry specific. In addition, we understand that complex issues take time to resolve and we appreciate the consideration, integrity, diligence and commitment to independence and public service with which the Office of the Auditor has approached its task. Finally, we would like to confirm our regard for, and appreciation of the talent, artistic excellence and dedication of our colleagues at the Resident Arts Partner program. Our comments in this preliminary report do not reflect our deep respect for their commitment to community and to their artistic craft, but address business and economic issues which, once resolved, we hope will result in a sustainable operating model that will support their endeavors.

The conversation and thoughtful review this process has catalyzed, concerning issues of best practices, revenue generation, and programming choices within an emerging arts environment, is timely. The report of the City Auditor asks hard questions, as it must. We look forward to continued work with City staff to sort through the answers and to re-build an operations model that is at once sustainable and innovative. Many of the potential answers are already emerging from this joint effort of the Auditor's staff, City staff and MHC.

In this regard, we have identified several items in the Audit Report which merit response to both complete the record and to indicate our strong desire to work with the Auditor's Office to present a fair and accurate report to the City Council. Accordingly, we respectfully offer the following discussion.

At the outset MHC notes it fundamentally agrees with the overall conclusions of the ausitor's report and specifically, with three findings:

1. MHP leadership has consistently stated (and as asserted in the 1995 Wolf Report to the City Council) that the operating model imposed by the City on the MHP is fundamentally flawed. The findings of the City Auditor in the Audit Report confirm this premise. Since June of 2006 MHC has approached the City Manager on at least three occasions to attempt a discussion to review the present operating model and suggest a potential solution to ensure MHC's ability to function as a strong and vital performing arts organization. Copies of our communications are attached to this response. The audit of the MHC, commenced several months after our initial request to assess the situation, is an outcome of these requests.

2. The MHP agrees with the City Auditor's findings that the financial relationship with the RAP groups and the rate structure of rental facilities requires reevaluation and appropriate adjustments.

3. MHP agrees for the need for a comprehensive 5-year Plan that will maximize the MHP's viability and minimize City participation over time. A draft business plan is complete and submitted with this response.

Executive Summary

Today, the work of the MHC Board and staff to revitalize the Mexican Heritage Plaza and build a reputation as a leading arts presenter and producer is bearing fruit. Significant challenges remain, however, before the Plaza's recent success may be regarded as characteristic of a sustainable organization.

The work of the Plaza's Board and staff began in October 2004, when the corporation commenced an extensive financial and management reorganization. This decision followed several years of MHC's struggle to create a sustainable business model for the operation of the regional arts venue known as The Mexican Heritage Plaza, notwithstanding financial support it received from the City of San Jose, which owns the venue. As described more fully below, the challenges faced by MHC since its selection as the exclusive operator of the Plaza facility in 1999 were both external (such as a severe downtown in the local economy) and internal, (e.g., lack of staff and Board capacity, and lack of professional management).

By the fourth quarter of 2004, MHC faced a severe financial crisis. The corporation's expenses significantly exceeded its revenues. Fund development was non-existent. Programming was unprofessional resulting in a poor reputation with audiences, and with funders from both the corporate and philanthropic sectors.

Without a radical and innovative change in how MHC did business, it would need to file for bankruptcy protection. MHC faced an immediate need to restructure the operation but it decided not to appeal to the Plaza's owner, the City, for financial assistance. Instead, MHC proceeded to determine if a sustainable arts management model for the Plaza could be proposed that would warrant such a discussion, and subsequently set upon a course of self-correction. The plan consisted, in essence, of reorganization outside of bankruptcy and included internal financial reviews to determine whether any sustainable operations model was possible given the unique constraints it faced.

Specifically, the restructuring encompassed a top-down and bottom-up survey of the old operations model and the completion of several critical milestones, including but not limited to:

- The adoption of a comprehensive Board strategic plan;
- The reorganization of the Board of Trustees to fully transition from its origins as a grass-roots governing body to a fundraising governing body; and
- The conduct of a national and international CEO search and the hire of an experienced senior entertainment industry executive with expertise in non-profit and arts management.

