



2007-2008 SANTA CLARA COUNTY CIVIL GRAND JURY REPORT

CITY FAILS TO HOLD HISTORY SAN JOSE ACCOUNTABLE

Introduction

The 2007-2008 Santa Clara County Civil Grand Jury (Grand Jury) conducted an investigation into the financial and management problems of History San Jose (HSJ), the nonprofit organization responsible for the preservation and promotion of local history.

Background

The San Jose Historical Museum (Museum) was established in Kelley Park in 1971 in recognition of the importance of preserving and promoting the area's culture and history. The Museum was owned and operated by the City of San Jose (City), which developed a nonprofit entity, the San Jose Historical Museum Association (Association), for fundraising and community involvement. In the early '90s, the Association advocated to the City that a nonprofit entity could better manage the combined Museum and the Peralta Adobe and Fallon House historical sites under the assumption that privatization would enable the Museum to attract more private and corporate funding.

In 1994, the City commissioned The Wolf Organization, Inc. (Wolf), an outside consulting firm, to conduct an assessment of transferring operations of the facilities from the City to a nonprofit entity. The original Wolf assessment rejected all of the nonprofit options it considered and recommended that a Museum Commission of prominent citizens oversee the Museum and create a new nonprofit organization which would eventually be able to operate the Museum. The City instead decided to transfer operations of the Museum to a restructured and renamed Association. In its report, Wolf cautioned that a proven fundraising track record was critical to the future success of the nonprofit entity, especially in the difficult fundraising environment of San Jose. Further, it warned that the City would "either have to continue to shoulder a tremendous percentage of the burden or see the Museum diminish in size and scope of programming."

In July of 1997, the nonprofit History Museums of San Jose began managing some of the key programs and services at the Kelley Park and Peralta Adobe/Fallon House facilities under an Interim Operating Agreement; and on April 1, 1998, the City and the History Museums of San Jose (later renamed History San Jose) entered into a 20-year renewable Operation Agreement. Key provisions included the following:

- The City would provide a subsidy to HSJ in the amount of \$8 million over 20 years, paid quarterly. (This amount was later amended to \$12 million to include additional salaries per the original agreement.) To support HSJ's request that the subsidy be paid out in the first ten years, the payment schedule "front loaded" much of the funding through FY 2007-2008 with the assumption that HSJ could secure increasing private donations. The subsidy schedule is shown in Appendix A.
- HSJ was required to provide to the City a strategic plan, annual progress reports, and timely and accurate financial information to support both annual funding and any additional funding requests.
- HSJ was required to build a cash flow reserve of a minimum of 3% per year until it reached 25%.
- The property and collections remained the property of the City. Maintenance and security costs are shared between HSJ and the City, with the City providing landscaping and utilities, and HSJ providing building maintenance and janitorial services.

Discussion

History San Jose Financial Management

In the second year of its contract (FY 1999-2000), HSJ reported a deficit of over \$150,000. The following year, despite receiving a sizeable City endowment, HSJ reported in its Annual Report to the City that it ended the year with a deficit of over \$350,000 and had to borrow from its cash reserve.

From 2001 to 2007 HSJ's financial condition continued to deteriorate, and it stopped delivering annual reports and strategic plans to the City. Parrish & Peterson Accountancy Corporation, HSJ's external auditor, documented concerns in the FY 2003-2004 audited financial statement about the organization's ability to acquire additional donations and continue to provide its current level of programs and services. In the audited financial statements for FY 2004-2005 and FY 2005-2006, outside auditor Petrinovich Pugh & Company, LLP, included a letter expressing "substantial doubt about the Organization's ability to continue as a going concern." Operating deficits totaled over \$480,000 in the four years ending FY 2006-2007, with a deficit of \$324,000 reported for the final year of that period.

In May 2007, HSJ requested that the City increase the level of annual City funding on a permanent basis to meet its basic annual operating cost of \$1.9 million. The City engaged the services of the Macias Consulting Group (Macias) to perform an audit to assess the organization's financial viability, its compliance with the Operation Agreement, and the cost to operate an organization of the Museum's size and nature, including what funding level the City should support.

