



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

February 7, 2011

**The Honorable City Council
Palo Alto, California**

Finance Committee Recommendation to Accept Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2010 and Management Letter

Recommendation

On December 21, 2010, the Finance Committee unanimously recommended that Council accept the attached Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2010 and Management Letter.

Respectfully submitted,

Mike Edmonds
Acting City Auditor

ATTACHMENTS:

- Attachments A-G Financial Statements and Management Letter (PDF)
- Attachment 1 Minutes from the Finance Committee Meeting of December 21, 2010 (PDF)

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED
JUNE 30, 2010**

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2010

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MEMORANDUM ON INTERNAL CONTROL

October 22, 2010

To the City Council of the
City of Palo Alto, California

We have audited the financial statements of the City of Palo Alto for the year ended June 30, 2010 and have issued our report thereon dated October 22, 2010. In planning and performing our audit of the financial statements of the City of Palo Alto as of and for the year ended June 30, 2010, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the City's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We identified certain deficiencies in internal control that we consider to be significant deficiencies that are included on the Schedule of Significant Deficiencies.

The City's written responses included in this report have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.



**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL
SCHEDULE OF SIGNIFICANT DEFICIENCIES**

2010-01 – Gas Service Charges to the Electric Fund

Criteria

All gas meters belong to City should be properly connected to a reading route which should be read and maintained by City.

Condition

During our fieldwork, we were informed by the Administrative Services Department that the Utilities Department reviewed utility rates for interfund billings to confirm if correct billing rates were used. During the review, it was determined that the utility billing of the Gas Fund was not setup in the accounting software (BANNER) to record expenditures to the Electric Fund and revenues to the Gas Fund.

COBUG, a 5-Megawatt backup generator powered by natural gas for power outage emergencies was purchased by the City a few years ago. The generator was owned by the Electric Fund but fueled by the Gas Fund. In November 2007 the City intended to add the COBUG meter to a reading route of the Gas Fund and bill the Electric Fund using BANNER. However, the set up process was not completed and the Electric Fund has not been billed for the last three fiscal years.

Effect

The Gas Fund was owed \$500,000 of unbilled expenditures on behalf of the Electric Fund.

Cause

Based on our conversation with City staff, the meter was not setup on any of the City's meter routes. No gas consumption was recorded for the Electronic fund since then.

Recommendation

The generator usage should be billed to the Electric Fund.

Management Response:

The COBUG gas meter has been added to the meter reading route. The Gas Fund billed and received \$453,266 from the Electric Fund for three prior years of service. All financial transactions are recorded and are current as of FY 2010 financial statements.

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL**

CURRENT STATUS OF PRIOR YEAR SIGNIFICANT DEFICIENCIES

2009-01 – Utility System Implementation

Effective May 2009 the City implemented a new utility billing system. There are a number of complications which occurred in fiscal 2008-09 and required staff to record correcting journal entries. For example,

- Certain interfund billings for utility services were corrected with journal entries due to system errors.
- A duplicate billing was detected by staff and corrected late in fiscal 2008-09.
- Certain remittance advices contain data errors such that the amount listed as due on the remittance stub portion of the invoice is erroneous while the detail on the customer invoice portion is correct.
- Customer support time has dramatically increased due to billing and transition issues.

We met with staff and reviewed documentation of the above issues and discussed the status of the system implementation. We also selected a sample of billings under the new system and tested utility billings for propriety. We noted one exception out of forty-five billings due to refuse charge from the former hauler that staff could not support. We also perform certain analytical procedures to gain further evidence that revenues for the utility funds were materially accurate for fiscal 2008-09 and did not note material errors.

While it is important to note that staff detected the above errors and made appropriate corrections in fiscal 2008-09, the system implementation issues if left uncorrected represent a potential for errors to occur and go undetected with out timely identification and resolution. We are aware that staff have continued to work on resolving these issues and bringing increased reliability to the system. Resources should continue to be brought to bear to complete the implementation and correct system issues so that accurate data is produced without staff intervention.

Management Response as of June 30, 2009: Since implementation of the SAP utility billing and customer information system in May 2009, the system has performed as expected overall. The vast majority of utility bills (99.33%) are going out on time and are correct. However, in the area of billing, staff has experienced unexpected challenges with a small number of billing errors. Shortly after go-live, a small number of bills, approximately 200 out of 30,000 monthly bills were sent to customers with incorrect amounts in the bill detail. Correct bills were later sent. Since that time, bills that have an incorrect bill detail have been caught by staff and corrected. In these instances, the total bill amount is correct on the bill payment stub on the front of the bill; however, the bill detail inside the bill does not reflect the same total. Staff is working to eliminate any instances of errors in billing detail. Additional resources have been committed to this effort.

Since the August timeframe, customer service response time has improved and it continues to trend downward reflecting improved response. This is reflected in the call hold time measure which was nearly 50 minutes in late August and has dropped to less than four minutes in October.

Current Status: Since January 2010 the SAP utility billing system has been stable and in a normal operating mode. Ongoing tracking of system performance indicators is in place and reviewed regularly by the Program Management Office (PMO). If these indicators show poor performance or errors in a given area the PMO assigns resources to resolve the issue.

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL**

CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

2009-02 – Utility Billing System IT Controls

During fiscal 2008-09 staff requested that we perform an Information System Review of the new utility billing system. Our work was performed using the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA). Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

While the results of our work did not indicate material weaknesses or serious exploitable vulnerabilities, we did note a few areas which could be improved which were communicated to staff for follow-up.

Management Response as of June 30, 2009: The City has encrypted credit card data and installed an internal firewall device. An existing process to review role assignments in SAP has been revised to include the new roles in SAP/CCS. This continues to provide protection against unauthorized internal access.

Current Status: The SAP Program Management Office continues to monitor system security and addresses issues when they arise. A comprehensive overhaul of the SAP role authorization process was conducted in 2010 to ensure ownership accountability for SAP access.

2009-03 – Other Internal Control Areas

With our current year audit we rotated some of our emphasis to delve deeper in to a variety of areas as we were able to build on the extensive controls work conducted last year due to new audit standards. As a result we noted the following controls which were not deemed material weaknesses, but did warrant improvement. We communicated these to staff for their use in determining appropriate action.

Accounts Receivable Reconciliation - Based on our control testing of receivable oversight and reconciliations, we noted that staff had not performed the sub-module reconciliation to the General ledger in December 2008. The reports generated from module were not properly reflecting correct balances as the IT department was in the process of updating the reports in order to fix the problem.

Management Response as of June 30, 2009: The report has been corrected and the reconciliation has been completed for each month of the fiscal year.

Current Status: In FY 2009, during the monthly reconciliation ASD staff noticed SAP reporting problems and worked with IT staff to resolve. The report was corrected before the end of FY 2009 and the reconciliation was brought to a current status resulting in no financial impact. For FY 2010 the reconciliation continues to be completed on a monthly basis.

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL**

CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

Check Register Review and Approval - Based on our control testing, we noted no evidence that check register reports were reviewed and approved since the Sr. Accountant in charge was transferred to the Enterprise Accounting section in August 2008. Check register reviews should be documented to ensure proper internal control for disbursement in place. We recommend the City assign a designated staff to review and approve the check register report at least on monthly basis to ensure proper control of disbursement during the transition period.

Management Response as of June 30, 2009: The Accounts Payable Supervisor now reviews the check register in detail each time checks are issued. The Supervisor then certifies in writing that the register has been reviewed and indicates on the certification whether there were any exceptions that were noted during the review. This certification is then attached to the check register and filed in the appropriate binder.

Current Status: The procedures established in FY 2009 continue each time Accounts payable checks are processed; The Accounts Payable Supervisor reviews the check register in detail, certifies in writing that the register has been reviewed and indicates on the certification whether there were any exceptions that were noted during the review. This certification is then attached to the check register and filed in the appropriate binder.

Inventory Adjustment/Variance Report Review and Approval - During our inquiry for inventory write-off procedures, we found that the Warehouse Supervisor has access to the inventory. He is also responsible for writing off inventory based on the inventory counts. However the adjustment/variance report for the inventory write-off was not reviewed by a second staff. We recommend a designated staff to review the inventory adjustment report on monthly basis to ensure the adjustment was properly supported and justified.

Management Response as of June 30, 2009: A procedure is in place whereby Accounting staff monitors the monthly stores inventory adjustment activity and forwards the report to the ASD Deputy Director, including quantity and part number information of all items over \$5K for review. The procedure began with the March 2009 close.

Current Status: A procedure is in place whereby Accounting staff monitors the monthly stores inventory adjustment activity and forwards the report to the ASD Deputy Director, including quantity and part number information of all items over \$5K for review. The procedure began with the March 2009 close.

2009-04 - Statement No. 53 - Accounting and Financial Reporting for Derivative Instruments (Effective for fiscal 09/10)

This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

**CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL**

CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

Current Status: City staff has worked with external auditors and has determined that for fiscal year 2009-2010, there are no accounting and reporting requirements for derivative instruments.

2009-05 Statement No. 54 Fund Balance Reporting and Governmental Fund Type Definitions (Effective for fiscal 10/11)

This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

The initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with inventories. This Statement also provides for additional classification as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds *other than the general fund*, assigned fund balance represents the remaining amount that is not restricted or committed.

Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. *In other funds*, the unassigned classification should be *used only to report a deficit balance* resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition also was clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Current Status: Staff will work closely with external auditors to prepare for the implementation of GASB 54. Required changes will be incorporated with the fiscal year 2010-2011 CAFR.

