



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

September 18, 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 San José Repertory Theatre*. This report is in accordance with City Charter Section 805. The San José Repertory Theatre will submit a response under a separate cover.

I would like to thank the San José Repertory Theatre staff for their cooperation, input and assistance in completing this assessment.

This report will be presented to the Council at its September 19, 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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GS:lg

cc:	Les White	Larry Lisenbee	Karin Murabito
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## Memorandum

**TO:** HONORABLE MAYOR AND CITY COUNCIL  
**FROM:** Gerald A. Silva, City Auditor  
**SUBJECT:** *Financial Assessment of the San José Repertory Theatre*  
**DATE:** September 18, 2006

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We have reviewed the San José Repertory Theatre (SJRT) current financial condition and have identified several issues that cast doubt on the SJRT's ability to function as a going concern. Specifically, we have identified issues regarding SJRT's spending and possible inappropriate uses of endowment funds, total long-term debt, current proposed budget, cash flow projections, and in-house financial management capacity. In our opinion, given its total outstanding debt and financial structure, it is highly unlikely that the SJRT will be able to continue operating beyond the current calendar year without a \$1 million City loan. However, the \$1 million City loan in and of itself will not be sufficient to remedy the SJRT's long-term financial needs.

### **The SJRT Has Spent 77 Percent Of Its Century Fund Endowment And Cash Reserve Funds**

Between 2001 and 2005, the SJRT raised \$3,850,181 in Century Fund Endowment and Critical Moment Campaign funds. Specifically, the SJRT raised \$2,831,739 for the Century Fund and about \$1,018,000 in the Critical Moment Campaign. The goal of the Century Fund was to establish an \$11 million endowment to use interest earnings to fund operational activities. The goal of the Critical Moment Campaign was to build a \$1 million cash reserve fund to deal with short-term cash flow problems. As of September 15, 2006 SJRT financial records reveal that only \$885,000 of the \$3,850,181 endowment and cash reserve funds remains unspent. This \$885,000 includes \$275,000 in investments held at Comerica Securities and a \$610,000 Certificate of Deposit, both of which the SJRT transferred to Comerica Bank as collateral against its line of credit with the Bank. Since 2002, the SJRT has spent \$2,965,181 or 77 percent of its endowment and cash reserve funds to pay down debt and fund operational expenses. On at least two occasions in 2002 and 2004, the SJRT approached donors about unrestricting \$2.1 million in endowment funds. Due to the SJRT's lack of complete financial records, we were not able to identify what use the SJRT made of the unrestricted endowment and cash reserves. In addition, members of the SJRT's Board of Directors to whom we spoke did not have complete knowledge of how the SJRT spent the endowment and cash reserve funds.

### **The SJRT May Have Misused Restricted Century Fund Endowment Monies**

The SJRT may have misused Century Fund endowment monies by using them as collateral against a line of credit with Comerica Bank. We found that the SJRT's \$885,000 line of credit was secured by:

- 1) A \$610,000 Certificate of Deposit currently being held by the Comerica Bank, and
- 2) \$275,000 in investments at Comerica Securities which Comerica Bank secured through a "control agreement" with the SJRT.

SJRT staff was unable to provide us with any evidence of donor or Board approval for this use. According to the California State Attorney General's Office "*if a charitable organization holds funds for a restricted purpose, it would be unlawful to encumber those funds as collateral for a loan if the loan proceeds will not be used for the restricted purpose.*" The SJRT's legal counsel, who is also a board member, told us that the SJRT had not consulted with her on the endowment issue and as a board member she did not have any knowledge of the endowment monies being used as collateral at Comerica Bank. We have referred this matter to the City Attorney's Office for further review.

### **The SJRT Has Significant Long-term And Short-term Debt Which May Cause Financial Instability For The Organization**

In addition to the SJRT's liabilities related to the endowment, the organization carries a significant amount of short-term and long-term debt. According to the SJRT's 2004-05<sup>1</sup> audited financial statements, "*the Theater has significant reductions in grants and contributions, experienced significant decreases in unrestricted net assets and total net assets, and incurred negative cash flows from operating activities for the year ended August 31, 2005. ... These factors raise substantial doubt about the Theatre's ability to continue as a going concern.*" Those concerns coupled with the aforementioned spending of endowment and cash reserves cast serious doubts about the SJRT's ability to pay its current debt and deficit and continue its current operations. We found that SJRT has a current debt liability of about \$3.3 million. This liability includes the following:

- An \$841,524 open line of credit with a 5.7 percent interest rate. Currently, the SJRT is making minimum interest payments on this line of credit. The line of credit at the Comerica Bank is payable on demand.
- A \$34,272 loan payable in September 2007 at Comerica Bank at a 5.96 percent interest rate with monthly payments of \$2,739.51.

