



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

February 4, 2013

The Honorable City Council
Palo Alto, California

Finance Committee Recommendation to Accept Macias Gini & O'Connell's (LLP) Financial Statements and Management Letter

The Office of the City Auditor recommends acceptance of Macias Gini & O'Connell's (LLP) Audit of the City of Palo Alto's Financial Statements as of June 30, 2012 and Management Letter. At its meeting on December 4, 2012, the Finance Committee approved and unanimously recommended the City Council accept this report. The Finance Committee action minutes are included in this packet.

Respectfully submitted,

Jim Pelletier
City Auditor

ATTACHMENTS:

- Attachment A: Macias Gini & O'Connell's (LLP) Financial Statements and Management Letter (PDF)
- Attachment B - Finance Committee Meeting Minutes Excerpt (December 4, 2012) (PDF)

Department Head: Jim Pelletier, City Auditor

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TO: HONORABLE FINANCE COMMITTEE

FROM: CITY AUDITOR'S OFFICE

DATE: DECEMBER 4, 2012

STAFF REPORT: 3262

SUBJECT: AT-PLACES MEMO

We are providing copies of the following items as prepared by Macias Gini & O'Connell LLP (MGO):

- Required Communications
- Independent Accountant's Report on Applying Agreed-Upon Procedures Related to the Article XIII-B Appropriations Limit
- Pedestrian/Bicycle Facilities Grant Metropolitan Transportation Commission Transportation Development Act Funds, Article III
- City of Palo Alto Public Improvement Corporation
- Redevelopment Agency of the City of Palo Alto
- Cable TV Franchise Statement of Franchise Revenues and Expenditures
- City of Palo Alto Regional Water Quality Control Plant
- City of Palo Alto General Obligation Bonds Capital Projects Fund

These attachments should have been included with item #1 on the agenda.



JIM PELLETIER
City Auditor

CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012

**CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012**

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

In planning and performing our audit of the financial statements of the City of Palo Alto, California (City) as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal controls over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing our 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.

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 City's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. However, material weaknesses may exist that have not been identified.

Following this letter, we have included a report on communications with the Finance Committee (Committee) as required by auditing standards generally accepted in the United States of America.

This communication is intended solely for the information and use of the Mayor and City Council, the Committee, management and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & CConnell LLP
Walnut Creek, California
November 26, 2012

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CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012

REQUIRED COMMUNICATIONS

We have audited the financial statements of the City of Palo Alto (City) as of and for the year ended June 30, 2012 and have issued our report thereon dated November 26, 2012. Professional auditing standards require that we communicate to you the following information related to our audit.

I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards and OMB Circular A-133

As stated in our engagement letter dated July 30, 2012, our responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit of the financial statements does not relieve you or management of your responsibilities.

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal controls over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 is not an objective of our audit. Also in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the OMB *Circular A-133 Compliance Supplement* applicable to each of its major programs for the purpose of expressing an opinion on the City's compliance with those requirements. While our audit will provide a reasonable basis for our opinion, it will not provide a legal determination on the City's compliance with those requirements.

CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012

REQUIRED COMMUNICATIONS (Continued)

II. Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the City's financial statements and our report thereon does not extend beyond financial information identified in our report, and we have no obligation to perform any procedures to corroborate other information contained in these documents. We, however, read the other information included in the City's comprehensive annual financial report to determine whether any matters came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or its manner of presentation, appearing in the basic financial statements. 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 its manner of presentation, appearing in the basic financial statements.

III. Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our engagement letter dated July 30, 2012.

IV. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the City's basic financial statements. No significant changes were made to the basic financial statements during the year as a result of new accounting pronouncements. We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's 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 significantly from those expected.

**CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012**

REQUIRED COMMUNICATIONS (Continued)

The most sensitive estimates affecting the financial statements were:

- *Fair value of investments.* The City's investments are generally carried at fair value, which is defined as the amount that the City could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller and is generally measured by quoted market prices.
- *Estimated allowance for losses on notes and loans receivable.* The allowance for losses on notes and loans receivable was based on management's estimate regarding the likelihood of collectability.
- *Useful life estimates for capital assets.* The estimated useful lives of capital assets were based on management's estimate of the economic life of its capital assets.
- *Accrued landfill closure/post-closure costs.* The City has estimated, based on a study conducted by consultants, the closure/post-closure costs of the Palo Alto 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.
- *Valuation of the net other postemployment benefits (OPEB) asset.* The net OPEB asset is the amount of cumulative City contributions that exceeded the actuarially determined annual required contributions, which is based upon certain approved actuarial assumptions.
- *Annual required contributions to pension and other postemployment benefit plans.* The City is required to contribute to its pension and OPEB plans at an actuarially determined rate and to measure these benefit costs based upon certain approved actuarial assumptions.
- *Claims loss reserve.* The City is exposed to a variety of risks of loss due to general liability, workers' compensation and other claims and records an estimate of these losses based on actuarial studies performed by third party actuaries. These studies are 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 may vary from these estimates.

We evaluated the key factors and assumptions used to develop the accounting estimates described above in determining that they are reasonable in relation to the City's basic financial statements taken as a whole.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and 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. There were no misstatements, other than those that were trivial, detected as a result of audit procedures.