By the end of FY 2005-2006 MHC was able to report a modest operating surplus, a newly revamped programming model, and a visual and performing arts season that resulted in critical acclaim and record revenues. Notwithstanding this success, the MHC faces a continued challenge to its financial stability due to inherent defects in the operating structure originally agreed to by the City and MHC in 1999. Without additional changes to this outdated model, MHC will not be able to continue its present operations. As a result, MHC has completed a new business plan that sets forth its recommendations to achieve sustainable growth, with reduced dependency on City support, within five years.

Mission of the MHC

As previously discussed with the audit staff, the mission statement of the MHC (approved in 2003) encompasses a programming policy that embraces both the Mexican culture and multicultural arts. Specifically, the mission of the MHC is to affirm, celebrate and preserve the rich cultural heritage of Mexico and showcase multicultural arts in the region. MHC's program model is described in detail in the attached business plan, which sets forth MHC's methodology for embracing diversity in all of its programming activities.

Discussion of Structural Issues

The Current Situation: The Plaza is In a Critical Stage in Its Growth and History

The Plaza is a multi-disciplinary arts center that both presents and produces artistic and cultural events in several venues – a theatre, gallery, performing arts pavilion, gardens and central plaza. MHC is governed by a Board of Trustees and maintains a staff of eleven. The facility itself is owned by the City of San Jose. Funding sources include major philanthropic organizations, the City of San Jose, and earned revenue from sponsorships of programs, ticket sales to performing arts events and facilities rentals.

The Plaza is entering a critical phase in its growth, currently implementing a $1 million capital improvement program and building increased brand awareness following two years of re-structuring of its financial, operations and program functions, which have resulted in significantly improved and critically acclaimed visual and performing arts programming. MHC management believes the Plaza is now uniquely positioned to leverage its recent success to reach what has been called "The Emerging American Audience" - the culturally diverse, tech savvy and increasingly younger, consumer of arts and entertainment content in Silicon Valley and the greater Bay Area.

Background on the Plaza Operations Model

As reported in the City's audit, the original model for the operation of the Plaza, including facilities maintenance and programming, was established over seven years ago by the City of San Jose and MHC. The original model contemplated an arrangement in which MHC would provide facilities management and some programming functions but that community arts groups would provide the majority of programming for the Plaza in exchange for steeply discounted rental rates for usage of the Plaza theatre, offices and other Plaza venues. This model was implemented at the recommendation of an arts management consulting group called The Wolf Organization Inc. who were commissioned by the City of San Jose to assist the City in determining an appropriate operations model for the new facility.

In 1995, three years after the City and RDA initiated development of the Mexican Cultural Heritage Gardens with the MHC, the RDA contracted with the Wolf Organization to conduct an operation and management study of the MHC facility. The consultants were asked to examine the theatre, related performance spaces, galleries, and studios as well as public use spaces such as classrooms, multipurpose rooms, and the outdoor plaza in order to provide a full operating plan. The findings of this study identified numerous challenges that both the City and the MHC would need to address regarding the facility and MHC's capacity.

In addition to the challenges set forth in the City's audit, the Wolf Report made observations regarding funding challenges that both the City and the MHC would

encounter if the project proceeded. In addition, the Wolf Report noted the importance of justifying the project and its subsidies (in 1995 the Report recommended an annual subsidy of $600,000) to taxpayers and making clear what objectives are being served by this outlay of dollars. Specifically, the Wolf Organization noted the importance of sufficient funding to subsidize use of the facility by the resident arts organizations and the fact that as of 1995, only the City was in a position to offer such support. The Wolf Report stated this would be the case for many years to come and must be factored into the City's total cost in supporting the operation of the facility. We believe the process jointly undertaken today by MHC, City staff and the City Auditor's Office, will present a complete analysis to enable the community and the City Council to understand the complex facilities issues the Plaza presents.