REQUIRED COMMUNICATIONS

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October 22, 2010

To the City Council of the
City of Palo Alto, California

We have audited the financial statements of the City of Palo Alto as of and for the year ended June 30, 2010, and have issued our report thereon dated October 22, 2010. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2010. During the year, the following pronouncements became effective without materially impacting the City's financial statements:

- **GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets***

Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements are referred to in the GASB 34 description of capital assets which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability

- **GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments***

This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during fiscal year 2009-10.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are discussed below:

- *Estimated Fair Value of Investments* (Note 3 to the financial statements) - As of June 30, 2010, the City held approximately \$462 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2010. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2010.
- *Allowance for Doubtful Account – Notes Receivable* (Note 5 to the financial statements): The City has loaned approximately \$23.5 million to other parties to promote its low and moderate income housing programs. As of June 30, 2010, management had established an allowance for collectability of approximately \$14.8 million based on its estimate of the ultimate likelihood of collection.
- *Accrued Landfill Postclosures Costs* (Note 9 to the financial statements)- The City has estimated post closure costs of a landfill based on what it would cost to perform all currently mandated closure and post-closure care. Actual closure and post-closure care costs may be higher due to inflation variances, changes in technology, or changes in State or Federal regulations.
- *Claims Loss Reserves* (Note 14 to the financial statements)- The City is exposed to a variety of risks of loss due to general liability and workers compensation claims and records an estimate of these losses based on an actuarial study performed by a third party consultant actuary. This study is prepared based on the City's prior claims history which is used as a basis for extrapolating losses for known and incurred but not reported claims. Actual loss experience will vary from estimates.

Disagreements with Management: For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process.

Uncorrected Misstatements: Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the audit committee.

This report is intended solely for the information and use of the City Council, its committees, and management and is not intended to be and should not be used by anyone other than these specified parties.

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**INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH THE PROPOSITION 111
2009-2010 APPROPRIATION LIMIT INCREMENT**

Honorable Mayor and Members
of the City Council, of the
City of Palo Alto, California

We have applied the procedures below to the Appropriations Limitation Worksheet for the City of Palo Alto for the year ended June 30, 2010. These procedures, which were suggested by the League of California Cities and presented in their Article XIII B Appropriations Limitation Uniform Guidelines were performed solely to assist you in meeting the requirements of Section 1.5 of Article XIII B of the California Constitution. This engagement to apply agreed-upon procedures was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified users of this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. This report is intended for the information of management and the Honorable Mayor and Members of the City Council; however, this restriction is not intended to limit the distribution of this report, which is a matter of public record.

The procedures you requested us to perform and our findings were as follows:

- A. We obtained the Appropriations Limitation Worksheet and determined that the 2009-2010 Appropriations Limit of \$116,380,638 and annual adjustment factors were adopted by resolution of City Council. We also determined that the population and inflation options were selected by a recorded vote of the City Council.
- B. For the Worksheet, we recomputed the 2009-2010 Appropriations Limit by multiplying the 2008-2009 Appropriations Limit by the 2009-2010 Adjustment Factors.
- C. For the Appropriations Limitation Worksheet, we agreed the Per Capita Income, County and City Population Factors to California State Department of Finance Worksheets.

These agreed-upon procedures are substantially less in scope than an audit, the objective of which is the expression of an opinion on the Appropriations Limitation Worksheet. Accordingly, we do not express such an opinion. Had we performed additional procedures or had we made an audit of the Appropriations Limitation Worksheet and the other completed worksheets described above, matters might have come to our attention which would have been reported to you.



October 22, 2010

**CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION**

**BASIC COMPONENT UNIT
FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED
JUNE 30, 2010**

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION BASIC COMPONENT UNIT FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2010
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INDEPENDENT AUDITOR'S REPORT

The Honorable Mayor and
Members of the City Council of the
City of Palo Alto, California

We have audited the accompanying basic component unit financial statements of the governmental activities and the major fund of the Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2010, as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly in all material respects the financial position of the governmental activities and the major fund of the Palo Alto Public Improvement Corporation as of June 30, 2010, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

Management's Discussion and Analysis is not a required part of the basic component unit financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of required supplementary information. However we did not audit the information and we express no opinion on it.



October 22, 2010

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, follows the provisions of Government Accounting Standards Board Statement 34 (GASB 34), "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments."

The Corporation is controlled by the City of Palo Alto and was organized to assist the City in financing public improvements. The Corporation issues debt and turns the proceeds of the debt over to the City under lease agreements that provide a revenue source for the repayment of this debt. The Corporation has three debt issues and has turned the proceeds of these issues over to the City, which pledged certain lease payments as collateral for this debt as discussed in Note 4 to the financial statements.

FISCAL 2010 FINANCIAL HIGHLIGHTS: CORPORATE-WIDE BASIS AND FUND BASIS

GASB 34 requires the issuance of corporate-wide financial statements as well as fund financial statements. The corporate-wide financial statements report the balance of the Corporation's long-term debt issues while the individual fund statements do not.

In fiscal year 2002, the Corporation issued its 2002A Civic Center Refinancing Certificates of Participation (COPs) in the amount of \$3.5 million to refund its 1992 Civic Center Project COPs, reducing debt service requirements by \$372 thousand and producing an account gain of \$137 thousand. The Corporation also issued its 2002B Downtown Parking Improvements COPs in the amount of \$3.6 million. In fiscal year 2005, a partial redemption was completed by placing excess construction and debt service reserve funds into an escrow account to defease \$900 thousand of 2002B Downtown Parking Improvements COPs. These issues, including the 1998 Golf Course Capital Improvements COPs, comprise the Corporation's outstanding debt.

Interest expense on these COP issues was \$396 thousand for fiscal year 2010, a decrease of \$41 thousand over the prior year. The interest for leases on the assets securing these COP issues was \$374 thousand, a decrease of \$63 thousand from the prior year. Program expenses exceeded lease revenues by \$22 thousand, thereby resulting in a decrease in net assets of \$22 thousand over the prior year.

The Corporation ended fiscal year 2010 with total assets of \$7.0 million, a decrease of \$0.9 million from the prior year. Total assets consist of \$1.3 million in cash and \$5.7 million of leases receivable (recorded at net present value) from the City of Palo Alto. Total liabilities were \$6.9 million, a decrease of \$0.8 million from the prior year, and included \$1.0 million of current debt as well as \$5.9 million of long-term debt.

At the fund level, the Corporation's expenditures exceeded its revenues by \$90 thousand whereas revenues had exceeded expenditures in the prior year by \$22 thousand.

As of June 30, 2010, the Corporation had one fund, the Debt Service Fund, which reported a \$1.3 million fund balance, reflecting a \$0.1 million decrease over the prior year.

OVERVIEW OF THE CORPORATION'S BASIC FINANCIAL STATEMENTS

The Basic Financial Statements are in two parts:

- (1) Management's Discussion and Analysis (this part);
- (2) The Basic Financial Statements, which include the corporate-wide and the fund financial statements, along with the notes to these financial statements.

The Basic Financial Statements

The Basic Financial Statements comprise the corporate-wide Financial Statements and the Fund Financial Statements. These two sets of financial statements provide two different views of the Corporation's financial activities and financial positions, both short-term and long-term.

The corporate-wide Financial Statements provide a long-term view of the Corporation's activities as a whole and comprise the Statement of Net Assets and the Statement of Activities. The Statement of Net Assets provides information about the financial position of the Corporation as a whole, including all its long-term liabilities on the full accrual basis, similar to that used by corporations. The Statement of Activities provides information about all the Corporation's revenues and expenses on the full-accrual basis with an emphasis on measuring the net revenues or expenses of the Corporation's programs. The Statement of Activities explains in detail the change in net assets for the fiscal year.

The Fund Financial Statements report the Corporation's operations in more detail than the corporate-wide statements and focus primarily on the short-term activities of the Debt Service Fund. Fund Financial Statements measure only current revenues and expenditures; current assets, liabilities, and fund balances; and they exclude capital assets and long-term debt.

Together, these statements are called the Basic Financial Statements.

DEBT ADMINISTRATION

The Corporation issues debt in the form of Certificates of Participation (termed COPs) for future lease receipts from the City of Palo Alto. Legally, these COPs issues are the Corporation's debt only; the City is liable only for the payment of the amounts set forth in the lease securing each COPs issue.

The Corporation issued two COPs for the fiscal year ending June 30, 2002, one of which was refunded by an earlier issue.

ECONOMIC OUTLOOK AND MAJOR INITIATIVES

The economy of the City of Palo Alto and its major initiatives for the coming year are discussed in detail in the City's Comprehensive Annual Financial Report.

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

The Basic Financial Statements are intended to provide citizens, taxpayers, investors, and creditors with a general overview of the Agency's finances. Questions about these statements should be directed to the Finance Department of the City of Palo Alto, 250 Hamilton Avenue, Palo Alto, CA 94301.

CITY OF PALO ALTO - PUBLIC IMPROVEMENT CORPORATION**STATEMENT OF NET ASSETS
AND STATEMENT OF
ACTIVITIES**

The Statement of Net Assets and the Statement of Activities summarize the entire Corporation's financial activities and financial position. They are prepared on the same basis as is used by most businesses, which means they include all the Corporation's assets and all its liabilities, as well as all its revenues and expenses. This is known as the full accrual basis; the effect of all the Corporation's transactions is taken into account, regardless of whether or when cash changes hands; but all material internal transactions between Corporation funds have been eliminated.

The Statement of Net Assets reports the difference between the Corporation's total assets and the Corporation's total liabilities, including all the Corporation's capital assets and all its long-term debt. The Statement of Net Assets presents similar information to the old balance sheet format but presents it in a way that focuses the reader on the composition of the Corporation's net assets, by subtracting total liabilities from total assets.

The Statement of Net Assets summarizes the financial position of all the Corporation's Governmental Activities in a single column that presents the financial position of the entire Corporation.

The Corporation's Governmental Activities include the activities of its Debt Service Fund.

The Statement of Activities reports increases and decreases in the Corporation's net assets. It is also prepared on the full accrual basis, which means it includes all the Corporation's revenues and all its expenses, regardless of when cash changes hands. This differs from the "modified accrual" basis used in the Fund financial statements, which reflect only current assets, current liabilities, available revenues and measurable expenditures.