CITY OF PALO ALTO
Required Communications
For the Year Ended June 30, 2012

REQUIRED COMMUNICATIONS (Continued)

Disagreements with Management

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

Management Representations

We have requested certain representations from management that are included in the management representation letter dated November 26, 2012.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Other Matters

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

CITY OF PALO ALTO
Current Year Comment and Status of Prior Year Comments
For the Year Ended June 30, 2012

CURRENT YEAR RECOMMENDATIONS

None were reported.

STATUS OF PRIOR YEAR RECOMMENDATIONS

2011-01 A Comprehensive Disaster Recovery Plan Has Not Been Fully Developed and Tested
(Significant Deficiency)

General computer controls should ensure that plans have been developed and documented to provide contingency for unforeseeable events, including the recovery of operational and financial data in the event of a disaster. The City, however, has not completed the development of a comprehensive disaster recovery plan. The current draft plan started development in 2008 and has yet to be completed. City's IT management stated the prolonged plan development process was due to a lack of sufficient resources. The lack of a comprehensive plan that has been fully tested places the City at an increased risk of loss of financial data in the event of a disaster that affects the City's server room.

We recommend the City's CIO (acting), working with the City Manager, should plan to budget for the resources necessary to complete the development of a comprehensive disaster recovery plan. Once the plan is completed, it should be fully tested to ensure the City's financial data can be restored in a reasonable amount of time.

Current Year Status:

In Progress. The City's Chief Information Officer (CIO) has hired an Information Security Manager (ISM). Presently, the new ISM is in the process of developing a comprehensive Disaster Recovery and Government Continuity Plan, which should tentatively be deployed by March 31, 2013.

2011-02 The City's IT Assets Are Exposed to an Active Water-Based Fire Suppression System
(Significant Deficiency)

General computer controls should ensure that IT assets are adequately protected from physical and environmental hazards. The City's server room, however, still has an active water-based fire suppression system. This places the City's IT assets at increased risk of damage should the system be activated or should a pipe rupture.

We recommend the City CIO (acting), working with the City Manager, should research the feasibility of implementing a dry fire suppression system in the City's server room. Alternately, the active water-based system could be replaced by a dry-pipe system. If it is determined that the systems could be implemented, the City should budget for the replacement of the water-based system. Should the system replacement be deemed infeasible, alternative mitigating controls should be implemented, such as the installation of high temperature sprinkler heads and the development of a comprehensive disaster recovery plan.

Current Year Status:

In Progress. The City's new ISM is researching the feasibility of implementing a gas-based fire suppression system in the City's server room. The ISM plan is to replace the current "water-based fire suppression system" with a "gas-based fire suppression system" which will provide fast, safe and reliable fire suppression solution that extinguishes any fire in seconds and protect electronic equipment, media, and personnel within the server room. As this is in the research phase, no implementation date has been established.

CITY OF PALO ALTO
Current Year Comment and Status of Prior Year Comments
For the Year Ended June 30, 2012

2011-03 A Comprehensive IT Risk Assessment Has Not Been Performed
(Significant Deficiency)

General computer controls over the access to programs and data should require that a mechanism or procedures be in place to identify and react to risks arising from internal and external sources. A comprehensive means to identify IT risks is through the periodic performance of IT risk assessments. The City, however, has not performed a formal comprehensive and independent IT risk assessment to help identify the risks to the delivery of IT services and the accuracy and integrity of the City's financial and personnel data.

We recommend the City's CIO (acting) should plan and budget for an independent IT risk assessment to be performed on the department's functions. The risk assessment should focus on identifying all of the possible risks to the City's IT department, the delivery of IT services and the accuracy and integrity of the City's financial and personnel data. The risk assessment should quantify the likelihood of an event, the impact of the event and the mitigating controls that would address the possible risk. The risk assessment should also include network penetration testing to ascertain the vulnerabilities of the City's computer network from hacking attempts.

Current Year Status:

In Progress. Presently, the City's ISM is conducting a preliminary security assessment to identify areas of improvement. The ISM's plan is to conduct a comprehensive IT risk assessment [per ISO 27001/2 Information Security Management Systems (ISMS) standards] by December 31, 2012 to identify all of the possible risks to the City's IT department, the delivery of IT services and the accuracy and integrity of the City's financial and personnel data. The risk assessment will also include network penetration testing to ascertain the vulnerabilities of the City's computer network from hacking attempts.

In addition, the plan is to conduct a technical impact assessment by March 31, 2013 to quantify the likelihood of an event, the impact of the event and the mitigating controls that would address the possible risk.

2011-04 City IT Department Does Not Have Oversight Over Non-Core Financial Applications
(Significant Deficiency)

The City has several applications that are used by the various departments. These include; Class, used by Parks and Recreation; Chameleon, used by Animal Services; Horizon, used by the Libraries; and Acella, used for Permitting. These applications are owned by the individual departments and not controlled nor managed by the City's IT Department. Since management of the applications is decentralized, the individual applications may not adhere to best practices for application access (password configuration) or management of authorization profiles. This places the City's network and financial data at increased risk of unauthorized access.