In August 2007, HSJ notified the City that it had spent its reserve and City-funded endowment and would not be able to meet its August payroll without emergency funds. Although HSJ requested advances on both its second and third quarter payments, the City advanced the second quarter only as the Macias audit was almost complete.

The Macias audit was published in September 2007. Among its findings were the following:

- HSJ's financial stability is poor. Total revenues have declined and are insufficient to support its current mission and level of services.
- HSJ has not had a predictable level of outside funding. The HSJ Board of Directors (Board) is not meeting its fundraising goals and the organization's fundraising consultant works only part time.
- Financial management concerns were identified. HSJ has not designated the key position of Chief Financial Officer (CFO) as full time, and HSJ consistently overprojects its revenues in its budget.

Macias recommended a four-year performance plan that included restructuring to hire a full-time CFO and fundraiser, recruiting additional Board members to increase fundraising, and replacing non-critical employees with volunteers as employees leave through normal attrition.

In its response, HSJ agreed that it needs to improve its fundraising and requested a "realistic subsidy of \$1.2 million annually with a built in cost of living increase." No budget, strategic plan, or rationale was provided.

At an October 2007 City Council meeting, the City Council accepted but did not discuss the Macias audit and approved a recommendation by City staff to advance the third quarter payment to HSJ. City staff was instructed to work with HSJ to understand their funding request and make a recommendation in December.

In December 2007, the City Council approved the following:

- An advance of the fourth quarter payment for FY 2007-2008 to meet HSJ's December payroll because HSJ had based its spending on a \$2 million budget with an assumption of a \$1.2 million City subsidy.
- An increase of over \$300,000 in the annual operating subsidy for FY 2007-2008 to a total of \$875,000.
- Deferred approval of additional funding at the \$875,000 level for the following two fiscal years.
- Direction to have staff work with HSJ to bring forth a funding plan and schedule at the beginning of FY 2009-2010 for the remaining years of the agreement.

In an effort to comply with the City Council's direction, HSJ started to develop a strategic plan and cost controls. As of March 2008, HSJ's cost reduction plan is to defer hiring a Director of Education and several other vacant staff positions. The February 2008 financial plan for the current fiscal year depends on HSJ raising \$421,000 in revenues before the end of the fiscal year to achieve a balanced budget. No contingency plans are in place if that target is not met. HSJ is developing a strategic plan based on receiving an \$875,000 annual City subsidy through FY 2009-2010.

History San Jose Governance

The HSJ Board of Directors is accountable for the financial and fiduciary performance of HSJ. It also is responsible for setting and implementing a strategic plan and monitoring the performance of the organization and its CEO.

Individual Board members are responsible for raising \$3500 annually. The Board Chair acknowledges that this responsibility is not being met and that Board fundraising is an area that needs improvement.

City of San Jose Oversight

The City has had one Administrative Officer who acts as liaison and contract administrator for the City's cultural venues. This position is responsible for receiving and reviewing the financial and administrative reports from seven or more nonprofit organizations and gives verbal summaries to management. The position is also responsible for attending the nonprofit organizations' Board meetings, although according to Board minutes the last HSJ Board meeting attended by the City was in May of 2007. The position does not require expertise in financial analysis and is unable to spend time reviewing performance and deliverables against contract requirements. The Administrative Officer estimated to the Grand Jury that approximately ten percent of the position is devoted to HSJ.

Due to concerns about HSJ's financial viability, the City has recently designated a director-level individual with a financial background to act as the liaison between HSJ and City management. This individual is working with HSJ to ensure that they develop a realistic budget and operating plan for the rest of this fiscal year and track to that budget, and also to report to the City next year on the appropriate funding level for the organization going forward.