The Statement of Activities presents the Corporation's expenses and follows with program revenues. Revenues which are generated directly by these programs are deducted from program expenses to arrive at the net expense of the governmental program. The Corporation's general revenues are then listed in the Governmental Activities column, and the Change in Net Assets is computed and reconciled with the Statement of Net Assets.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF NET ASSETS
 JUNE 30, 2010

ASSETS

Cash and investments held by trustee (Note 3)	\$1,275,699
Interest receivable	10,455
Investment in leases to City of Palo Alto (Note 2C)	<u>5,748,558</u>
Total Assets	<u>7,034,712</u>

LIABILITIES

Interest payable	117,000
Long-term debt (Note 4):	
Due in one year	870,000
Due in more than one year	<u>5,895,000</u>
Total Liabilities	<u>6,882,000</u>

NET ASSETS

Restricted (Note 5A)	<u>152,712</u>
Total Net Assets	<u><u>\$152,712</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF ACTIVITIES
 FOR THE YEAR ENDED JUNE 30, 2010

EXPENSES

Interest and fiscal agent charges	<u>\$369,291</u>
Total Program Expenses	<u>369,291</u>

REVENUES

Interest on leases from City of Palo Alto	<u>374,335</u>
Net Program Expenses	<u>5,044</u>

GENERAL REVENUES

Investment income	<u>9,669</u>
Change in Net Assets	14,713
Net assets at the beginning of year	<u>137,999</u>
Net assets at the end of year	<u><u>\$152,712</u></u>

See accompanying notes to financial statements

FUND FINANCIAL STATEMENTS

Major funds are defined generally as having significant activities or balances in the current year.

The Corporation has one fund in fiscal 2010.

Debt Service Fund - This fund accounts for debt service payments on the Corporation's long-term debt issues.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 DEBT SERVICE FUND BALANCE SHEET
 JUNE 30, 2010

ASSETS

Cash and investments held by trustee (Note 3)	\$1,275,699
Interest receivable	10,455
Investment in leases to City of Palo Alto (Note 2C)	<u>5,748,558</u>
Total Assets	<u><u>\$7,034,712</u></u>

LIABILITIES

Deferred revenue	<u>\$5,748,558</u>
Total Liabilities	<u>5,748,558</u>

FUND BALANCE (Note 5B)

Reserved for:	
Debt service	<u>1,286,154</u>
Total Fund Balance	<u>1,286,154</u>

RECONCILIATION OF FUND BALANCE TO NET ASSETS:

Accrual adjustment to remove deferred revenue from the balance sheet	
Deferred revenue	5,748,558
Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds	
Long-term debt:	
Interest payable	(117,000)
Due within one year	(870,000)
Due in more than one year	<u>(5,895,000)</u>
NET ASSETS OF GOVERNMENTAL ACTIVITIES	<u><u>\$152,712</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 DEBT SERVICE FUND
 STATEMENT OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCE
 FOR THE YEAR ENDED JUNE 30, 2010

REVENUES

Lease receipts from City of Palo Alto:	
Principal	\$746,847
Interest	374,335
Investment income from cash and investments	<u>9,669</u>
Total Revenues	<u>1,130,851</u>

EXPENDITURES

Debt service:	
Principal repayment	840,000
Interest and fiscal agent charges	<u>381,291</u>
Total Expenditures	<u>1,221,291</u>
NET CHANGE IN FUND BALANCE	(90,440)
Fund balance at beginning of year	<u>1,376,594</u>
Fund balance at end of year	<u><u>\$1,286,154</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 STATEMENT OF REVENUES, EXPENDITURES AND
 CHANGES IN FUND BALANCES
 GOVERNMENTAL FUNDS TO THE
 STATEMENT OF ACTIVITIES - FOR THE YEAR ENDED JUNE 30, 2010

Net change in fund balances-total governmental funds	(\$90,440)
Amounts reported for governmental activities in the Statement of Activities are different because:	
<p style="margin-left: 40px;">Repayment of bond principal is an expenditure in the governmental funds, but in the Statement of Net Assets the repayment reduces long-term liabilities.</p>	
Fund balance is increased by the amount of debt repayment	840,000
<p style="margin-left: 40px;">Some amounts reported in the Statement of Revenues, Expenditures and Changes in Fund Balances reflect the collection of an asset which are not includable as revenues on the Statement of Activities</p>	
Change in deferred revenue	(746,847)
Change in interest payable	<u>12,000</u>
Change in net assets of governmental activities	<u><u>\$14,713</u></u>

See accompanying notes to financial statements

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 1 - DESCRIPTION OF REPORTING ENTITY

The Palo Alto Public Improvement Corporation (the Corporation) was incorporated in September 1983 under the General Nonprofit Corporation Law of the State of California to acquire, construct and lease capital improvement projects. The Corporation is exempt from federal income taxes under Section 501(c)(4) of the Internal Revenue Code. The Corporation provides financing of public capital improvements for the City through the issuance of Certificates of Participation (COPs), a form of debt which allows investors to participate in a stream of future lease payments. Proceeds from the COPs are used to construct projects which are leased to the City for lease payments which are sufficient in timing and amount to meet the debt service requirements of the COPs.

The Corporation is an integral part of the City of Palo Alto. It primarily services the City and its governing body is composed of the City Council. Therefore, the financial data of the Corporation has also been included as a blended component unit within the City's comprehensive annual financial report for the year ended June 30, 2010.

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

Corporate-wide Statements: The Statement of Net Assets and the Statement of Activities include the financial activities of the Corporation. Eliminations have been made to minimize the double counting of internal activities.

The Statement of Activities presents a comparison between direct expenses and program revenues for each function of the Corporation's activities. Direct expenses are those that are specifically associated with a program or function and, therefore, are clearly identifiable to a particular function. Program revenues include (a) charges paid by the recipients of goods or services offered by the programs and (b) grants and contributions that are restricted to meeting the operational or capital requirements of a particular program. Revenues that are not classified as program revenues, including all taxes, are presented as general revenues.

Fund Financial Statements: The fund financial statements provide information about the Corporation's funds. Separate statements for each governmental fund are presented. The emphasis of fund financial statements is on major individual funds, each of which is displayed in a separate column.

B. Major Funds

Major funds are defined as funds that have either assets, liabilities, revenues or expenditures equal to ten percent of their fund-type total and five percent of the grand total. The Corporation has one fund which is reported as a major governmental fund in the accompanying financial statements:

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Debt Service Fund - This fund accounts for debt service payments on the Corporation's long-term debt issues.

C. Investment in Leases

Improvements financed by the Corporation are leased to the City for their entire estimated useful life and will become the City property at the conclusion of the lease. The Corporation therefore records the present value of the lease and considers the leased improvements to have been sold for this amount when leased.

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE

A Trustee under the provisions of the Corporation's COP issues, holds, and invests all the Corporation's cash.

A. Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Normally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. Information about the sensitivity of the fair values of the Corporation's investments to market interest rate fluctuations is provided by the following table that shows the distribution of the Corporation's investments by maturity:

Investment Type	Amount	Maturity Date
CAMP	\$56,605	N/A
U.S. Agency Obligations:		
FNMA	631,144	February 15, 2011
Money Market Mutual Funds	587,950	N/A
Total Investments held by Trustee	<u>\$1,275,699</u>	

California Asset Management Program

The City is a voluntary participant in the California Asset Management Program (CAMP). CAMP is an investment pool offered by the California Asset Management Trust (the Trust). The Trust is a joint powers authority and public agency created by the Declaration of Trust and established under the provisions of the California Joint Exercise of Powers Act (California Government Code Sections 6500 et seq., or the "Act") for the purpose of exercising the common power of its Participants to invest certain proceeds of debt issues and surplus funds. The Pool's investments are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code. The City reports its investments in CAMP at the fair value amounts provided by CAMP, which is the same as the value of the pool share. At June 30, 2010, fair value approximated cost. At June 30, 2010, these investments have an average maturity of 48 days.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE (Continued)

Money Market Mutual Funds are available for withdrawal on demand at June 30, 2010, and have an average maturity of 27 days.

B. Credit Risk

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. The actual ratings as of June 30, 2010 for all U.S. Agency Obligations and Money Market Mutual Funds are Aaa as provided by Moody's Investment Rating system. As an external investment pool, the California Asset Management Program was rated Aaa-M as of June 30, 2010.

C. Investment Policy

The Corporation must maintain required amounts of cash and investments with trustees under the terms of certain debt issues. These funds are unexpended bond proceeds or are pledged as reserves to be used if the Corporation fails to meet its obligations under these debt issues. The California Government Code requires these funds to be invested in accordance with bond indentures or State statute. All these funds have been invested as permitted under the Code. The Investment Policy is described in detail in the City of Palo Alto Comprehensive Annual Financial Report.

The table below identifies the investment types that are authorized by the City's Investment Policy. The table also identifies certain provisions of the City's Investment Policy that address interest rate risk, credit risk and concentration of credit risk. The table addresses investments of debt proceeds held by bond trustee that are governed by the provisions of debt agreements of the City rather than by the general provisions of the City's investment policy.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE (Continued)

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment In One Issuer
U.S. Government Securities	10 years	N/A	No Limit	No Limit
U.S. Government Agencies	10 years	N/A	No Limit (A)	No Limit
Certificates of Deposit	10 years	N/A	20%	10% of the par value of portfolio
Bankers Acceptances	180 days	N/A	30%	\$5 million
Commercial Paper	270 days	AAA	15%	\$3 million (B)
Local Agency Investment Fund	N/A	N/A	No Limit	\$40 million per account
Short-Term Repurchase Agreements	1 year	N/A	No Limit	No Limit
City of Palo Alto Bonds	N/A	N/A	No Limit	No Limit
Money Market Deposit Accounts	N/A	N/A	No Limit	10%
Mutual Funds (C)	N/A	N/A	20%	10%
Negotiable Certificates of Deposit	10 years	N/A	10%	\$5 million
Medium Term Corporate Notes	5 years	AA	10%	\$5 million

(A) Callable and multi-step securities are limited to no more than twenty percent of the par value of the portfolio, provided that:

- 1) the potential call dates are known at the time of purchase.
- 2) the interest rates at which they "step-up" are known at the time of purchase.
- 3) the entire face value of the security is redeemed at the call date.

(B) The lesser of \$3 million or 10% of outstanding commercial paper of any one institution.