CITY OF PALO ALTO
Current Year Comment and Status of Prior Year Comments
For the Year Ended June 30, 2012

2011-04 City IT Department Does Not Have Oversight Over Non-Core Financial Applications
(Significant Deficiency)

We recommend the City's Internal Auditor, working with the CIO (acting), should review the password configuration requirements being used in the City's non-core financial applications. If it is found that the password requirements do not meet industry best practices shown in the table below, the password configuration settings within the applications should be updated, if possible.

Account Setting	Best Practices
Password Length (Min.)	7-9 characters
Expiration Period	30-60 days
Account Lockout Threshold	3-5 invalid logon attempts will lock the account.
Strong Passwords Required	Yes

Current Year Status:

In Progress. Presently the City's ISM is in the process of developing information security policies and standards which will be aligned with industry leading practices. The ISM's plan is to enforce (through CIO communication to department directors) industry leading practices around application access control, authentication and authorization. The written and formal policy and standards are expected to be completed by March 2013.

2011-05 City Firewalls Are Managed by a Single Person
(Significant Deficiency)

General computer controls require that logical security management be properly administered. The City's firewalls, however, are accessible and configurable by mainly only one person within the IT Department. Although the City has additional staff that can assist with firewall activities, it does not have a single staff person that is a dedicated back up. This places the City's network, application and data at increased risk should this person be unavailable for an extended period, or if the one person decided to lock all others out of the network.

We recommend the CIO (acting) should either have at least one other IT staff or manager trained in the management of firewalls or have an outside consultant retained for these services. An additional secured account should also be created for firewall administration that could be used in the event the primary firewall administrator is unavailable for an extended period of time.

Current Year Status:

Corrected. The City's IT department has cross trained another technical resource to provide technical services to maintain and support firewalls. This additional IT professional is accessing the firewalls from an account separate from the primary firewall administrator's account.

CITY OF PALO ALTO
Current Year Comment and Status of Prior Year Comments
For the Year Ended June 30, 2012

2011-06 City Has Not Performed PCI Data Security Standards Compliance Assessment
(Significant Deficiency)

The Payment Card Industry Data Security Standard (PCI DSS) is a set of requirements designed to ensure that all entities that process, store or transmit credit card information maintain a secure environment. Entities that do not comply with PCI DSS may be subject to fines, card replacement costs, forensic audits, brand damage, etc., by the major credit card brands should a breach event occur. The City, however, has not performed a compliance assessment for PCI DSS.

We recommend the City Manager, working with the CIO (acting) should have a PCI compliance audit conducted over the City's payment card practices and security measures.

Current Year Status:

In Progress. The City's IT manager has reported that the department has conducted preliminary PCI compliance audit on the City's payment card practices and implemented following initial security measures on the City's ERP systems:

1. Installed required firewall configuration to protect cardholder data;
2. Verified that all vendor-supplied defaults are changed as appropriate for system;
3. Implemented required controls to protect stored card data;
4. Implemented cardholder data encryption solution protocol during transmission of the date; across open, public networks;
5. Restricted access to cardholder data by business on need-to-know basis;
6. Assigned a unique ID to each person with computer access; and
7. Restricted physical access to cardholder data

The City's ISM is planning to conduct a more detail PCI compliance audit and will implement additional PCI compliance controls (on the City's IT infrastructure) which are consistent with industry leading practices. This is planned to be completed by December 2012.

2011-07 City-wide Capital Asset Policies Are Outdated
(Significant Deficiency)

During the current year, the City purchased software in the amount of \$232,696 and capitalized it as a nondepreciable asset under governmental-type activities. Given the constant evolution of technology, software typically has a useful life ranging from 5 to 20 years based on the expected duration and complexities of the system, rather than treating it as indefinite. Capitalizing software as nondepreciable seems to overstate the value of these intangible assets over time and would necessitate a large write-off when service utility is diminished or when it becomes obsolete.

CITY OF PALO ALTO
Current Year Comment and Status of Prior Year Comments
For the Year Ended June 30, 2012

2011-07 City-wide Capital Asset Policies Are Outdated (Continued)
(Significant Deficiency)

Furthermore, upon our review of capital assets, we observed that the City-wide capital asset policies currently in place have not been updated since 1996 for governmental funds and 2005 for enterprise funds. These policies should be updated to address current practices and the provisions of subsequently issued Governmental Accounting Standards Board (GASB) guidance that may not be properly reflected in these dated policies. For instance, GASB issued Statement No. 34 in December 1999 that made revolutionary changes over the accounting and reporting of capital assets, including new provisions for infrastructure, and issued Statement No. 51 in June 2007 that provided accounting and financial reporting guidance for intangible assets, including internally generated computer software.

We recommend that the City review and update the current capital asset policies for both governmental and enterprise funds to ensure the City is properly accounting and reporting for its capital assets under U.S. generally accepted accounting principles. Once the updated policies are in place, we also recommend the City conduct a review of its existing capital assets to ensure compliance with these policies.

Current Year Status:

Corrected. The City performed a comprehensive review of their existing capital asset policy for both governmental activities and enterprise funds. As a result, the policy for governmental activities, which includes the City's General Fund and Internal Service Funds, were revised in March 2012.