The Wolf Recommended Operations Model Is Not Sustainable Due to Multiple Factors

The ability of the MHC to sustain the operations of the Plaza facility has been severely impacted by multiple factors. These include:

- the downturn in the economy in 1999-2001;
- MHC subsidizes the programming of the current resident arts organizations through its payment of all facilities expenses of the venue and its provision of steeply discounted rental rates to the organizations;
- the lack of any revenue sharing arrangement between MHC and the resident partners;
- MHC's inability to mitigate the impact of the subsidy it provides to the resident partners since it cannot offer inventory to commercial renters or non-profit arts organizations who can pay MHC's standard commercial or non-profit rental rate due to scheduling conflicts with Resident Arts Partners programming;
- The unwillingness of philanthropy to fund operations costs of the Plaza venue such as key staff positions and facilities maintenance;
- rising energy and other costs associated with general facilities maintenance; and
- management and fund development set backs experienced in the Plaza's formative years, arising, in part, from MHC's industry inexperience, which resulted in financial crisis impacting staff and programming capacity.

The MHC Board Determines It Must Re-Structure the Operating Model to Achieve Sustainability

In addition to the corrective items listed above, beginning in 2004 MHC completed the following critical milestones:

- a Board retreat to review and confirm the Board strategic plan;
- additional recruitment of new Board members from the tech community, consumer retail business and legal community;

- internal assessment of the agency's financial management systems and implementation of systems procedures and controls to ensure adequate oversight and financial reporting;
- internal assessment of the agency's fund development systems and the creation of a comprehensive business plan (which is attached);
- reduction of expenses and imposition of a strict zero based operations budget;
- imposition of an innovative programming model to solve its three most critical challenges:

    1. First, to create arts programming of the highest artistic and production values;
    2. Second, to deliver arts education programming to San Jose youth with curriculum that meets current State guidelines and industry standards, and
    3. Third, to achieve the foregoing within a business and operations model that is financially stable and sustainable.

A timeline of historical developments is attached for reference.

MHC's new program model develops, produces and delivers content through collaborations, joint ventures or joint production arrangements with "best-of-breed' content companies or organizations, whereby the cost of production is shifted to or absorbed by the content partner. Content development and marketing strategies are well informed by market data on emerging populations in Silicon Valley and nationwide. This allows MHC to leverage its most significant asset - the Plaza - to secure and deliver programming that a) increases revenue without taking on undue financial risk and b) to deliver content with high production and artistic values, thereby offering the community excellence in arts programming while enjoying higher margins and cost efficiencies.

For FY 2005-2006 MHC reported a modest operating surplus. MHC produced or presented programming relaunched in 2005 to critical acclaim. As a result, the Plaza's brand is now recognized for quality, innovation and artistic excellence. Since MHC's re-organization, the Plaza's leadership position as an arts programmer has been recognized by regional and national media, art critics, US Latino leadership and corporate and philanthropic organizations.[1] Most recently, the Plaza's CEO was asked to submit written testimony to the United States Senate in connection with hearings on the feasibility of a proposed national Latino arts center in Washington DC.

Discussion of Audit Findings

The Audit Report contains many items which should be addressed in order to ensure the record is complete, as follows:

Pages 1-10

[1] Reviews and media coverage are attached to this report.

1. The programming list for the season for 2006-2007 states that certain events have already occurred when they have not, and includes events the Plaza no longer produces (Cinco de Mayo). For an accurate statement of the Plaza season we refer to our season summary set forth on our web site at www.mhcviva.org.

2. The statement contained on page six relative to audience draw and that the Plaza's identity as a "Mexican" center potentially alienates audiences should be clarified to reflect that a finding from the Wolf Report circa 1996 about potential audience attendance for events at the Plaza is not valid in 2007. Specifically, the statement from the Wolf Report that "an initial audience analysis indicated there would be a challenge in attracting large numbers of people to cultural events in the proposed location..." is no longer valid since it fails to address in any manner the current US Latino market for arts, culture and entertainment programming or the general market for Latin muisc and arts events.