Conclusions

- The original contract between the City of San Jose and HSJ was established on the basis of a decreasing subsidy for the City with revenue generation being transferred to HSJ. Over the last ten years, as the subsidy has decreased, HSJ has not raised the offsetting revenues or adjusted its operating model for decreased expenditures.
- The 2007 audit report from the Macias Consulting Group pointed out significant financial and organizational issues within HSJ.
- HSJ is not staffed to provide appropriate financial management as it lacks a full-time CFO and full-time fundraiser. HSJ management has not demonstrated an ability to develop and manage to a balanced budget.
- The City of San Jose failed to enforce the Operation Agreement with HSJ and failed to heed auditors' and HSJ's early warnings of financial problems.
- Based on its current structure, the City of San Jose is not organized to provide sufficient oversight of nonprofit organizations including contract compliance and financial analysis.
- The City engaged the services of two professional consultants, The Wolf Organization and the Macias Consulting Group, but did not follow their recommendations.

Findings and Recommendations

Findings were reviewed with the subject agencies.

Finding 1

The City of San Jose has failed in its fiduciary oversight of History San Jose. In spite of recommendations made by the Macias Consulting Group, the City Council approved a subsidy increase to HSJ this year of over \$300,000 without HSJ meeting its contractual requirements for documentation.

Recommendation 1a

The City Council should determine based on its overall budget and priorities the appropriate subsidy level for History San Jose.

Recommendation 1b

Based on its spending priorities and the subsidy level it determines to be appropriate, the City should amend its Operation Agreement to adjust its subsidy schedule with History San Jose and hold HSJ to its contractual agreements.

Recommendation 1c

The responsibility for arts and cultural nonprofit oversight should reside within a City department with sufficient authority and appropriate staffing to enforce contract compliance.

Finding 2

History San Jose's organizational structure lacks the overall leadership, financial management, and fundraising strength to meet its contractual obligations.

Recommendation 2

The HSJ Board should re-evaluate the organization's management structure and hire a full-time CFO and full-time fundraiser.

Finding 3

History San Jose's Board is not meeting their responsibilities as outlined in HSJ's Board Responsibilities document.

Recommendation 3

History San Jose should recruit Board members with financial and management expertise to mentor HSJ management and oversee the turnaround of the organization. All Board members need to meet and exceed their fundraising goals, bring in additional Board members, and come up with creative means to enable HSJ to increase fundraising capabilities.

Key References

Documents

City of San Jose, Memorandum. *Approval for Long Term Operating Agreement with History Museums of San Jose (HMSJ)*, March 16, 1998.

City of San Jose, Memorandum. *History Museums of San Jose*, March 20, 1998.

City of San Jose, Memorandum. *Approval of Amendment to Operation Agreement with History Museums of San Jose to Include Maintenance Obligations and Approval of Grant Agreement for Funds Previously Appropriated in the Amount of \$419,000*, June 9, 1999.

City of San Jose, Memorandum. *Second Amendment to the Operation Agreement between the City of San Jose and History San Jose*, May 22, 2006.

City of San Jose, Memorandum. *Request from History San Jose for Additional Funding*, May 8, 2007.

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City of San Jose, Memorandum. *History San Jose Funding Strategy*, October 2, 2007.

City of San Jose, Memorandum. *History San Jose*, October 11, 2007.

City of San Jose, Memorandum. *Actions Related to Additional Funding for History San Jose*, December 7, 2007.

City of San Jose. *Minutes of the City Council*, October 16, 2007.

City of San Jose. *Minutes of the City Council*, December 18, 2007.

City of San Jose. *Resolution No. 68008*, adopted March 24, 1998.

City of San Jose. *Resolution No. 68995*, adopted June 29, 1999.

First Amendment to the Operation Agreement between the City of San Jose and History Museums of San Jose, June 29, 1999.

History Museums of San Jose. *Annual Report to the City of San Jose for Fiscal Year*

1998-1999.

Documents – continued

History Museums of San Jose. *Annual Report to the City of San Jose for Fiscal Year 2000-2001.*

History San Jose. *Annual Report to the City of San Jose FY'06 and FY'07*, October 13, 2007.