2011-08 Accounting for Retention Payable
(Significant Deficiency)

During our search for unrecorded liabilities, which included an examination of disbursements issued subsequent to year-end, we observed that the City does not accrue a liability for retention amounts withheld from its payments to vendors. In total, we identified 7 payments within our sample of disbursements that contained retention amounts withheld totaling \$322,871, which were not accrued as fund liabilities. While retention amounts may not be due and payable until some future date when project milestones are met to the City's satisfaction, they are customarily recognized as a liability since the goods and/or services have been received.

We recommend that the City review its current practices over accounting for retention payable to determine whether or not its liabilities are understated for amounts owed to vendors. At a minimum, the City should accumulate a total of retention amounts withheld to determine the significance of these amounts by opinion unit and, for governmental funds, whether or not the timing of payments would necessitate the recording of a fund liability in the current period.

Current Year Status:

Corrected.

CITY OF PALO ALTO

Independent Accountant's Report on Applying
Agreed-Upon Procedures Related to
the Article XIII-B Appropriations Limit

For the Year Ended June 30, 2012

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

**Independent Accountant's Report
on Applying Agreed-Upon Procedures**

We have performed the procedures enumerated below to the accompanying Appropriations Limit Worksheet of the City of Palo Alto, California (City), for the year ended June 30, 2012. These procedures, which were agreed to by the City and the League of California Cities (as presented in the publication entitled *Article XIII B California Constitution Appropriations Limit Procedures Guidelines for California Counties*), were performed solely to assist the City in meeting the requirements of Section 1.5 of Article XIII B of the California Constitution. The City's management is responsible for the Appropriations Limit Worksheet.

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in 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.

The procedures performed and our findings were as follows:

1. We obtained the completed worksheets setting forth the calculations necessary to establish the City's appropriations limit and compared the limit and annual adjustment factors included in those worksheets to the limit and annual adjustment factors that were adopted by resolution of the City Council. We also compared the population and inflation options included in the aforementioned worksheets to those that were selected by a recorded vote of the City Council.

Finding: No exceptions were noted as a result of our procedures.

2. For the accompanying Appropriations Limit Worksheet, we added last year's limit to total adjustments, and compared the resulting amount to this year's limit.

Finding: No exceptions were noted as a result of our procedures.

3. We compared the current year information presented in the accompanying Appropriations Limit Worksheet to the worksheets described in No. 1 above.

Finding: No exceptions were noted as a result of our procedures.

4. We compared the prior year appropriations limit presented in the accompanying Appropriations Limit Worksheet to the prior year appropriations limit adopted by the City Council.

Finding: No exceptions were noted as a result of our procedures.

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on the Appropriations Limit Worksheet. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. No procedures have been performed with respect to the determination of the appropriations limit for the base year, as defined by Article XIII B of the California Constitution.

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

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

CITY OF PALO ALTO, CALIFORNIA
Appropriations Limit Worksheet
For the Year Ended June 30, 2012

Appropriations limit, fiscal year 2010-2011		\$ 115,057,884
Adjustment factors:		
Population growth	$\frac{0.89+100}{100}$	1.0089
Inflation	$\frac{2.51+100}{100}$	1.0251
Appropriations limit, fiscal year 2011-2012		<u>\$ 118,995,555</u>

CITY OF PALO ALTO, CALIFORNIA

Pedestrian/Bicycle Facilities Grant
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III

Independent Auditor's Reports,
Financial Statements and
Supplementary Information

For the Year Ended June 30, 2012



Certified Public Accountants.

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grant
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 For the Year Ended June 30, 2012

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

Independent Auditor's Report

We have audited the accompanying balance sheet of the Pedestrian/Bicycle Facilities Grant (Grant) made to the City of Palo Alto, California (City), by the Metropolitan Transportation Commission, Transportation Development Act Funds, Article III as of June 30, 2012 and the related statement of revenues, expenditures and changes in fund balance (deficit) for the year then ended. 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 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over the Grant's financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 described in Note 1 to the financial statements, the financial statements of the Grant are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and the major governmental fund of the City that is attributable to the activities of the Grant. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2012, and changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Grant made to the City by the Metropolitan Transportation Commission, Transportation Development Act Funds, Article III as of June 30, 2012, and the changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 26, 2012 on our consideration of the City's internal control over the Grant's financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters for the year ended June 30, 2012. 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.

Management has not presented the management's discussion and analysis that governmental accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

CITY OF PALO ALTO, CALIFORNIA
Pedestrian/Bicycle Facilities Grant
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III
Balance Sheet
June 30, 2012

Assets

Due from Metropolitan Transportation Commission	\$ 87,408
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Liabilities and Fund Balance (Deficit)

Liabilities

Due to other funds of the City	\$ 87,408
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Fund Balance

Unassigned	-
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Total liabilities and fund balance	\$ 87,408
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See accompanying notes to the financial statements.

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grant
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 Statement of Revenues, Expenditures, and Changes in Fund Balance (Deficit)
 For the Year Ended June 30, 2012

Revenues	
Grant	\$ 201,317
Expenditures	
Capital outlay	<u>192,656</u>
Excess of revenues over expenditures	8,661
Fund Balance (deficit) - beginning of year	<u>(8,661)</u>
Fund Balance - end of year	<u><u>\$ -</u></u>

See accompanying notes to the financial statements.