Specifically, the Wolf Report analysis with respect to potential audience attendance was made fully four years before the US Census Report of 2000 which documented for the first time the explosive growth in the US Latino population. Now, eleven years later, the power and clout of the US Latino population is fully documented in numerous studies, surveys and consumer reports by advertising agencies, media companies and economic analysts. The attached MHC business plan sets forth a partial summary of the US Latino market for arts and cultural events. Other sources include the Kagan research organization, Spanish language media organizations such as Univision and Telemundo, the US Census Report, and the numerous research reports published by the Association of Hispanic Advertising Agencies.

In 2005-2006 the audience attendance for MHC-produced events at the Plaza and in downtown San Jose is robust. We have already provided our audience attendance figures to the City auditors for the mariachi festival. Similarly, our music concerts presented with Another Planet Entertainment generated audiences in the thousands. Los Lupeños dance concerts are routinely sold out or nearly sold out.

The fact is when there is a high-profile event that is well promoted at the Plaza, location is not a factor. This is also true for Teatro Vision events where the featured artist is well known, such as their presentation of Herbert Siguenza's play "Cantinflas" which generated sold out audiences for the first time in Teatro's history.

We also note that the MHC mission statement explicitly provides that it is a multicultural arts facility. Since MHC branded programming resumed in the 2005-2006 season, MHC's seasons have been characterized by a broad selection of intercultural offerings from disparate artists and curators. This multicultural aspect of MHC new programming mix was specifically singled out for praise by the San Jose Mercury News, Art Week, funders and Plaza visitors. Moreover, the Plaza is routinely sought after by a variety of

multi-cultural arts groups, such as Abinaya Dance Company, and is the venue for the San Jose Multicultural Artists Guild.

Moreover, we have provided key information to the auditor regarding current feasibility studies being undertaken by the RDA and MHC relative to the development of the Alum Rock neighborhood. The construction of the Plaza was a critical component of a larger redevelopment plan intended for the Alum Rock area. Had the redevelopment plan been executed in its entirety, feasibility of the Plaza would have been assisted by the addition of important infrastructure, such as retail and restaurants, contemplated in the redevelopment plan. Today, the redevelopment plans are once again in an active phase, after several years of dormancy due to prevailing economic conditions. Any expression of opinion or assessment of the Plaza's feasibility should therefore factor the current demographics and redevelopment plans for the Alum Rock area.

Finally, for obvious reasons apart from marketing concerns, MHC objects to the Wolf Report's finding that the Plaza's identity as a "Mexican" center makes it less attractive.

To summarize, since it assumed the operation of the Plaza in 1999, MHC's financial situation is impacted by the following:

1. Capital adequacy – e.g., the chronic *undercapitalization* of the venue. The statements in the report that the City has provided significant funding to MHC fail to address whether such funding is *adequate*, given a) the issues raised by the Wolf Report, b) the impact of both past management practices and the delay in completing the redevelopment of the Alum Rock area, c) the downturn in the Silicon Valley economy experienced in the earlier part of the decade and d) the current impact to MHC of its ongoing subsidy of the Resident Arts Program imposed by the O&M Agreement. MHC does not dispute the amount of funding received from the City. What is at issue is whether such capitalization adequately provides for the operation and programming of the venue in a manner which is consistent with sound industry practice as well as the amount of funding the City provides to peer institutions such as the San Jose Museum of Art, San Jose Rep and the Tech. A review of similar venues, such as that discussed in MHC's letters to the City Manager, would be useful and instructive in this regard.
2. The actual financial impact of MHC's subsidy of the Resident Arts Program. In this regard, MHC previously prepared a detailed analysis for the City (copy attached) which shows the potential lost income to MHC as a result of its maintenance of the current resident arts program. MHC's analysis of the RAP situation is discussed in greater detail below.
3. A portion of the City's historical support was provided not in the form of a grant, as contemplated by the Wolf Report, but through the provision of a loan, which caused the operator to report a deficit on its balance sheet. As reported in our audited financial statements, this long term liability is the primary reason for their negative statement of going concern.