Debt Agreements:

(C) Golf PIC COP 1998, University Avenue Parking Bond 2001 and University Avenue Parking Bond 2002 are allowed to invest in the California Asset Management Program.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 4 - CERTIFICATES OF PARTICIPATION

The Corporation's changes in long-term debt are presented below:

	Balance June 30, 2009	Retirements	Balance June 30, 2010	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
1998 Golf Course				
4.00-5.00%, due 09/01/2018	\$4,415,000	\$355,000	\$4,060,000	\$370,000
2002A Civic Center Refinancing				
2.00-4.00%, due 03/01/2012	1,175,000	380,000	795,000	390,000
2002B Downtown Parking				
Improvements				
4.55-6.00%, due 03/01/2022	2,015,000	105,000	1,910,000	110,000
	<u>\$7,605,000</u>	<u>\$840,000</u>	<u>\$6,765,000</u>	<u>\$870,000</u>

In August 1998, the Corporation issued the **Golf Course Capital Improvements and Refinancing Project Certificates of Participation, Series 1998**, in the amount of \$7.8 million to refund and subsequently retire the 1978 Golf Course Lease Revenue Bonds issued by the City through the Palo Alto Golf Course Corporation and to finance various improvements at the Palo Alto Public Golf Course, including upgrading five fairways and various traps, trees and greens, constructing new storm drain facilities, replacing the existing irrigation system, upgrading the driving range, and installing new cart paths. Under the terms of the 1998 COPs, the Corporation transferred \$473 thousand to an agent for the Golf Course Corporation which used the funds to retire the 1978 Bonds.

On January 16, 2002, the Corporation issued the **2002A Civic Center Refinancing Certificates of Participation** in the amount of \$3.5 million to refund the City's 1992 Civic Center Project Certificates of Participation. Principal payments for the 2002A COPs are due annually on March 1 and interest payments semi-annually on March 1 and September 1 and are payable from lease revenues from the City from available funds. During the year ended June 30, 2002, the 1992 Civic Center COPs were retired.

On January 16, 2002, the Corporation issued the **2002B Downtown Parking Improvements Certificates of Participation** in the amount of \$3.6 million to finance the construction of certain improvements to the non-parking area contained in the City's Bryant/Florence Garage complex. Principal payments are due annually on March 1 and interest payments semi-annually on March 1 and September 1 and are payable from lease revenue received from the City from available funds.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 4 - CERTIFICATES OF PARTICIPATION (Continued)

On January 25, 2005, the City defeased \$900 thousand of the 2002B Downtown Parking Improvements Certificates of Participation. The City placed \$1.0 million in surplus cash from the Civic Center Refinancing and Downtown Parking Improvement Project Construction account in an irrevocable trust to provide for future debt payments. Accordingly, the trust account assets and the liability for the defeased Bonds are not included on the financial statements. The outstanding amount of the defeased debt at June 30, 2010 is \$700 thousand.

The COPs are payable and secured by lease revenues received by the Public Improvement Corporation from any City General Fund revenue source. Principal and interest are payable semi-annually on March 1 and September 1.

Future annual debt service on the COPs is expected to be provided by the lease receipts discussed above, and is shown below:

For the Year Ending June 30	Governmental Activities		
	Principal	Interest	Total
2011	\$870,000	\$344,109	\$1,214,109
2012	905,000	305,559	1,210,559
2013	530,000	263,512	793,512
2014	555,000	235,509	790,509
2015	590,000	205,575	795,575
2016-2020	2,890,000	522,554	3,412,554
2021-2022	425,000	41,926	466,926
Total	\$6,765,000	\$1,918,744	\$8,683,744

NOTE 5 - NET ASSETS AND FUND BALANCES

A. Net Assets

Net Assets are described below:

Restricted describes the portion of Net Assets which is restricted as to use by the terms and conditions of agreements with outside parties, governmental regulations, laws, or other restrictions which the Corporation cannot unilaterally alter. These principally include debt proceeds received for debt service requirements.

B. Fund Balances

Fund balances consist of reserved fund balance representing that portion of fund balance which is legally segregated for debt service.

**CITY OF PALO ALTO
REGIONAL WATER QUALITY
CONTROL PLANT**

FINANCIAL STATEMENTS

**FOR THE YEAR ENDED
JUNE 30, 2010**

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2010**

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INDEPENDENT AUDITOR'S REPORT

The Honorable Mayor and
Members of the City Council of the
City of Palo Alto, California

We have audited the accompanying statements of Net Expenditures and Net Changes in Commitments and Quarterly Billings of the City of Palo Alto Regional Water Quality Control Plant, a component unit of the City of Palo Alto, for the year ended June 30, 2010, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1 to the Financial Statements, the financial statements referred to above were prepared for the purpose of complying with the provisions of the Basic Agreement between the City of Palo Alto, the City of Mountain View and the City of Los Altos for Acquisition, Construction and Maintenance of a Joint Sewer System dated October 10, 1968, and subsequent letters of agreement dated December 5, 1977, January 14, 1980, April 9, 1985, July 3, 1990, July 31, 1992 and March 16, 1998, and are not intended to be a presentation in accordance with generally accepted accounting principles in the United States.

In our opinion, the financial statements referred to above present fairly in all material respects the net expenditures and net changes in commitments of the Regional Water Quality Control Plant, and its quarterly billings to the Cities of Mountain View and Los Altos for the year ended June 30, 2010, on the basis of accounting described in Note 1.

This report is intended for the information of the Mayor, Members of the City Council, management, and others within the City of Palo Alto, and the Cities of Mountain View and Los Altos. However, this report is a matter of public record and its distribution is not limited.



October 22, 2010

CITY OF PALO ALTO
 REGIONAL WATER QUALITY CONTROL PLANT
 STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS
 FOR THE YEAR ENDED JUNE 30, 2010

	<u>Totals</u>	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
DIRECT EXPENDITURES:				
Source control program	\$1,071,690	\$393,953	\$116,386	\$561,351
Public outreach	98,851	36,337	10,735	51,779
Permitting and enforcement	946,917	250,375	15,377	681,165
Operations and maintenance	10,693,585	3,930,962	1,161,323	5,601,300
System improvement CIP (Note 2)	645,793	237,394	70,133	338,266
	<u>13,456,836</u>	<u>4,849,021</u>	<u>1,373,954</u>	<u>7,233,861</u>
TOTAL Direct Expenditures				
INDIRECT ADMINISTRATIVE EXPENDITURES:				
Source control program	830,802	305,403	90,225	435,174
Public outreach	1,833	674	199	960
Permitting and enforcement	356,666	231,115	14,195	111,356
Operations and maintenance	1,734,912	637,754	188,411	908,747
	<u>2,924,213</u>	<u>1,174,946</u>	<u>293,030</u>	<u>1,456,237</u>
TOTAL Indirect Expenditures				
DEBT SERVICE EXPENDITURES:				
Refunding 1990 Series A Bonds	284,257	144,971	22,172	117,114
1999 Wastewater Treatment New Project	541,953	205,346	51,323	285,284
	<u>826,210</u>	<u>350,317</u>	<u>73,495</u>	<u>402,398</u>
TOTAL Debt Service Expenditures				
TOTAL EXPENDITURES	17,207,259	6,374,284	1,740,479	9,092,496
DEDUCT JOINT SYSTEMS REVENUES (Note 5)	<u>(318,949)</u>	<u>(117,246)</u>	<u>(34,638)</u>	<u>(167,065)</u>
NET EXPENDITURES	16,888,310	6,257,038	1,705,841	8,925,431
ADD NET CHANGES IN COMMITMENTS (Note 1)				
	<u>(315,561)</u>	<u>(116,000)</u>	<u>(34,270)</u>	<u>(165,291)</u>
NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS	<u>\$16,572,749</u>	<u>\$6,141,038</u>	<u>\$1,671,571</u>	<u>\$8,760,140</u>

See accompanying notes to financial statements

CITY OF PALO ALTO
 REGIONAL WATER QUALITY CONTROL PLANT
 STATEMENT OF QUARTERLY BILLINGS
 FOR THE YEAR ENDED JUNE 30, 2010

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
BILLINGS BY QUARTER BEGINNING:		
July 1, 2009	\$1,939,163	\$557,683
October 1, 2009	2,029,617	576,654
January 1, 2010	1,939,163	557,683
April 1, 2010	<u>1,801,152</u>	<u>490,801</u>
 Total quarterly billings	 7,709,095	 2,182,821
 Net expenditures and net changes in commitments	 <u>6,141,038</u>	 <u>1,671,571</u>
 Excess of net expenditures and net changes in commitments over total billings	 <u>\$1,568,057</u>	 <u>\$511,250</u>

See accompanying notes to financial statements

CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

The Cities of Palo Alto, Mountain View and Los Altos (the Members) participate jointly in the cost of maintaining and operating the Regional Water Quality Control Plant and related system (the Plant). The Members shared the original costs of acquisition and construction of the Plant in the same proportions as the allocation of capacity rights to them. The City of Palo Alto (the City) is the owner and administrator of the Plant. The Cities of Mountain View and Los Altos are entitled to use a portion of the capacity of the Plant for a period of 50 years as set forth in the Basic Agreement between the City of Palo Alto, the City of Mountain View and the City of Los Altos for Acquisition, Construction and Maintenance of a Joint Sewer System dated October 10, 1968 and subsequent letters of agreement dated December 5, 1977, January 14, 1980, April 9, 1985, July 3, 1990, July 31, 1992 and March 16, 1998. The original agreement, as amended, may terminate any time after 50 years provided that written notice of withdrawal is tendered ten years preceding the date of withdrawal.

The Plant is an enterprise that is operated by the City and its operations are accounted for as an enterprise fund in the City's basic financial statements. The accompanying financial statements are intended to present the Plant's net expenditures and net changes in commitments and quarterly billings by the Plant to the Cities of Mountain View and Los Altos pursuant to the agreement of the Members as described above and are not intended to be a complete presentation of the Plant's financial position or results of operations. Additionally, the capital cost and the outstanding debt of the Plant are not presented in these statements but are presented in the basic financial statements of the City.