CITY OF PALO ALTO, CALIFORNIA
Pedestrian/Bicycle Facilities Grant
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III
Notes to the Financial Statements
For the Year Ended June 30, 2012

NOTE 1 – DESCRIPTION OF REPORTING ENTITY

The accompanying financial statements are prepared from the accounts and financial transactions of the City of Palo Alto, California (City) for the projects funded under the Transportation Development Act of 1971 (TDA) Article III of the State of California, which include the construction of pedestrian and bicycle paths. The financial statements do not purport to present the financial position or changes in financial position of the City. The projects represent a portion of the accounts of the City and, as such, are included in the City's basic financial statements.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) *Basis of Presentation*

The Pedestrian/Bicycle Facilities Grant (Grant) has been accounted for in the capital project fund, which is a major governmental fund type and is included in the City's basic financial statements. The capital project fund accounts for resources used for acquisition and construction of capital facilities by the City, with the exception of those assets financed by proprietary funds.

(b) *Basis of Accounting*

The accompanying financial statements have been prepared on the modified accrual basis of accounting. Under the modified accrual basis of accounting, expenditures are recorded when the related governmental fund liabilities are incurred. Grant revenues, which are received as reimbursement for specific purposes or projects, are recognized when they become measurable and available (received within 90 days after year-end).

(c) *Fund Balance*

The City reports fund balance for governmental funds in specific classifications (nonspendable, restricted, committed, assigned and unassigned) based on the extent to which the City is bound to the constraints on the specific purposes for which funds can be spent. At June 30, 2012, the Grant did not report any fund balance and only receives restricted revenues.

(d) *Due to other funds of the City*

Cash has been advanced to the Pedestrian/Bicycle Facilities Grant projects for expenditures paid by the City's major capital projects fund for the benefit of the TDA Article III projects. The projects are obligated to immediately repay these advances upon reimbursement.

CITY OF PALO ALTO, CALIFORNIA
Pedestrian/Bicycle Facilities Grant
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III
Notes to the Financial Statements (Continued)
For the Year Ended June 30, 2012

NOTE 3 – COMPLIANCE REQUIREMENTS

The TDA is defined at Chapter 4 of the California Public Utilities Code commencing with Section 99200. Funds received pursuant to Section 99235 of the TDA (Article 3) may only be used for facilities provided for exclusive use by the project.

NOTE 4 – SECTION 99301 – INTEREST EARNED ON ALLOCATED FUNDS

The City incurred and paid expenditures prior to the receipt of the Grant reimbursements; as a result, no interest was earned on Grant funds.

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grant
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 Schedule of Construction Projects with Capital Outlay Expenditures
 For the Year Ended June 30, 2012

The following schedule identifies the projects with capital outlay expenditures during fiscal year 2012:

Title of Project	Project Number	Awards Carried Over from Prior Year	Current Year Allocation/ (Recission)	Total Awards	Cumulative Capital Outlay Expenditures as of June 30, 2011	Current Year Capital Outlay Expenditures	Cumulative Capital Outlay Expenditures as of June 30, 2012	Status of Project
TDA 09-10 Park Boulevard Bicycle Boulevard	10001048	\$ 60,000	\$ -	\$ 60,000	\$ -	\$ 60,000	\$ 60,000	Completed
TDA 09-10 Purchase and Installation of Bike Racks	10001049	50,000	(25,000)	25,000	7,861	17,139	25,000	Completed
TDA 09-10 Upgrading Bicycle & Pedestrian Master Plan	10001050	55,000	-	55,000	55,000	-	55,000	Completed
TDA 09-10 Installation of Directional Guide Signs	10001051	40,000	(15,000)	25,000	800	24,200	25,000	Completed
TDA 09-10 Enhance Crosswalk at Various Locations	10001052	51,317	-	51,317	-	51,317	51,317	Completed
TDA 11-12 Updating Bike/Pedestrian Master Plan	12001061	-	25,000	25,000	-	25,000	25,000	Completed
TDA 11-12 Enhance Crosswalk at Various Locations	12001062	-	15,000	15,000	-	15,000	15,000	Completed
TDA 11-12 Bicycle Detection at Traffic Signals	12001042	-	55,597	55,597	-	-	-	On-going
		\$ 256,317	\$ 55,597	\$ 311,914	\$ 63,661	\$ 192,656	\$ 256,317	

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

**Independent Auditor’s Report on Internal Control Over
Financial Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements Performed in
Accordance with *Governmental Auditing Standards* and
the Transportation Development Act**

We have audited the accompanying balance sheet of the Pedestrian/Bicycle Facilities Grant (Grant) made to the City of Palo Alto, California (City), by the Metropolitan Transportation Commission, Transportation Development Act Funds, Article III as of June 30, 2012, and the related statement of revenues, expenditures, and changes in fund balance (deficit) for the year then ended, and have issued our report thereon dated November 26, 2012. Our report includes an explanatory paragraph describing that the financial statements of the Grant present only that portion of the governmental activities and the major governmental funds of the City that is attributable to the activities of the Grant and an explanatory paragraph describing management’s omission of the management’s discussion and analysis required by accounting principles generally accepted in the United States of America. 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

Management of the City is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the City’s internal control over the Grant’s financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over the Grant’s financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City’s internal control over the Grant’s 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 would not necessarily 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 Grant's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, including the applicable statutes, rules and regulations of the Transportation Development Act, including Section 6666 of Title 21, of the California Code of Regulations, and the allocation instructions and resolutions of the Metropolitan Transportation Commission, 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 or other matters that are required to be reported under *Government Auditing Standards* or the Transportation Development Act.