4. The description of the historical funding and operations management of the MHC is useful and instructive. Taken together, it reveals that corrective actions to the Plaza operations model, such as the installation of expense controls, professional management, and increased support to promote MHC's programs such as the mariachi festival, resulted in a break even position for fiscal year 2005-2006. This recent improvement was assisted not only by increased support from the City and the RDA, but also by MHC's strong focus on increasing earned revenue and corporate donations, as well as contributions from other government agencies such as the $1 million capital improvement grant from the State of California which will be used to refurbish the Plaza's physical plant and ensure long-term viability of the structure, the County of Santa Clara, as well as philanthropy.

   For example, MHC's earned revenue from the mariachi festival improved over 200% from 2004. In addition, contributions from sources other than the City for FY2006-2007 will exceed $2 million in cash and contributed in-kind services. These contributions provided not only much needed direct support to MHC, but a significant return on the RDA's investment of promotional dollars to support the mariachi festival. A detailed schedule of the donated advertising which supports the mariachi festival was previously provided. It shows that for every dollar provided by the RDA to support the 2006 mariachi festival, it received a 10-1 return in advertising dollars that promoted San Jose's signature Latin music event. This donated advertising resulted in over 40 million documented media impressions delivered throughout all six Bay Area counties.

   Finally, we note that MHC's fundng from philanthropy has improved, with short term program grants received from The Castellano Family Foundation, The Christensen Fund, The Flora Family Foundation, Arts Council Silicon Valley, The Packard Foundation, the California Arts Council and Community Foundation Silicon Valley.

Page 10-22. The discussion of MHC's present financial condition underscores the need for a re-capitalization of the operator. From October 2004 through July of 2005 MHC capacity was severely reduced in order to bring the corporation's expenses in line with revenues, which at the time, amounted to the monthly O&M support provided by the City. This expense reduction contributed to the corporation's ability to break even for FY 2005-2005. At the same time, MHC relaunched its own programming activities in the spring of 2005 to critical acclaim and restored some staff positions in its facilities rentals and program areas. Staff restoration in these two areas was done to increase immediate earned revenue opportunities through facilities rentals and the mariachi festival and to demonstrate to the community the type of programming the facility was capable of under new management. This last step is also critical in approaching philanthropy, since foundation support will not support use of the facility as a rental venue.

Accordingly, MHC's cash flow projection reflects this increase in activity and staff. MHC's recent growth in earned revenue is insufficient, however, to support both the continued existence of the Resident Arts Program and to restore all key capacity staff positions needed to build the necessary contributed and earned revenue to ensure a sustainable operation – these include full time fund development, marketing and finance staff. Hence, MHC commenced conversations in June of 2006 with the City to review the situation. Further notes on the discussion of MHC's present position are as follows:

1. The insufficient cash flow projection is also due to the delay in obtaining from the City its response to MHC's numerous requests for clarification of the funding responsibilities of the parties under the O&M agreement. We understand that this delay was caused by factors beyond the control of City staff relative to developments affecting other San Jose arts groups. Nevertheless, this delay has caused further detriment to MHC's financial position and to MHC's ability to pursue an alternative course of action, such as termination of its service as the operator of the Plaza and focusing solely on the production of the mariachi festival.

2. MHC's management of cash flow has been predicated upon a good faith belief that the contractual issues MHC has identified would be resolved in an amicable and timely manner. In this regard, as recently as a month ago, MHC communicated with the City Manager that the City's delays would severely impact its cash reserve and that the situation must be resolved in a timely fashion in order to permit MHC to meet its fiduciary obligations to its creditors and employees if a transition from operating the Plaza was deemed to be the best course of action.

3. The City audit report does not address the unintended consequences of the City's loan to MHC. That is, when the City determined to provide MHC support in the form of a loan rather than in the form of a grant, this eliminated the ability of the agency to seek long term support from philanthropy. The reason for this unintended consequence are two-fold: first, as far as present MHC management has been able to determine, the loan proceeds were not utilized to build the agency's capacity but to address past due liabilities. Second, as MHC has discussed in previous letters and meetings with the City, this liability impedes the ability of MHC to approach funders in philanthropy for long term program support. Based upon our discussions with MHC's independent auditor, short of MHC's receipt of a major gift or a new capital restructuring that would eliminate or offset the liability on MHC's balance sheet and help to restore staff capacity, sustained fund development activity in philanthropy by MHC is severely constrained.