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<sup>1</sup> The SJRT's fiscal year is from September 1 to August 31.

- A \$150,000 loan from the Silicon Valley Arts Fund held at the Community Foundation. Under its agreement with the Community Foundation, the SJRT is not required to repay the loan until it is able to do so.
- As mentioned above, during the Critical Moment Campaign, the SJRT raised about \$1 million which was to be put in a permanent cash reserve. However, the SJRT spent the entire \$1 million on operating expenses and debt reduction. In essence, the SJRT borrowed the \$1 million from itself. Therefore, the SJRT is obligated to pay \$1 million back into a cash reserve account, per the requirements of the Critical Moment Campaign.
- During the 2004 Critical Moment Campaign, one of the SJRT's major donors agreed to unrestrict about \$500,000 of his original \$1 million donation to the Century Fund endowment. However, the donor stipulated that once the SJRT's financial situation stabilized, the SJRT was required to pay the \$500,000 back into the endowment. However, when we spoke to this donor he said that he was willing to withdraw his stipulation given the SJRT's current financial condition.
- The SJRT also has about \$485,000 in accounts payable, the majority of which is 90 days or more past due. These accounts payable are described below.

### **More Than Half Of The SJRT's \$485,000 Accounts Payable Are 90 Days Or More Past Due**

As of August 31, 2006, the SJRT had accounts payable of \$485,000, of which \$254,000 were more than 90 days past due. These accounts payable included \$65,000 to its former auditors, and \$26,000 in credit cards. In its current budget, the SJRT shows that it intends to make minimum payments of \$62,000 per year for its accounts payable. SJRT staff stated the SJRT's former managing director reached agreements with some vendors regarding payments, but could not provide us with any written documentation regarding vendor agreements for delayed or partial payments. According to the SJRT's Controller, most of these vendor agreements were verbal. At least one vendor has retained the services of a credit collection bureau to pursue collection of a "severely past due" bill.

### **The SJRT Has Established Ambitious Fundraising Goals**

In the current fiscal year (2006-07), the SJRT has established a target of fundraising \$1.7 million in contributions from individuals, corporations, and foundations. In our opinion, this fundraising goal is ambitious based on recent past contributions. The following table shows SJRT's contributions received in 2005-06 and forecast for 2006-07.

**SJRT's Contributions Received In 2005-06 And Forecast For 2006-07**

<b>Donors</b>	<b>2005-06</b>	<b>Projected 2006-07</b>	<b>Percent Change</b>
<b>Individuals</b>	\$ 666,279	\$ 800,000	20.07%
<b>Corporate</b>	\$ 218,845	\$ 400,000	82.78%
<b>Foundation</b>	\$ 582,500	\$ 500,000	-14.16%
<b>Sub-Total</b>	<b>\$ 1,467,624</b>	<b>\$ 1,700,000</b>	<b>15.83%</b>
<b>Foundation</b> without \$250,000 supplementary grants	\$ 332,500	\$ 500,000	50.38%

As shown above, in 2005-06, the SJRT received \$1,467,624 in contributions from individuals, corporate, and foundation donors and is forecasting \$1,700,000 for 2006-07 – a 15.83 percent increase. In our opinion, the SJRT's projected foundation fundraising target in 2005-06 is ambitious. In 2005-06, the SJRT received a \$150,000 supplemental grant from the William and Flora Hewlett Foundation (Hewlett) and a \$250,000 special consideration grant from the David and Lucille Packard (Packard) Foundation. These grants were emergency stabilization grants that were used to pay off operational deficits and bridge loans to Board Members. According to the SJRT Development Director, these grants were \$250,000 more than the SJRT typically receives from the Hewlett and Packard Foundations. The SJRT does not expect the Hewlett or Packard Foundations to contribute similar amounts in 2006-07. Without this extra \$250,000, the SJRT would have received \$332,500 (\$582,100-\$250,000) in Foundation grant funds in 2005-06. Accordingly, excluding the supplemental Hewlett and Packard Foundation grants, the SJRT is projecting to increase its foundation contributions by 50 percent in 2006-07 when compared to 2005-06.