Plant expenditures, commitments and joint system revenues, debt service and industrial waste compliance expenditures are shared by the Members based on agreed upon allocation percentages. The expenditures and commitments, including indirect administrative expenditures (see Note 3), are allocated to each of the Members based primarily on their respective percentages of the annual sewage flow and treatment needed for suspended solids, chemical oxygen demand and ammonia. Commitments represent operating encumbrances with suppliers for long-term projects, which have not yet been completed. Net changes in commitments represent commitments of \$1,279,727 at June 30, 2010, less commitments of \$1,595,288 at June 30, 2009. Revenues from services, fines and penalties are allocated to each of the Members in the same proportions as those of expenditures and commitments. Debt service payments are allocated based on percentages established at the time of bond issuance. Industrial waste compliance (Public Outreach and permitting and enforcement) charges are allocated to Members primarily based upon the number of industries and efforts required to maintain compliance with sewage use ordinances and other EPA regulations.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2010**

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES (Continued)

The percentages used for the year ended June 30, 2010, to allocate expenditures, commitments and revenues were:

	City of Mountain View	City of Los Altos	City of Palo Alto
Public Outreach, operations and maintenance system improvement CIP, commitments and joint system revenues	36.76%	10.86%	52.38%
Debt Services expenditures:			
Refunding 1990 Series A Bonds	51.00%	7.80%	41.20%
1999 Wastewater Treatment New Project	37.89%	9.47%	52.64%
Permitting and enforcement	36.93%	2.27%	60.80%

The City is allocated 52.38% of total usage of the treatment plant. The City does not fully utilize its percentage allocation, therefore, the City has entered into separate contracts to allocate portions of its excess to other entities. Fiscal year 2010 allocations are as follows:

East Palo Alto Sanitary District	6.47%
Stanford University	6.33%
Town of Los Altos Hills	1.16%
Remaining City percentage	38.42%
Total	<u>52.38%</u>

The agreement the City has with the above entities has no effect on the partnership agreement between the Members.

Billings are made in advance and are based on the adopted budget for the plant and estimated sewage flow. Excess billings (over) under net expenditures and net changes in commitments are offset against the subsequent year payments during the second quarter of the subsequent fiscal year.

NOTE 2 - SYSTEM IMPROVEMENT CIP (MINOR CAPITAL)

The basic agreement between the Members, dated October 10, 1968, provides that the administrator of the Plant is responsible for capital additions. These capital additions should be for the replacement of obsolete or worn-out units, or minor capital additions to improve the efficiency of the Plant's operation. Per an addendum to the agreement dated March 16, 1998, the Members agreed that capital additions could not exceed \$1.9 million in 1998-99 (base year). For future years, the base year amount will be adjusted annually based on increases to the Consumer Price Index-Urban Wage Earners and Clerical Workers for the San Francisco-Oakland-San Jose area. Actual System Improvement CIP expenditures amounted to \$645,793 for fiscal year 2010.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2010**

NOTE 3 - INDIRECT ADMINISTRATION EXPENDITURES

Indirect expenditures include those costs allocated from the City's General Fund administrative services, which supports all operating departments of the City. Other indirect expenses are administrative charges from the City's Internal Service Funds. These allocations are applied on a uniform basis throughout the City. The allocations are in accordance with the subsequent letter of agreement dated April 9, 1985.

NOTE 4 - DEBT SERVICE EXPENDITURES

Debt service expenditures include principal repayments, interest expenses and amortization of bond discount reduced by any interest income earned from cash with fiscal agent, related to the 1999 Series A Bonds.

In prior years, the City of Palo Alto, City of Mountain View, City of Los Altos, Town of Los Altos Hills, East Palo Alto Sanitary District and Stanford University (members) agreed to issue new bonds (1999 Series A Bonds) to finance the rehabilitation of the Wastewater Treatment System's two sludge incinerators and to refund the existing 1990 Series A Bonds.

At June 30, 2010, the outstanding principal of the 1999 Series A Bonds relating to the rehabilitation of the Wastewater Treatment system's sludge incinerators (1999 Wastewater Treatment New Project) and to refund the 1990 Series A Bonds amounted to \$7,941,971.

The portion of the 1999 Series A Bonds relating to the 1999 Wastewater Treatment New Project and the portion use to refund the 1990 Series A Bonds were allocated to the members as follows:

	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	Total
City of Palo Alto	\$1,986,227	\$684,242	\$2,670,469
City of Mountain View	1,972,175	1,395,855	3,368,030
City of Los Altos	492,914	213,484	706,398
East Palo Alto Sanitary District	397,662	325,700	723,362
Stanford University	273,783	112,216	385,999
Town of Los Altos Hills	82,239	5,474	87,713
Total	<u>\$5,205,000</u>	<u>\$2,736,971</u>	<u>\$7,941,971</u>

The 1999 Series A Bonds are covered by an insurance policy issued by Ambac Assurance Corporation (the insurer). The policy unconditionally guarantees the payment of the 1999 Series A Bonds in the event of default.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2010**

NOTE 5 – JOINT SYSTEM REVENUES

The plant's joint system revenues for the year ended June 30, 2010, totaled \$318,949. This consisted of \$15,000 for salt water marsh services, \$47,058 from the City's Water Fund for lab services, \$204,311 for septic tank hauling services and \$52,580 in other revenues.

NOTE 6 - RELATED PARTY TRANSACTIONS

During fiscal 2010, the Plant paid the City \$2,003,407 for utility costs. Such costs are included in the statements of net expenditures and net changes in commitments as source control program, permitting and enforcement and operations and maintenance expenditures.

Vehicle replacement charges of \$32,760 were paid to the City of Palo Alto Equipment Replacement Fund. Of the total, \$29,900 and \$2,860 are included in the statement of net expenditures and net changes in commitments as operations and maintenance expenditures, and enforcement respectively.

CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED
DECEMBER 31, 2009 AND 2008

**CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008**

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INDEPENDENT AUDITOR'S REPORT

The Members of the
Cable TV Franchise

We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2009 and 2008, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance as to whether the financial statement is free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, the statements referred to above were prepared for the purpose of complying with the provisions of the Amended and Restated Joint Exercise of Powers Agreement signed on June 9, 2009, between the City of Palo Alto, the City of East Palo Alto, the City of Menlo Park, the County of San Mateo, the County of Santa Clara and the Town of Atherton, for the provision of cable television and video services, and are not intended to be a presentation in accordance with generally accepted accounting principles in the United States of America.

In our opinion, the statements referred to above present fairly in all material respects the revenues and expenditures of the Franchise for the years ended December 31, 2009 and 2008, on the basis of accounting described in Note 1.

This report is intended for the information of the members, management, and others within the City of Palo Alto, the City of East Palo Alto, the City of Menlo Park, the County of San Mateo, the County of Santa Clara and the Town of Atherton. However, this report is a matter of public record and its distribution is not limited.



October 22, 2010

CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE REVENUES AND EXPENDITURES
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	<u>2009</u>		<u>2008</u>	
REVENUES:				
Franchise fees	<u>\$1,451,778</u>		<u>\$1,394,950</u>	
Total Receipts	<u>1,451,778</u>		<u>1,394,950</u>	
EXPENDITURES:				
Franchise administration	46,955		48,737	
Consulting fees	<u>7,953</u>		<u>13,545</u>	
Total Expenditures	<u>54,908</u>		<u>62,282</u>	
Net Receipts	<u>\$1,396,870</u>		<u>\$1,332,668</u>	
DISTRIBUTED NET RECEIPTS:				
	<u>2009</u>		<u>2008</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$688,238	49%	\$654,186	49%
City of Menlo Park	364,636	26%	346,592	26%
Town of Atherton	100,961	7%	101,139	8%
City of East Palo Alto	136,881	10%	130,344	10%
County of San Mateo	29,867	2%	27,937	2%
County of Santa Clara	<u>76,287</u>	<u>6%</u>	<u>72,470</u>	<u>5%</u>
Total	<u>\$1,396,870</u>	<u>100%</u>	<u>\$1,332,668</u>	<u>100%</u>

See accompanying notes to financial statements

**CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
Notes to Financial Statements
For the Years Ended December 31, 2009 and 2008**

NOTE 1 - JOINT OPERATING AGREEMENT AND BASIS OF ACCOUNTING

In July 1983 a Joint Exercise of Powers Agreement was entered into by and between the Cities of Palo Alto, Menlo Park, East Palo Alto, the Counties of San Mateo and Santa Clara and the Town of Atherton (the "Members") for the purpose of obtaining a state-of-the-art cable service for residents, businesses, and institutions, within each of their jurisdictions in the most efficient and economical manner possible.

On August 9, 2000, the City of Palo Alto (the "City"), acting on behalf of the Members, signed a Franchise Agreement with TCI Cablevision of California, Inc., a wholly owned subsidiary of AT&T Broadband, third party contractor, which was granted a non-exclusive franchise to construct, operate, maintain and repair a cable television system within the Members jurisdictions. In 2002, the franchise agreement was transferred from AT&T Broadband to Comcast Corporation.

TCI also signed an asset purchase agreement with Cable Communications Cooperative of Palo Alto, Inc. (CCCOPA), the former cable television system operator/owner, and acquired the system.

In October 1988, a Joint Operating Agreement was formed by the Members in which the City of Palo Alto (the "City") was granted the power and the authority to administer and coordinate the activities of the Franchise and exercise the rights and responsibilities of the City pursuant to the Franchise. The activities are administered by the City and are accounted for as part of the Administrative Services Department within the General Fund of the City's basic financial statements. The Program is accounted for using the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual (both measurable and available) and expenditures are recognized when the liability is incurred.

On January 1, 2007, the Digital Infrastructure and Video Competition Act (DIVCA) went into effect. Under DIVCA, cable and video service franchises are now granted exclusively by the California Public Utilities Commission (Commission) rather than by local franchising entities. On March 30, 2007, the Commission granted AT&T a statewide franchise. Comcast was allowed to seek a state franchise after January 1, 2008, when another state franchise holder (in this case AT&T) entered the local market. On January 2, 2008, the Commission granted Comcast a state franchise.

On June 9, 2009, the Members approved an amended and restated Joint Exercise of Powers Agreement, in substitution of the existing Joint Exercise of Powers Agreement and the Joint Operating Agreement, to reflect changes in the law due to DIVCA and to continue to allow Palo Alto to administer the cable and video franchise enforcement and monitoring process for state franchise holders.