4. Relative to the report's discussion regarding MHC's accounts payables, we note that MHC fully intends to pay down its accounts payable liability upon the culmination of its financial audit, which is presently ongoing, and upon the determination of the actual amount of accrued liability. MHC has previously stated to the audit team that, in the opinion of MHC, the payables liability is overstated. The financial audit and subsequent survey of vendors must be completed before any pay down of the liability commences.

5. Given present capacity constraints, MHC utilizes a dual approach relative to financial planning. First, the corporation has prepared, with the advice of professional arts management consultants, a planning budget that sets forth estimated revenue and expense to achieve full capacity as an arts organization. This planning budget assumes staffing levels that reflect what similarly situated arts organizations managing large facilities should maintain in order to ensure sustainable growth. This planning budget was prepared by reviewing the organizational capacity of both large and small institutions, and with the corporation's new programming model in mind. Thus, the planning budget reflects staffing expense for fund development, finance, marketing, and education programs, as well as appropriate operations and administrative personnel, but it does not reflect deep staff levels for content/program development or for production expenses other than its annual music festival, since the corporation pursues such activities through joint production or collaborative arrangements that minimize financial costs in those areas. The budget sets forth MHC's reasonable projected personnel expenses assuming the corporation receives the capital injection and reimbursement it requests from the City. It should also be noted that these personnel projections were also requested by the City Manager. They represent a reasonable budget for the management of the Plaza based on peer reviews of similar arts venues.

6. MHC agrees with the recommendation of the Auditor relative to the use of monthly operating budgets and fully intends to implement the recommendation.

7. In view of the financial and organizational capacity issues the agency presently faces, the corporation formally adopted a "zero-based" spending guideline for day-to-day operations. Under this policy, the corporation may not expense any programs if firm written commitments have not been secured to underwrite the activity or if earned revenue from the proposed activity is insufficient to cover the cost. The Corporation follows a conservative policy relative to estimated ticket revenue, assuming 20% earned revenue from its presented or produced events. This policy is combined with a cash based management of expenses and revenue, pursuant to which the corporation monitors cash flow on a weekly basis to ensure that internal expense controls are followed.

8. The MHC planning budget for FY 2006-2007shows an $800,000 surplus. This amount is revenue from a capital grant projected to be received by the Corporation in FY 2006-2007 for the refurbishment and improvement of the Plaza facility. The costs associated with the capital improvements are capitalized and not recorded as expenses and will be reflected on the Corporation's balance sheet as a capital asset.

9. MHC's legal obligation under relevant mariachi production contracts is appropriately reflected by showing projected gross revenues and expenses, resulting in a statement that reflects the projected net income from this activity. The planning budget shows a projected net revenue of approximately $200,000, which MHC did indeed earn from its 2006 mariachi festival.

10. With regard to the $1 million capital improvement grant, MHC notes that these funds are being dedicated to the refurbishment and upgrade of the Plaza facility and that MHC, RDA, a representative from the City Manager's Office and the City's General Services Agency meet regularly to review the project scope and management of the project. We also note that MHC presently has no liability to the RDA nor has it agreed to any future liability or a contingent liability under any promissory note or instrument which evidences indebtedness. As we previously advised the auditor's staff, the payment mechanism under the California state grant is as follows: the MHC and the RDA jointly determine the scope of work on the project. Contractors are jointly identified for each job on the project. Bids are submitted to and jointly approved by MHC and RDA. Once a contractor's bid is accepted, MHC submits a payment request to the State, along with notice to proceed notifications to the contractors. The State remits payment to MHC pursuant to the payment request. MHC pays the contractors. If MHC is not able to negotiate payment terms with a contractor, the RDA will pay the contractor from authorized funds approved for this purpose by the City Council. RDA submits a reimbursement request to MHC. MHC reimburses RDA.