In terms of 2006-07 foundation contributions, five foundations have contributed a total of \$30,000. In addition, the SJRT has submitted seven foundation grant applications totaling \$300,000 for 2006-07, including a first-time \$200,000 grant application to the Bank of America. The SJRT has not received responses to any of its pending foundation grant applications. The SJRT also plans to seek an additional \$150,000 in grant funds from the Hewlett Foundation and Packard Foundation. The SJRT expects to use the foundation funds to support the Red Ladder Theatre Company and education and outreach activities.

The SJRT also has ambitious fundraising targets for corporate and individual contributions. In 2005-06, the SJRT received \$218,845 in corporate donations. The SJRT development staff expects to increase this amount by 82.78 percent to \$400,000. Over the last six years, the SJRT has averaged about \$335,000 in corporate donations. Similarly, in 2005-06, the SJRT received \$666,279 in individual donations. Included in this amount was \$154,469 in donations received in August due to a last minute push for

contributions resulting from the SJRT's publicized financial troubles. The SJRT development staff originally expected to increase individual donations from \$666,279 in 2005-06 to \$1,000,000 in 2006-07. Staff recently reduced its 2006-07 individual contributions projection by \$200,000 to \$800,000, which still represents a 20 percent increase over its 2005-06 individual contributions.

During the last six years, the SJRT averaged \$1.5 million<sup>2</sup> in contributed income from individuals, corporations, and foundations. According to the SJRT interim managing director, the decrease in contributed income in 2005-06 was an anomaly because for seven months the SJRT was without any development department staff.

### *Local Philanthropy Environment*

The SJRT development staff is attempting to meet its ambitious fundraising targets in a very challenging fundraising environment. For example, in May 2006, the Silicon Valley Community Foundation reported to the City that:

*“We know from our research that local philanthropy has decreased in our region over the past five years. This decrease has been exacerbated further by several recent changes and events that are not reflected in our study.*

*Specifically, in the time since we published the 2005 Santa Clara County Nonprofit Benchmark Study:*

- *Hurricane Katrina struck the Gulf Coast region. Local residents, corporations and other funders responded generously, but at times this generosity replaced giving in our own community.*
- *San Jose lost the corporate generosity of two major corporations with the sale of Knight Ridder, which contributed roughly \$1.5 million to the community, and the bankruptcy of Calpine, which contributed roughly \$500,000 to local nonprofit organizations in 2004.*
- *The Skoll Foundation has eliminated its Silicon Valley funding program, which contributed \$1.6 million locally in fiscal year 2005.*
- *The Valley Foundation is shifting its funding to focus on medical needs and issues, thereby eliminating access to funding for many local nonprofits who previously benefited from the organization's grants. In fiscal year 2005, the Valley Foundation awarded \$3.9 million locally.”*

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<sup>2</sup> This average excludes \$1.1 million in Century Fund monies that donors unrestricted in 2001-02 and \$1 million in Century Fund monies that donors unrestricted in 2003-04.

While the SJRT has not received funding from the above noted corporations and foundations, their absence will adversely impact the pool of available corporate and foundation funding for all non-profits in the local community. As a result, fundraising for all local non-profits will be more challenging in 2006-07.

**2006-07 Budget And Cash Flow Issues**

According to the SJRT’s audited financial statements and reports, the SJRT began deficit spending several years ago. We should note that we relied upon SJRT reports for financial and admission information and that some SJRT reports contained conflicting and/or contradictory information. For example, the SJRT shows 2006-07 admissions revenue on four different reports. The admissions revenue on these four reports varied from \$2.5 million to almost \$2.9 million. For projected 2006-07 financial information, various SJRT reports showed expenditures ranging from \$4.8 million to \$5.2 million and contributed income ranging from \$1.9 million to \$2.2 million. The following table highlights income and expenses before extraordinary one-time occurrences.

**Summary Of SJRT Income, Expenses, And Net Income (Losses)  
 From 2001-02 Through 2006-07**

	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06*</b>	<b>2006-07**</b>
<b>Total Income</b>	\$5,640,433	\$5,572,987	\$5,583,867	\$5,905,394	\$5,497,741	\$4,962,940
<b>Total Expenses</b>	\$6,793,181	\$6,248,669	\$6,126,326	\$7,452,702	\$5,808,838	\$4,826,568
<b>Net Income (Loss)</b>	<b>(\$1,152,748)</b>	<b>(\$675,682)</b>	<b>(\$542,459)</b>	<b>(\$1,547,308)</b>	<b>(\$311,097)</b>	\$136,372

Source: Financial Assessment of San José Repertory Theatre (APG & Company 1/20/06, SJRT records).

\* Unaudited

\*\* Projected and Unapproved Budget Information. Includes net savings from proposed American Musical Theatre merger.