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

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

**CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION**
(A Component Unit of the City of Palo Alto)

Annual Financial Report
For the Year Ended June 30, 2012

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

Independent Auditor's Report

We have audited the accompanying basic financial statements of the governmental activities and the major fund of the Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto, as of and for the year ended June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 opinions.

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 Corporation as of June 30, 2012, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis as listed in the table of contents be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

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CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Management's Discussion & Analysis (Unaudited)

The Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto (City), follows the provisions of Governmental Accounting Standards Board (GASB) Statement No. 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 2012 FINANCIAL HIGHLIGHTS

GASB 34 requires the issuance of government-wide financial statements as well as fund financial statements. The government-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 accounting 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 the 2002B Downtown Parking Improvements COPs.

During the fiscal year 2012, the City entered into a master lease-purchase agreement with JP Morgan Chase Bank, N.A. and the proceeds, together with the reserve fund, were used to redeem the 1998 Golf Course Capital Improvements COPs. In addition, the 2002A Civic Center Refinancing COPs has been paid off. As of June 30, 2012, the 2002B Downtown Parking Improvements COPs comprise the Corporation's outstanding debt.

Interest expense and other fiscal agent charges on these COP issues were \$146 thousand for fiscal year 2012, a decrease of \$186 thousand over the prior year. The interest for leases on the assets securing these COP issues was \$224 thousand, a decrease of \$73 thousand from the prior year. The interest on leases from the City exceeded interest expense by \$78 thousand, thereby resulting in an increase in net assets of \$80 thousand over the prior year.

The Corporation ended fiscal year 2012 with total assets of \$1.9 million, a decrease of \$4.2 million from the prior year. Total assets consist of \$251 thousand in cash and \$1.7 million of leases receivable from the City of Palo Alto. Total liabilities were \$1.7 million, a decrease of \$4.3 million from the prior year, and included \$162 thousand of current liabilities as well as \$1.6 million of long-term debt.

At the fund level, the Corporation's revenues exceed its expenditures by \$2.1 million. As of June 30, 2012, the Corporation had one fund, the Debt Service Fund, which reported a \$251 thousand fund balance, reflecting a \$1.0 decrease over the prior year, due to the payment to the escrow account to redeem the 1998 Golf Course COPs.

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Management's Discussion & Analysis (Unaudited)

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 government-wide and the fund financial statements, along with the notes to these financial statements.

The basic financial statements comprise the government-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 government-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 the emphasis on measuring net revenues or expenses of the Corporation's program. The statement of activities explains in detail the change in net assets for the 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 (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 1998 Golf Course COPs were redeemed and the 2002A Civic Center Refinancing COPs were paid off during the fiscal year 2012. As of June 30, 2012, the Corporation has one outstanding debt for 2002B Downtown Parking Improvement projects.

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

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.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Statement of Net Assets
June 30, 2012

Assets:

Cash and investments held for operations	\$ 12,088
Cash and investments held by trustee	238,745
Investment in leases to City of Palo Alto	<u>1,685,000</u>
Total assets	<u>1,935,833</u>

Liabilities:

Interest payable	36,508
Long-term debt:	
Due in one year	125,000
Due in more than one year	<u>1,560,000</u>
Total liabilities	<u>1,721,508</u>

Net Assets:

Restricted for debt service	<u><u>\$ 214,325</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, 2012

Expenses:

Interest and fiscal agent charges	\$ 145,946
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Program revenues:

Interest on leases from City of Palo Alto	224,249
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Net program revenues	<u>78,303</u>
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General Revenues:

Investment income	1,867
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Change in net assets	80,170
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Net assets, beginning of the year	<u>134,155</u>
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Net assets, end of the year	<u><u>\$ 214,325</u></u>
-----------------------------	--------------------------

See accompanying notes to financial statements.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION**(A Component Unit of the City of Palo Alto)**

Balance Sheet
Debt Service Fund
June 30, 2012

Assets:

Cash and investments held for operations	\$ 12,088
Cash and investments held by trustee	238,745
Investment in leases to City of Palo Alto	1,685,000
	1,935,833
Total assets	\$ 1,935,833

Liabilities and Fund Balance:

Liabilities:	
Deferred revenue	\$ 1,685,000
Fund balance restricted for debt service	250,833
	1,935,833
Total liabilities and fund balance	\$ 1,935,833

Reconciliation of fund balance to net assets:

Fund balance restricted for debt service	\$ 250,833
Accrual adjustment to remove deferred revenue from the balance sheet	1,685,000

Some liabilities, including bonds payable, are not due and payable in the the current period and therefore are not reported in the funds:

Interest payable	(36,508)
Long-term debt due within one year	(125,000)
Long-term debt due in more than one year	(1,560,000)
	214,325
Net assets of governmental activities	\$ 214,325

See accompanying notes to financial statements.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Statement of Revenues, Expenditures and Changes in Fund Balance
Debt Service Fund
For the Year Ended June 30, 2012

Revenues:

Lease receipts from City of Palo Alto:

Principal	\$ 3,181,132
Interest	224,249
Investment income from cash and investments	1,867

Total revenues	3,407,248
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Expenditures:

Debt service:

Principal repayment	520,000
Interest and fiscal agent charges	214,243
Payment to bond refunding escrow	586,219

Total expenditures	1,320,462
--------------------	-----------

Excess of Revenues over Expenditures	2,086,786
--------------------------------------	-----------

Other Financing (Uses):

Payment to bond refunding escrow

(3,103,781)

Net change in fund balance

(1,016,995)

Fund balance, beginning of the year

1,267,828

Fund balance, end of the year

\$ 250,833

Reconciliation of net change in fund balance to net change in net assets:

Net change in fund balances-total governmental funds	\$ (1,016,995)
--	----------------

Amounts reported for governmental activities in the statement of activities are different because:

Repayment of bond principal is an expenditure in the governmental funds,

but in the statement of net assets the repayment reduces long-term liabilities.

4,210,000

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 as revenues on the statement of activities.

Change in deferred revenue

(3,181,132)

Change in interest payable

68,297

Change in net assets of governmental activities

\$ 80,170

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, 2012

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, 2012.

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation

Government-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:

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

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, 2012

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES (continued)

(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 improvement to have been sold for this amount when leased.

(d) Net Assets

The government-wide financial statements utilize a net assets presentation. Net assets are categorized as restricted and unrestricted.

Restricted Net Assets – This category presents external restrictions imposed by creditors, grantors, contributors or laws or regulations of other governments and restrictions imposed by law through constitutional provisions or enabling legislation.

(e) Fund Balances

At June 30, 2012, the Corporation's governmental funds' fund balances include the following classification:

Restricted Fund Balance – includes amounts that can be spent only for the specific purposes stipulated by external resource providers, constitutionally or through enabling legislation. Restrictions may effectively be changed or lifted only with the consent of resource providers.

(f) Estimates

The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

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, 2012

NOTE 3 – CASH AND INVESTMENTS HELD BY TRUSTEE

Under the provisions of the Corporation's COP issues, a Trustee holds and invests the Corporation's cash.

(a) Interest Rate Risk

Interest rate risk is the risk that a change in market interest rates will adversely affect the fair value of an investment. Normally, the longer it takes an investment to reach maturity, the greater will be that investment's sensitivity to changes in market 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:

<u>Investment Type</u>	<u>Amount</u>	<u>Maturity Date</u>
U.S. Agency obligations:		
Federal National Mortgage Association	\$ 237,670	122 days
Money Market Mutual Funds	<u>13,163</u>	28 days
Total Investments held by Trustee	<u>\$ 250,833</u>	

(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, 2012, for the investments in U.S. Agency Obligations and Money Market Mutual Funds are AAA and AAAM, respectively, as provided by Moody's Investors Services.

(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 obligation 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, 2012

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

<u>Authorized Investment Type</u>	<u>Maximum Maturity</u>	<u>Minimum Credit Quality</u>	<u>Maximum Percentage of Portfolio</u>	<u>Maximum Investment in One Issuer</u>
U.S. Government Securities	10 years	N/A	No Limit	No Limit
U.S. Government Agency Securities (C)	10 years	N/A	No Limit (A)	No Limit
				10% of the par value of portfolio
Certificates of Deposit	10 years	N/A	20%	\$5 million
Bankers Acceptances	180 days (D)	N/A (D)	30%	\$3 million (B)
Commercial Paper	270 days	AAA	15%	\$50 million per account
Local Agency Investment Fund	N/A	N/A	No Limit	No Limit
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 (E)	No Limit	No Limit
Mutual Funds (F)	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
Bonds of State of California Municipal Agencies	10 years	AA/AA2	10%	No Limit

(A) Callable and multi-step securities are limited to no more than 25% 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) Utility Revenue Bonds 2002 Series A and 1999 Series A allow general obligations of states with a minimum credit quality rating of A2/A by Moody's and Standard & Poor's.

(D) Utility Revenue Bonds 2002 Series A and 1999 Series A require a minimum credit quality rating of A-1/P-1 by Moody's and Standard & Poor's and maturing after no more than 360 days. Utility Revenue Bonds 1995 limit the maximum maturity to 365 days.

(E) Water Revenue Bonds 2009 Series A, Utility Revenue Bonds 2002 Series A and 1999 Series A require a minimum credit quality rating of AAAM or AAAM-G by Standard & Poor's.