    The State will not fund a request for proceedson the project unless relevant State forms and procedures are followed evidencing project readiness – e.g., that contractors have been properly selected, that notice to proceed letters have been sent etc. Thus, in the instant case, it is possible that the contractor selected to upgrade the HVAC system in the Plaza's theatre may not agree to payment terms that MHC is capable of handling if work is completed and the State reimbursement is delayed. If this is the case, RDA has the ability to facilitate payment to the contractor under the present arrangement.

11. With regard to O&M compliance issues, MHC has fully paid all current liabilities under its loan obligation. Until this audit report, MHC had not received any formal notice from the Office of the City Manager, the agency responsible for oversight of MHC that it is out of compliance with the reserve requirement.

Further, the City Manager is aware of MHC's lack of reserve and is preparing documentation acknowledging this fact for MHC's independent auditors. Finally, the City has maintained an ex officio position on the MHC Board for at least two years. City representatives diligently attend MHC Board meetings as well as the capital improvement project meetings and have received numerous and timely reports on MHC's financial condition and programming progress. MHC will also provide the reports required under the loan documents.

12. With regard to the Packard Foundation grant, MHC intends to staff this position as soon as the open issues regarding the Plaza's operating model and its capitalization are resolved. If the position is not filled, MHC will return the grant proceeds which are being held in reserve.

13. MHC notes that its quiet phase lasted approximately one year, not two years. Programming was back online by 2005. Programming by the RAP groups continued during the quiet phase.

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1. MHC agrees that there is a need to revisit the RAP program. By 2004, when a new Executive Director was hired by the MHC Board, a custom and practice of usage of the theatre and other venues by the RAP partners as well as rental rates had been established by the previous MHC management relative to this program. MHC agrees that the RAP rental pricing structure adopted when the program was first implemented, and which is still in place today, needs a significant adjustment. Such adjustments could include but not be limited to charging increased rental and office rates, and programming the Plaza with other offerings from San Jose arts groups, presenters or other producers and promoters which could generate increased contributed and earned revenue. In order to revise this arrangement, the City must agree to amend the O&M Agreement to explicitly provide for this revision, since MHC is contractually obligated to run the RAP program. For this and other reasons, MHC has refrained from unilaterally changing the RAP rental arrangement until agreement from the City is secured. This issue has been timely raised and addressed by MHC in its previous letters to the City Manager. Our communications included a detailed analysis of the revenue earned under the present RAP rate card and potential revenue if the current RAP season was priced at market rates. The potential income was calculated at a minimum of $100,000. This exercise was not intended to assert that there is a back-log of arts presenters who stand ready to program their seasons at the Plaza. Rather, the exercise was intended to demonstrate the significant lost income MHC faces under the present RAP operating model, which the audit confirms.

2. Relative to the audit report's analysis of the rental market for San Jose venues we note that industry factors such as a) the rental market for prestige cultural arts centers and ethnic specific venues such as the Plaza, b) the rental market for multi-disciplinary venues such as the Plaza and c) the rental market for non-union venues should be taken into account when determining a rate card. Specifically, a comparison of the Plaza with the Montgomery theatre should note that the rental market for Plaza venues consists of a broad variety of users – from corporations who seek a large facility with multiple venues for presentations or company events, to arts organizations and presenters, to families and individuals who seek a venue for weddings, queanceñeras or other special events. In addition, until recently, the Montgomery Theatre has been in a state of disrepair and low rental rates would appear to reflect the physical condition of the theatre. Finally, the Montgomery Theatre is a "union shop" managed by Team San Jose, a large and well staffed organization which also manages several other venues in downtown San Jose. We assume TSJ's pricing methodology for the Montgomery reflects economies of scale MHC does not enjoy and the fact that the total package a potential rental client will need to pay includes union wages for theatre staff. Given that such "house costs" may be significantly higher than what a non-union venue may charge, it is reasonable to assume that the Montgomery's venue rental fee is attractively priced to offset this expense to the customer.

   Our experience is that there is a demand for the Plaza with our present pricing scheme due to the significant business we turn away because of conflicts generated by RAP programming or MHC programming. This aspect to the Plaza's identity – its role as a programmer as well as a venue operator, requires a careful management of available inventory of rental dates in order to maintain its status as a regional arts center, rather than a mere rental venue.