The accompanying financial statement is intended to present the Franchise's revenues and expenditures pursuant to the Joint Exercise of Powers Agreement and is not intended to be a complete presentation of the Franchise's financial position or results of operations.

**CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
Notes to Financial Statements
For the Years Ended December 31, 2009 and 2008**

NOTE 1 - JOINT OPERATING AGREEMENT AND BASIS OF ACCOUNTING (Continued)

As compensation for services under the state franchise agreements, AT&T and Comcast pay annual franchise fees in an amount equal to 5% of annual gross revenues, taking into account a reasonable adjustment for bad debts. From these fees the City of Palo Alto is first reimbursed for out-of-pocket franchise administration costs. The remaining fees are distributed to each Member according to the percentage of revenues derived from the residents and businesses in each of the entities compared to revenues in total.

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS

A prior Franchise Agreement with CCCOPA was set to expire on March 24, 2001. On June 21, 1999, the City of Palo Alto hired a cable communications consultant and retained the services of a law firm to assist in the franchise renewal process. On July 31, 2000, CCCOPA reimbursed the City \$185,000 toward the actual costs incurred as part of the franchise renewal efforts.

On July 24, 2000, the City reached a settlement with CCCOPA in the amount of \$220,000 to resolve outstanding claims resulting from CCCOPA's alleged failure to fully perform under the prior Franchise Agreement.

On November 22, 2004, the City reached a settlement agreement with Comcast regarding cable plant construction claims in the amount of \$175,000. This money was to be used towards the institutional network connection costs.

In 2006, the City conducted a franchise compliance audit performed by the City Auditor's Office. A settlement was reached in the amount of \$155,391.

In addition, CCCOPA paid the City a \$250,000 grant to use to acquire, install, and/or maintain equipment to be used in connection with an institutional network defined in the Franchise Agreement.

These amounts have been deposited and are being held by the City and are earning interest. The City has since spent part of the settlements amount on various projects including installing and maintaining the institutional network equipment. As of December 31, 2009, remaining total amount on deposit was \$888,707.

**REDEVELOPMENT AGENCY OF
THE CITY OF PALO ALTO
BASIC COMPONENT UNIT
FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2010**

**REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
BASIC COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2010**

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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

Board of Directors of the
Redevelopment Agency of the City of Palo Alto
Palo Alto, California

We have audited the accompanying component unit financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2010, as listed in the Table of Contents. These component unit financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the component unit financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the component unit financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In accordance with *Government Auditing Standards*, we have also issued our report dated, October 22, 2010, on our consideration of the Agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

In our opinion the component unit financial statements referred to above present fairly in all material respects the financial position of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto for the year ended June 30, 2010, and the changes in financial position for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

Management's Discussion and Analysis is not a required part of the basic component unit financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of required supplementary information. However, we did not audit the information and we express no opinion on it.



October 22, 2010

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Redevelopment Agency (Agency) of the City of Palo Alto, a component unit of the City of Palo Alto is controlled by the City of Palo Alto and was formed on October 9, 2001.

FISCAL 2010 FINANCIAL HIGHLIGHTS-AGENCY-WIDE BASIS AND FUND BASIS

GASB 34 requires the issuance of Agency-wide financial statements as well as fund financial statements.

During fiscal year 2010, the Agency incurred on-going costs in the amount of \$6 thousand, the same as prior year. The Agency received a transfer from the City of Palo Alto in the amount \$6 thousand to fund these costs, the same as prior year. As of June 30, 2010, the Agency had not yet adopted a project area nor received any tax increment revenues.

OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS

The Basic Financial statements are in two parts:

- 1) Management's Discussion and Analysis (this part),
- 2) The Basic Financial Statements, which include the Agency-wide and the Fund financial statements, along with the Notes to these financial statements.

The Basic Financial Statements

The Basic Financial Statements comprise the Agency-wide Financial Statements and the Fund Financial activities and financial position-long-term and short-term.

The Agency-wide Financial Statements provide a longer-term view of the Agency's activities as a whole, and comprise the Statement of Net Assets and the Statement of Activities. The Statement of Net Assets provides information about the financial position of the Agency as a whole, including all its long-term liabilities on the full accrual basis, similar to that used by corporations. The Statement of Activities provides information about all the Agency's revenues and all its expenses, also on the full accrual basis, with the emphasis on measuring net revenues or expenses of the Agency's program. The Statement of Activities explains in detail the change in Net Assets for the year.

The Fund Financial Statements report the Agency's operations in more detail than the Agency-wide statements and focus primarily on the short-term activities. The Fund Financial Statements measure only current assets, liabilities and fund balances.

Together, all these statements are now called the Basic Financial Statements.

ECONOMIC OUTLOOK AND MAJOR INITIATES

The economy of the City of Palo Alto and its major initiatives for the coming year are discussed in detail in the City's Comprehensive Annual Financial Report.

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

These Basic Financial Statements are intended to provide citizens, taxpayers, investors, and creditors with a general overview of the Agency's finances. Questions about these Statements should be directed to the Finance Department of the City of Palo Alto, 250 Hamilton Avenue, CA 94301.

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2010

LIABILITIES

Accounts payable

NET ASSETS

Unrestricted

=====

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF ACTIVITIES
 FOR THE YEAR ENDED JUNE 30, 2010

EXPENSES

Planning and Community Reimbursements to the City	<u>(\$6,000)</u>
Change in Net Assets	(6,000)

GENERAL REVENUES

Transfer from the City of Palo Alto	<u>6,000</u>
Net assets at the beginning of year	<u> </u>
Net assets at the end of year	<u><u> </u></u>

See accompanying notes to financial statements

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

FUND FINANCIAL STATEMENTS

The Redevelopment Agency (Agency) of the City of Palo Alto only has one fund in fiscal 2010.

REDEVELOPMENT AGENCY GENERAL FUND

This fund accounts for the activities of establishing and administering the Agency.

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 BALANCE SHEET
 JUNE 30, 2010

	<u>General Fund</u>
LIABILITIES	
Due to the City of Palo Alto	_____
FUND BALANCE	
Unreserved, undesignated	_____
Total Fund Balance	_____
Total Liabilities and Fund Balance	=====

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCE
 FOR THE YEAR ENDED JUNE 30, 2010

	<u>General Fund</u>
OTHER FINANCING SOURCES (USES)	
Transfer in from the City of Palo Alto (Note 2)	\$6,000
Transfer (out) to the City of Palo Alto (Note 2)	(6,000)
Fund balance at beginning of year	_____
Fund balance at end of year	=====

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCE - BUDGET AND ACTUAL
 GENERAL FUND
 FOR THE YEAR ENDED JUNE 30, 2010

	<u>Budgeted Amount</u>		<u>Actual Amount Budgetary Basis</u>	<u>Variance with Final Budget Positive (Negative)</u>
	<u>Adopted</u>	<u>Adjusted</u>		<u>(Negative)</u>
OTHER FINANCING SOURCES (USES)				
Transfer in from the City of Palo Alto	\$9,000	\$9,000	\$6,000	(\$3,000)
Transfer out to the City of Palo Alto	<u>(9,000)</u>	<u>(9,000)</u>	<u>(6,000)</u>	<u>3,000</u>
Total Other Financing Sources (Uses)	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Fund balance at beginning of year			<u> </u>	
Fund balance at end of year			<u> </u>	

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Basic Component Unit Financial Statements
For the Year Ended June 30, 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. *Organization and Purpose*

The Redevelopment Agency (Agency) of the City of Palo Alto was created on October 9, 2001, under the provisions of the Redevelopment Law (California Health and Safety Code). The City Council serves as the governing body of the Agency and the City Manager serves as the Executive Director.

The Agency is an integral part of the City of Palo Alto and, accordingly, the accompanying financial statements are included as a blended component unit of the basic financial statements prepared by the City. A component unit is a separate governmental unit, agency or nonprofit corporation which, when combined with all other component units, constitutes the reporting entity as defined in the City's basic financial statements.

B. *Basis of Presentation*

The Agency's Basic Component Unit Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America. The Government Accounting Standards Board is the acknowledged standard setting body for establishing accounting and financial reporting standards followed by governmental entities in the United States of America.

These Standards require that the financial statements described below be presented.

Agency-wide Statements: The Statement of Net Assets and the Statement of Activities include the financial activities of the overall Agency government. Eliminations have been made to minimize the double counting of internal activities.

The Statement of Activities presents a comparison between direct expenses and program revenues for each function of the Agency's governmental activities. Direct expenses are those that are specifically associated with a program or function and, therefore, are clearly identifiable to a particular function. Program revenues include (a) charges paid by the recipients of goods or services offered by the programs, (b) grants and contributions that are restricted to meeting the operational needs of a particular program and (c) fees, grants and contributions that are restricted to financing the acquisition or construction of capital assets. Revenues that are not classified as program revenues, including all taxes, are presented as general revenues.

Fund Financial Statements: The fund financial statements provide information about the Agency. The Agency considers the Redevelopment Agency General Fund to be a major fund.

C. *Major Funds*

Major funds are defined as funds that have either assets, liabilities, revenues or expenditures/expenses equal to ten percent of their fund-type total and five percent of the grand total. Major funds are identified and presented separately in the fund financial statements.

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Basic Component Unit Financial Statements
For the Year Ended June 30, 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Agency reported the following major governmental fund in the accompanying financial statements:

REDEVELOPMENT AGENCY GENERAL FUND

This fund accounts for the activities of establishing and administering the Redevelopment Agency.

D. Basis of Accounting

The Agency-wide financial statements are reported using the *economic resources measurement focus* and the full *accrual basis* of accounting. Revenues are recorded when *earned* and expenses are recorded at the time liabilities are *incurred*, regardless of when the related cash flows take place.

Governmental funds are reported using the *current financial resources* measurement focus and the *modified accrual* basis of accounting. Under this method, revenues are recognized when *measurable and available*. The Agency considers all revenues reported in the governmental funds to be available if the revenues are collected within sixty days after year-end. Expenditures are recorded when the related fund liability is incurred, except for principal and interest on general long-term debt, claims and judgments, and compensated absences, which are recognized as expenditures to the extent they have matured. General capital asset acquisitions are reported as *expenditures* in governmental funds. Proceeds of general long-term debt and acquisitions under capital leases are reported as *other financing sources*.