History San Jose. *Board of Directors Meeting Minutes*, May 22, 2007.

History San Jose. *Board of Directors Meeting Minutes*, August 28, 2007.

History San Jose. *Board of Directors Meeting Minutes*, September 18, 2007.

History San Jose. *Board of Directors Meeting Minutes*, October 16, 2007.

History San Jose. *Board of Directors Meeting Minutes*, December 11, 2007.

History San Jose. *Board of Directors Meeting Minutes*, February 19, 2008.

History San Jose. *City of San Jose Contract Subsidy Update*, March 18, 2008.

History San Jose. *Financial Summary*, February 2008.

History San Jose. *HSJ Board Responsibilities* (undated).

History San Jose Organization Chart, January 7, 2008.

History San Jose Organization Chart, March 13, 2008.

History San Jose. *Promoting History, A Strategic Plan for History San Jose FY2008 – 2010*, March 18, 2008 (draft).

History San Jose. *Three Year Report Card 1998-2001.*

Macias Consulting Group. *Performance Audit History San Jose, City of San Jose*, September 2007.

Operation Agreement between the City of San Jose and The History Museums of San Jose, April 23, 1998.

Parrish & Peterson Accountancy Corporation. *History Museums of San Jose Financial Statements June 30, 1998*, September 17, 1998.

Parrish & Peterson Accountancy Corporation. *History Museums of San Jose Financial*

Statements June 30, 1999 and 1998, September 14, 1999.

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Parrish & Peterson Accountancy Corporation. *History San Jose Financial Statements June 30, 2000 and 1999, December 1, 2000.*

Parrish & Peterson Accountancy Corporation. *History San Jose Financial Statements June 30, 2001 and 2000, October 16, 2001.*

Parrish & Peterson Accountancy Corporation. *History San Jose Financial Statements June 30, 2002 and 2001, December 2, 2002.*

Petrinovich Pugh & Company, LLP. *History San Jose Audited Financial Statements June 30, 2003 and 2002, August 20, 2003.*

Petrinovich Pugh & Company, LLP. *History San Jose Audited Financial Statements June 30, 2004 and 2003, August 19, 2004 and November 23, 2004.*

Petrinovich Pugh & Company, LLP. *History San Jose Audited Financial Statements June 30, 2005 and 2004, December 1, 2005.*

Petrinovich Pugh & Company, LLP. *History San Jose Audited Financial Statements June 30, 2006 and 2005, January 9, 2007.*

President and CEO, History San Jose and Board of Directors Chair, History San Jose. Letter to City Manager, City of San Jose, May 1, 2007.

President and CEO, Board Chair, Board Chair 2001-2005, Board Chair 1997-2001, History San Jose. Letter to City Manager, City of San Jose, September 28, 2007.

The Wolf Organization. *The Future of the San Jose Historical Museum Final Report, March 1995.*

Interviews

December 5, 2007	City Manager, City of San Jose
December 11, 2007	Chief Deputy City Manager, City of San Jose
January 8, 2008	President and CEO, History San Jose
January 17, 2008	Director of General Services, City of San Jose
January 29, 2008	Administrative Officer, City of San Jose
February 4, 2008	Board Chair, History San Jose
February 11, 2008	Councilmember, City of San Jose
March 19, 2008	President and CEO, History San Jose

Meetings Attended

December 18, 2007	City of San Jose, City Council meeting
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PASSED and **ADOPTED** by the Santa Clara County Civil Grand Jury on this 1st day of May, 2008.

Raymond A. Blockie, Jr.
Foreperson

Tim Cuneo
Foreperson pro tem

Kathryn C. Philp
Secretary

Appendix A

History San Jose Subsidy Schedule

Year	Fiscal Year	HSJ Annual Subsidy, \$	Supplemental Staff Payment, \$	HSJ 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 ¹
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
Total		\$8,088,068	\$3,996,460	\$12,084,528

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

¹Actual amount paid to HSJ was \$714,124 for this period.