3. MHC's internal controls have significantly improved. Prior to March 2006, management of several functions was centralized with one manager – the COO/CFO. This individual was responsible for financial management and oversight, including preparation, and disbursement of expenses, financial reporting, grant management, human resources and compliance and facilities rentals and facilities operations.

Commencing in March 2006 these functions were separated into four departments and managed by appropriate staff. Financial management is overseen by a staff of three: the CFO, a senior accounting associate and a clerk who handles accounts payables. This staff is present at the Plaza venue 3-4 days a week. Disbursements of expenses follow appropriate internal procedures which require submissions of documentation, management approval and review by both the accounting department and CEO.

The CFO is an experienced senior finance manager with a graduate degree in business management. He was hired by MHC for his specific expertise in restoring accounting systems for small and large non-profits. His case load schedule is appropriate to his

position as CFO and his duties are not limited to mere fiscal general management. Under the terms of the MHC contract with MACSA, a copy of which was provided to the auditor's staff, the financial services agreement includes the preparation of budgets and appropriate planning documents for MHC, which includes, with the CEO, directing, planning and organization of MHC's financial operations. These activities have been ongoing since MHC's engagement of the present CFO and have already resulted in a significant improvement and restoration of MHC financial management systems, procedures and operations. While the current CFO may not be specifically familiar with historical planning discussions taking place prior to his engagement, to the best of our knowledge MHC's unaudited financial reports fairly represent our current financial position.

Human resources are staffed through a co-employment arrangement with a third party vendor who is certified in HR matters and a leading provider of co-employment services. Regulatory compliance, payroll, benefits and staff personnel matters are handled through this arrangement which also provides additional liability coverage for MHC.

Facilities rentals matters are handled by a two person staff and temporary crew as needed.

Operations matters are handled by a three person crew – a facility operations manager, night supervisor and a janitor. Additional cleaning crews are hired as needed for events.

Thus, numerous checks and balances have been established that provide for improved oversight of management and financial functions. MHC is also subject to an annual independent audit which thoroughly reviews MHC financial functions. Finally, the MHC Executive Committee meets regularly to review MHC's financial condition and also reviews the performance of the CEO on an annual basis. However, we agree with the findings of the audit relative to the need for increased staff capacity.

The discussion concerning fundraising accurately summarizes conclusions provided by MHC's fund development consultant. MHC has made significant progress, however, relative to Board development and engagement as well as fund development for short term program activity. First, for the last 2 years the MHC Board is a 100% contributor. That is, each Board member has made a contribution, either as an individual or as a representative of a corporation. These contributions of cash and in-kind services exceeded the minimum $3000 per Trustee goal set by the Board. These contributions are reflected in MHC's financial records either as individual contributions or as sponsorships or both. A schedule of Board contributions is attached.

In addition, the Board completed the City's previous request that it reconstitute itself – with the exception of two Trustees who remain on the Board from the founders group, the present Board represents a new governing body of capable professionals with significant non-profit Board experience and private sector management experience. Board membership also includes the ex oficio representation of the City. The City Manager's

Office, through its representation on the MHC Board has received numerous status and financial reports on a regular basis that exceed the quarterly requirement. Finally, as stated above, MHC has improved its fund development activity in philanthropy. Without full time fund development staff, however, this activity will be difficult to sustain.

Page 35 – MHC's draft business plan is attached. We note that it assumes an identity for the Plaza as a regional arts center, not as a community center or a training facility. The Wolf Report discusses such "non-arts" use in detail and determined that the physical plant of the Plaza was not conducive to either function. In our opinion, the primary use of the venue which may be supported by private sector funding is that of an arts or entertainment center. We further note that the cost analysis provided by the GSA does not address the programming aspects of the Plaza's operation and we agree that a review of the draft business plan presented as a response to the audit should be vetted by experienced arts, finance and facility professionals. MHC has formed a three person advisory board for this purpose, consisting of an experienced arts consulting organization, a venture capital professional with specific expertise in the Hispanic consumer market, and a senior bank executive.