Non-exchange transactions, in which the Agency gives or receives value without directly receiving or giving equal value in exchange, include property taxes, grants, entitlements, and donations. On an accrual basis, revenue from property taxes is recognized in the fiscal year for which the taxes are levied. Revenue from grants, entitlements, and donations is recognized in the fiscal year in which all eligibility requirements have been satisfied.

Other revenues susceptible to accrual include taxes, intergovernmental revenues, interest and charges for services.

E. Budgets and Budgetary Accounting

Budgets are adopted on a basis consistent with generally accepted accounting principles (GAAP).

Budget amounts in the financial statements are as originally adopted, or as amended by the Board.

Formal budgetary integration is employed as a management control device. Encumbrance accounting is employed as an extension of formal budgetary integration in all funds. Under encumbrance accounting, purchase orders, contracts and other commitments for the expenditure of monies are recorded in order to reserve that portion of the applicable appropriation. Encumbrances outstanding at year end are reported as reservations of fund balances since they do not constitute expenditures or liabilities and are reappropriated in the following year.

F. Net Assets

Net Assets is the excess of all the Agency's assets over all its liabilities, regardless of fund. Net Assets, which is determined only at the Agency-wide level, and is described below:

Unrestricted describes the portion of Net Assets which is not restricted as to use.

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Basic Component Unit Financial Statements
For the Year Ended June 30, 2010

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)

G. *Fund Balances, Reserves and Designations*

In the fund financial statements, fund balances represent the net current assets of each fund. Net current assets generally represent a fund's cash and receivables, less its liabilities.

NOTE 2 – TRANSACTIONS WITH THE CITY

During fiscal year 2001-02, the City established the Redevelopment Agency. The Agency and the City have an agreement whereby the City will advance funds to the Agency in support of startup and formation costs. However, the interfund advances have no specific repayment date. Generally accepted accounting principles require that such amounts as well as their repayments be treated as transfers in the year made.

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**REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

Board of Directors of the
Redevelopment Agency of the City of Palo Alto
Palo Alto, California

We have audited the financial statements of Redevelopment Agency of the City of Palo Alto as of and for the year ended June 30, 2010, and have issued our report thereon dated October 22, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Agency's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over financial reporting.

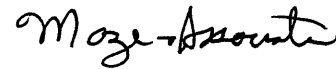
A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Agency's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Our audit included tests of compliance with provisions of the Guidelines for Compliance Audits of California Redevelopment Agencies. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

As part of our audit, we prepared and issued our separate Memorandum on Internal Control dated October 22, 2010, which is an integral part of our work and should read in conjunction with this report. This report is intended solely for the information and use of management, Agency Board, others within the Agency, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.



October 22, 2010

**CITY OF PALO ALTO
GENERAL OBLIGATION BONDS
CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)**

FUND FINANCIAL STATEMENTS

**FOR THE YEAR ENDED
JUNE 30, 2010**

**CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)**

**FUND FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2010**

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INDEPENDENT AUDITOR'S REPORT

The Honorable Mayor and Members of the City Council of the
City of Palo Alto, California

We have audited the accompanying fund financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund, a fund of the City of Palo Alto as of and for the year ended June 30, 2010, as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the fund financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the fund financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In accordance with *Government Auditing Standards*, we have also issued our report dated, October 22, 2010, on our consideration of the City's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

In our opinion, the financial statements referred to above present fairly in all material respects the financial position of the City of Palo Alto General Obligation Bonds Capital Projects Fund as of June 30, 2010, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.



October 22, 2010

CITY OF PALO ALTO
 GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
 BALANCE SHEET
 JUNE 30, 2010

ASSETS

Restricted cash and investments (Note 3):	
City treasury - CAMP	\$54,276,713
Trustee	<u>140,897</u>
Total Assets	<u><u>\$54,417,610</u></u>

LIABILITIES

Accounts payable and accrued liabilities	<u>\$310,816</u>
Total Liabilities	<u>310,816</u>

FUND BALANCE (Note 4)

Reserved for:	
Encumbrances	589,098
Appropriated for capital projects	49,822,964
Cost of issuance	140,897
Unappropriated bond proceeds	<u>3,553,835</u>
Total Fund Balance	<u><u>\$54,106,794</u></u>

See accompanying notes to financial statements

CITY OF PALO ALTO
 GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
 STATEMENT OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCE
 FOR THE YEAR ENDED JUNE 30, 2010

REVENUES

Interest on cash and investments	<u>\$348</u>
Total Revenues	<u>348</u>

EXPENDITURES

Capital outlay:	
Downtown Library	580,933
Mitchell Park Library and Community Center	3,590,468
Temporary Facility	<u>363,051</u>
Subtotal	4,534,452
Debt service:	
Costs of issuance and discounts	<u>430,310</u>
Total Expenditures	<u>4,964,762</u>

OTHER FINANCING SOURCES

Issuance of long term debt (Note 1)	<u>59,071,208</u>
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NET CHANGE IN FUND BALANCE	54,106,794
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Fund balance at beginning of year	<u> </u>
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Fund balance at end of year	<u><u>\$54,106,794</u></u>
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See accompanying notes to financial statements

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010

NOTE 1 - BACKGROUND

On November 4, 2008, more than two-thirds of registered voters of the City of Palo Alto approved Measure N and authorized the issuance and sale general obligation bonds not to exceed \$76,000,000 to be used to construct a new energy-efficient Mitchell Park Library and Community Center, expand and renovate the Main Library, and renovate the Downtown Library. Funds will also be used to provide additional space to expand library collections, add new children's and group program areas, replace outdated lighting, provide modern ventilation and air conditioning systems and ensure seismic safety and enhance disabled access.

On June 9, 2010, the City issued General Obligation Bonds, Election of 2008, Series 2010A (Library Bonds) to finance the costs of constructing a new energy efficient, environmentally friendly Mitchell Park Library and Community Center, renovating and expanding Main Library, and renovating the Downtown Library, including enhancements at all three facilities for seismic safety and disabled access, expanded space for library collections, meeting and study areas, and new air conditioning, ventilation and lighting systems (the "Project"). Proceeds from the Library Bonds included par of \$55,305,000 and a premium on issue of \$3,766,208 for a total of \$59,071,208. The Bonds are the first of two series of bonds to be sold and issued under the Authorization to finance a portion of the Project. As of June 30, 2010, \$20,695,000 of the Authorization remains unissued.

Specific projects approved by Council to be funded by the Library Bonds are as follows:

Project	Amended Budget	Expenses Not Charged to Bond Proceeds	Bond Eligible Expenses in	As of June 30, 2010	
				Encumbrances Outstanding	Project Balance Remaining
Downtown Library	\$3,911,056	\$156,516	\$580,933	\$72,385	\$3,257,738
Mitchell Park Library and Community Center	50,390,309	332,563	3,590,468	425,877	46,373,964
Temporary Facility	645,149	133,200	363,051	90,836	191,262
Total	<u>\$54,946,514</u>	<u>\$622,279</u>	<u>\$4,534,452</u>	<u>\$589,098</u>	<u>\$49,822,964</u>

**CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010**

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

A. Fund Accounting

The Projects are accounted for as part of the Capital Projects Fund of the City of Palo Alto. This fund is a set of self-balancing accounts which comprise its assets, liabilities, fund equity, revenues and expenditures.

B. Basis of Accounting

Basis of accounting refers to when revenues and expenditures are recognized. The Projects are accounted for in a governmental fund type and the modified accrual basis of accounting is used. Under the modified accrual basis, revenues are recognized when they become measurable and available as net current assets. Expenditures are recognized when they are incurred.

NOTE 3 – RESTRICTED CASH AND INVESTMENTS

The Fund's investments are carried at fair value, as required by generally accepted accounting principles. The Fund adjusts the carrying value of its investments to reflect their fair value at each fiscal year end, and it includes the effects of these adjustments in income for that fiscal year.

A. Project Funds Investment Policy

Pursuant to terms of the Trust Agreement, Bond proceeds to be used for project costs were remitted to and are maintained by the City as agent for the Bondholders. The City's Investment Policy allows it to invest in a variety of types of investments subject to maturity maximums, concentration limitations, and minimum credit quality requirements. Allowed investment types include U.S. government securities, U.S. government agency securities, certificates of deposit, money market mutual funds, bankers acceptances, commercial paper, the Local Agency Investment Fund, medium term corporate notes, State of California municipal agencies and city bonds. The City has invested all unexpended Project Funds in the California Asset Management Program (CAMP).

B. California Asset Management Program

CAMP is an investment pool offered by the California Asset Management Trust (the Trust). The Trust is a joint powers authority and public agency created by the Declaration of Trust and established under the provisions of the California Joint Exercise of Powers Act (California Government Code Sections 6500 et seq., or the "Act") for the purpose of exercising the common power of its Participants to invest certain proceeds of debt issues and surplus funds. The Pool's investments are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code. The Fund reports its investments in CAMP at the fair value amounts provided by CAMP, which is the same as the value of the pool share. At June 30, 2010, these investments had an average maturity of 57 days, were rated AAA and amounted to \$54.3 million.

**CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
NOTES TO BASIC FINANCIAL STATEMENTS
For the Year Ended June 30, 2010**

NOTE 3 – RESTRICTED CASH AND INVESTMENTS (Continued)

C. Permitted Investments

The Fund must maintain funds to be used for costs of issuance on the Bonds with a Trustee under the terms of the Bond Trust agreement. These funds are invested in money market funds which are a permitted investment under the Trust agreement and amounted to \$141 thousand as of June 30, 2010.

NOTE 4 – FUND BALANCES

Fund balances consist of reserved fund balance representing that portion of fund balance which is legally segregated.

Reserved for encumbrances represents the portion of fund balance set aside for open purchase orders.

Reserved for appropriated for capital projects represents the portion of fund balance appropriated for capital projects.

Reserved for costs of issuance represents the portion of fund balance set aside for costs of issuance on the Bonds.