As shown above, SJRT’s proposed budget projection shows a \$534,801 drop in total income from 2005-06 to 2006-07 which includes an anticipated reduction in admission revenue of \$269,143 from 2005-06 to 2006-07. Further, SJRT’s budget projection shows about \$982,270 in reduced expenses during that same period. SJRT staff believes that the elimination of one of seven productions, reduced production staff costs, and efficiencies due to a planned merger with the American Musical Theatre will generate this \$982,270 in cost savings. We should note that the SJRT’s cash flow projections show that it will exhaust its available operating funds by November 2006.

The SJRT projects that in 2006-07 it will sell about 72,000 tickets averaging \$35.34 per ticket. The following table shows five years of ticket sales information including 2006-07 projected ticket sales information.

**Summary Of SJRT Admission Revenue Tickets Sold, Average Ticket Price, Number Of Productions And Annual Ticket Price Increases From 2001-02 Through 2006-07**

	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>	<b>2006-07</b>
<b>Admission Revenue</b>	\$2,674,828	\$2,803,359	\$2,824,363	\$2,938,176	\$2,824,976	\$2,555,833
<b>Tickets Sold</b>	108,405	109,655	111,284	106,499	90,943	72,326
<b>Average Ticket Price</b>	\$24.67	\$25.67	\$25.38	\$27.59	\$32.29	\$35.34
<b>Number Of Productions</b>	6	7	7	7	7	6
<b>Annual Ticket Price Increase</b>	12.5%	3.6%	(0.7%)	8.7%	12.6%	9.4%

The SJRT relies heavily on admissions income to sustain operations. The SJRT reduced the number of its 2006-07 productions from seven to six. Additionally, the SJRT reduced costs by changing the formats and schemes of the remaining shows. Fewer productions, negative publicity due to the SJRT financial condition, and increased costs per ticket may also negatively affect admission revenue. Consequently, additional unanticipated reductions in admission revenue may further exacerbate the SJRT's already precarious financial condition.

*The SJRT Used 2006-07 Subscription Revenue To Pay For 2005-06 Expenses*

The SJRT used 2006-07 subscription revenue it collected during March, April, and May of 2006 to pay for 2005-06 expenses. While the SJRT used some of its 2006-07 revenue to pay for some 2006-07 expenses in 2005-06, the SJRT spent the vast majority of its 2006-07 subscription revenue to cover 2005-06 operating expenses. As a result, by the time the SJRT's 2006-07 year began, it had already spent all of its 2006-07 subscription revenue. The SJRT has practiced using next year's revenues to pay current year's costs for the last several years.

**Limited In-house Professional Capacity**

We have serious concerns about the SJRT's in-house professional capacity. As of September 1, 2006, the SJRT does not have a full-time Finance Director. From May 2006 to July 2006, an interim Finance Director was working only 10 to 20 hours per week. The current Controller does not have a financial background and was the SJRT's Administration Office Manager before assuming the Controller's position. As a result, the Controller will need the assistance of an experienced Finance Director to complete necessary tasks. On a number of occasions, the SJRT was unable to provide us with routine documents or identify basic financial information. According to a SJRT official,

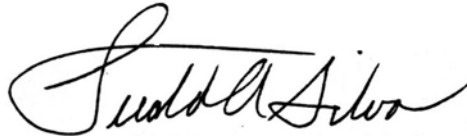


the SJRT suspended searching for an experienced, full-time Finance Director due to the uncertainty of its financial condition. Without an experienced Finance Director, it appears unlikely the SJRT will be able to address its fiscal situation, or effectively manage the requested \$1 million City of San José loan.

As of September 12, 2006, the SJRT had not closed its August 2006 books and the SJRT is in the process of selecting new auditors to conduct its 2005-06 financial audit. According to the SJRT's unaudited Internal Statements, the SJRT has a 2005-06 operating deficit of more than \$300,000. Conversely, the SJRT's original and revised 2005-06 budgets showed a \$260,000 surplus and near breakeven, respectively. According to the former Finance Director, the closing of the books may reveal a significantly larger deficit. SJRT estimates now indicate a 2005-06 operating deficit of \$370,000 to \$500,000.

Historical information indicates that the SJRT has required a supplemental infusion of about \$1 million every two years. Even if the City loans the SJRT \$1 million, it will probably require an additional \$1 million in supplemental funding within a year or two in order to continue operations if historical patterns continue.

In our opinion, limited in-house professional financial capacity, historical deficit spending, and significant long and short-term debt, create significant challenges to the long-term viability of the SJRT.



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Gerald A. Silva  
City Auditor