Unappropriated Bond Proceeds represents the portion of fund balance not yet appropriated, but restricted to project costs under the Indenture.

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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE
AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

The Honorable Mayor and Members of the City Council of the
City of Palo Alto, California

We have audited the financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund, a fund of the City of Palo Alto as of and for the year ended June 30, 2010, and have issued our report thereon dated October 22, 2010. We conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the City's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance and other matters that are required to be reported under *Government Auditing Standards*, except as discussed on the accompanying Schedule of Current Year Findings.

The City's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit the City's response and, accordingly, we express no opinion on it.

We have also issued a separate Memorandum on Internal Control dated October 22, 2010, which is an integral part of our audits and should be read in conjunction with this report.

This report is intended solely for the information and use of the City Council, the Oversight Committee, the City Auditor and the City's management and is not intended to be and should not be used by anyone other than these specified parties.



October 22, 2010

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INDEPENDENT ACCOUNTANT'S REPORT ON COMPLIANCE WITH MEASURE N

The Honorable Mayor and Members of the City Council of the
City of Palo Alto, California

We have examined the City of Palo Alto's (City) compliance with certain provisions of Measure N for the year ended June 30, 2010, as follows:

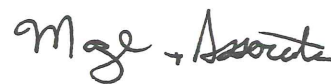
- a) Proceeds from the sale of the Bonds were used only for the purposes specified in Measure N.
- b) Proceeds for the Bonds were deposited into a Library/Community Center Project Construction Fund held by the City; and
- c) The Administrative Services Director of the City filed an annual report with the City Council commencing not later than November 1, 2009, containing pertinent information regarding the amount of funds collected and expended, as well as the status of the Library/Community Center project listed in the Measure.

Management is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on the City's compliance based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the City's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on the City's compliance with specified requirements.

In our opinion, the City complied, in all material respects, with the aforementioned requirements for the year ended June 30, 2010, except as discussed on the accompanying Schedule of Current Year Findings.

This report is intended solely for the information and use of the City Council, the Oversight Committee, the City Auditor and the City's management and is not intended to be and should not be used by anyone other than these specified parties.



October 22, 2010

SCHEDULE OF CURRENT YEAR FINDINGS**Finding 10-01: Annual Reporting**

Criteria: As a requirement of the General Obligation Bond issuance under Ordinance 4996, as approved by Council, the Administrative Services Director is required to file an annual report with Council no later than November 1st. The report is required to contain pertinent information regarding the amount of funds collected and expended as well as the status of the Library Projects approved in Measure N.

Condition: No annual report was filed in fiscal 2009-10.

Effect: The City is out of compliance with the Ordinance.

Cause: Staff was unaware of the requirement of an annual report being submitted to Council.

Recommendation: Administrative Services Director should prepare and file the report annually with Council.

Planned Corrective Actions: Staff inadvertently did not comply with this requirement. Since a Library Advisory Committee was established and the Committee was to issue a report on GO bond proceeds collected and spent, staff was under the impression that this was the required report. This Committee Chair delivered the report to the Finance Committee in November 2010. Staff will work on a separate report to comply with the requirement, albeit late, and deliver to Council in the month of January. Future reports will be presented in November as required.



FINANCE COMMITTEE

Special Meeting
Tuesday, December 21, 2010

Chairperson Schmid called the meeting to order at 6:06 p.m. in the Council Conference Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Schmid (Chair), Espinosa, Klein, Scharff

Absent:

1. Oral Communications

None.

2. Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2010 and Management Letter

Michael Edmonds, Acting City Auditor, provided a brief overview of the City's Financial Audit conducted by the firm of Maze and Associates for the fiscal year ending June 30, 2010. He noted that the Auditor's Opinion Letter and the Single Audit work were in the Comprehensive Annual Financial Report (CAFR) and the Management Letter and other Financial Statements and required reports were included as attachments A-G under the City Auditor's cover letter.

Cory Biggs, with Maze & Associates, stated that the purpose of the audit was to express an opinion on the City's Financial Statements. He reported that the audit results included a clean opinion on the Financial Statements. He also discussed the Single Audit, which was an audit of all the federal awards that the City received and these awards were subject to additional compliance requirements. The auditors review federal awards of major programs and rotate tests on programs each year. He noted that this year that Governmental Accounting Standards Board (GASB) had two new pronouncements, one on Intangibles and another on Derivatives. The City had no material activity related to either of these pronouncements; thus, no changes to the financial statements were required to implement the new pronouncements. In regards

to the financial statement audit, he discussed the Memorandum on Internal Control which included one significant deficiency, a billing problem between the Electrical Fund and the Gas Fund. The Gas Fund did not bill the Electric Fund for three years of natural gas used to power the Cooperatively Owned Back Up Generator (COBUG). This issue had been corrected and the Electric Fund had paid the Gas Fund for the last three year's billings. On compliance issues, he reported on an issue related to the Library Bond audit which was a new audit this year required by Measure N. He said that Measure N required the City to file an annual report with the Council no later than November 1, and the report had not by filed at the time the Audit was completed. He stated that he was not concerned with the issue because the City Council was receiving the information on a quarterly basis from the Library Bond Oversight Committee. In regards to the Single Audit report, he noted that the Single Audit report included three findings, which was unusual for Palo Alto. Two of the findings were related to agreement maintenance. He reported that the City was complying with the grant agreements but the internal controls were not adequate because the City did not have two grant agreements in place. This raised concern about future compliance. He discussed the third finding on the Single Audit work which he referred to as a significant deficiency. He said the City did not provide several sub-recipients with all the information that the Federal Government required. He stated that overall Staff was prepared for the audit which allowed the Auditors to proceed efficiently. He also noted a reduction in the number of post-closing adjustments, which was an indicator of accuracy in closing the books. During the previous year, the Auditors noted that approximately three dozen post-closing adjustments were made; however, this year, only about a dozen post-closing adjustments were needed.

Lalo Perez, Administrative Services Director, stated that Staff was already working in response to the recommendations. He said that they were creating a checklist to address the grant issue. The billing error was also being addressed.

Chair Schmid asked for clarification about information on page 85 of the CAFR that states "The City does not have a net pension obligation since it pays these actuarially determined contributions monthly." He was concerned that this term was contradictory to his understanding that the City would be liable if CalPers could not make required pension payments.

Mr. Biggs clarified that the term net pension obligation was a technical term in GASB 25 that refers to whether an organization funds its retirement contributions actuarially. It was a different measure than the unfunded actuarial liability. He said the key to pension accounting was to make sure that an

actuary determines a sound funding practice for annual pension contributions. As long as the City paid the annual actuarially determined contribution, it would not be required to report any other liabilities on its balance sheet.

Chair Schmid raised questions about of GASB 25. He cited the Securities Exchange Commission (SEC) interactions with the City of San Diego regarding the accuracy of reporting on their pension liability. He also noted that the American Academy of Actuaries was concerned with the reporting of pension liabilities and were working toward revising standards to clarify actuarial assumptions. He also noted that CalPers was reviewing the way it did business and had pending lawsuits to be more open with disclosures.

Mr. Biggs stated that GASB 25 was the standard measure for financial reporting and that was the measure that the auditors were required to use for financial reporting purposes...

Chair Schmid asked if there was anything the actuaries could do to help the City make accurate pension payments in the future.

Mr. Biggs suggested meeting with an actuary to provide clarity regarding the impact from changing assumptions. He then reviewed trends on rates of return to determine if they were reasonable. Recently, the rates of return had been negative and volatile. He said the pension plans would need to recognize that volatility in the future.

Chair Schmid raised a concern whether the financial reporting, which was based on the actuarial value and does not include the market value, provides the citizens of Palo Alto with the full knowledge of the risks associated with the City's pension liability.

Mr. Biggs stated that the City had made all the required disclosures. The actuarial value was used to make the annual pension contributions. The City could opt to include additional disclosures if deemed necessary.

Mr. Perez commented on GASB 25. He stated that they should discuss what additional information Council might want to add. For example, CMR 455-10 includes the actuarial value of the assets for Safety and the Miscellaneous Plans. This report included the actuarial and market value of the assets, demographic information, and employee information. Staff needed to provide information regarding the impact of the changes and rates that CalPers had provided. For example, the City's rate for the Miscellaneous Plan was 17.5% for FY 2011. The City's share of the employee contribution varies from 2.25%

to 6%. Thus, the total City contribution was a total of 19.7% to 23%. If the higher rates go into effect, the City's total contribution would increase to 28.4% to 32%. He said the City's long term financial forecasts would have to consider the financial impacts of these changes. The City would also have to consider how to address these cost increases.

Chair Schmid stated that he was concerned that the City had satisfied the legal reporting requirements but the assumed rate of return was unrealistic without taking significant risks.

Mr. Perez stated that CalPers was considering revising its assumed rate of return from 7.75% to 7.5%. If this change was implemented, CalPers estimated that these changes would increase Miscellaneous Plan contributions by 1.5% to 3% and Safety contributions would increase by 3% to 5%. Overall, these changes would increase Miscellaneous Plan contributions to about 33% to 35%. For Safety, these contributions would increase to 49% to 53%.

Chair Schmid noted that the adjustments would take place at the board level of CalPers, who did not have to make the payments.

MOTION: Council Member Klein moved, seconded by Espinosa that the Finance Committee recommends to the City Council acceptance of the External Audited Financial Statements and Management Letter.

MOTION PASSED 4-0.

3. Recommendation Regarding Adoption of Ordinance Authorizing Closing of the Budget for the Fiscal Year Ending June 30, 2010, Including Reappropriations Requests, Closing Completed Capital Improvement Projects, Authorizing Transfers to Reserves, and Approval of Comprehensive Annual Financial Report (CAFR)

David Ramberg, Assistant Director Administrative Services Division spoke regarding the Staff's recommendation for the Finance Committee to approve the CAFR. He said this was a required step and it was what carried over the funds from one year to the next. In October Staff presented the Committee with a preview stating there should be no major surprises; he said that things seemed to be on track. He said Staff tracked the salary savings from mid-year adjustments, and they were successful. The 2011 budget had no adverse affects from the 2010 budget. The General Fund Reserve was healthy