(F) Utility Revenue Bonds 2002 Series A, 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, 2012

NOTE 4 – CERTIFICATES OF PARTICIPATION

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

	Balance June 30, 2011	Retirements	Balance June 30, 2012	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
1998 Golf Course	\$ 3,690,000	\$ 3,690,000	\$ -	\$ -
2002A Civic Center Refinancing 2.00 - 4.00%, due 03/01/2012	405,000	405,000	-	-
2002B Downtown Parking Improvements 4.55 - 6.50%, due 03/01/2022	1,800,000	115,000	1,685,000	125,000
	<u>\$ 5,895,000</u>	<u>\$ 4,210,000</u>	<u>\$ 1,685,000</u>	<u>\$ 125,000</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 drains 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. The 1998 COPs were secured by lease revenues received by the Public Improvement Corporation from golf course revenues or other unrestricted revenues of the City. On August 2, 2011, the City entered into a master lease-purchase agreement with JP Morgan Chase Bank, N.A. Proceeds together with the COPs reserve fund were deposited into an escrow account to redeem all of the COPs in the aggregate amount of \$3.7 million. At June 30, 2012, the 1998 COPs were fully redeemed.

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 revenues 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, 2012

NOTE 4 – CERTIFICATES OF PARTICIPATION (continued)

The COPs are payable and secured by lease revenues received by the Public Improvement Corporation from any City General Fund revenue source.

Future annual debt service on the 2002B COPs is expected to be provided by the lease receipts discussed above, and is shown below:

For the Year Ending June 30	Principal	Interest	Total
2013	\$ 125,000	\$ 109,525	\$ 234,525
2014	130,000	101,400	231,400
2015	145,000	92,950	237,950
2016	150,000	83,525	233,525
2017	160,000	73,775	233,775
2018-2022	975,000	197,925	1,172,925
Total	\$ 1,685,000	\$ 659,100	\$ 2,344,100

**REDEVELOPMENT AGENCY OF
THE CITY OF PALO ALTO**

Independent Auditor's Reports,
Management's Discussion and Analysis, and
Basic Financial Statements

For the Period from July 1, 2011 through
October 7, 2011

**REDEVELOPMENT AGENCY OF THE
CITY OF PALO ALTO**
For the Period from July 1, 2011 through October 7, 2011

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto (Agency), a component unit of the City of Palo Alto (City), as of October 7, 2011 and for the period from July 1, 2011 through October 7, 2011, which collectively comprise the Agency's basic financial statements as listed in the table of contents. These 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 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over the Agency's financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and major fund of the Agency as of October 7, 2011, and the respective changes in financial position thereof, and the respective budgetary comparison for the period from July 1, 2011 through October 7, 2011, in conformity with generally accepted accounting principles in the United States of America.

As discussed in Note 1(a) and Note 3 to the basic financial statements, the City Council of the City of Palo Alto passed Ordinance No. 5126 on September 6, 2011 dissolving the Agency effective October 7, 2011.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 26, 2012, on our consideration of the internal control over the Agency's 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis as listed in the table of contents be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Macias Gini & Cannelo LLP

Walnut Creek, California
November 26, 2012

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

Management's Discussion and Analysis (Unaudited)

For the Period from July 1, 2011 through October 7, 2011

The Redevelopment Agency of the City of Palo Alto (Agency), a component unit of the City of Palo Alto (City) was formed on July 9, 2001. As discussed in Note 3 to the basic financial statements, the City Council passed Ordinance No. 5126 on September 6, 2011, dissolving the Agency effective October 7, 2011.

FISCAL 2012 FINANCIAL HIGHLIGHTS-AGENCY-WIDE BASIS AND FUND BASIS

During the period from July 1, 2011 through October 7, 2011, the Agency incurred costs in the amount of \$9 thousand. The Agency received a transfer from the City in the amount of \$9 thousand to fund these costs. As of the day of dissolution, 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 government-wide and the fund financial statements, along with the notes to these financial statements.

The Basic Financial Statements

The basic financial statements comprise the government-wide financial statements and the fund financial activities and financial position-long-term and short-term.

The government-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.

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 Administrative Services Department of the City of Palo Alto, 250 Hamilton Avenue, CA 94301.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTOStatement of Net Assets and
Governmental Fund Balance Sheet
October 7, 2011

	Redevelopment General Fund	Adjustments	Governmental Activities - Statement of Net Assets
	<u> </u>	<u> </u>	<u> </u>
Assets:			
Cash and investments	\$ -	\$ -	\$ -
	<u> </u>		
Liabilities:			
Accounts payable	\$ -	<u> </u>	<u> </u>
Fund balance/net assets:			
Fund balance:			
Unassigned	<u> </u>	<u> </u>	<u> </u>
Total liabilities and fund balance	<u>\$ -</u>		
Net Assets:			
Unrestricted		<u> </u>	<u> </u>
Total net assets		<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to the financial statements.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Statement of Activities and
Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance
For the Period from July 1, 2011 through October 7, 2011

	Redevelopment General Fund	Adjustments	Statement of Activities
	<u> </u>	<u> </u>	<u> </u>
Expenditures/expenses:			
Community development:			
Planning and community reimbursements to the City of Palo Alto	\$ 9,377	\$ -	\$ 9,377
General revenues:			
Intergovernmental revenues from the City of Palo Alto	<u>9,377</u>	<u>-</u>	<u>9,377</u>
Change in fund balance/net assets	-	-	-
Fund balance/net assets,			
Beginning of period	<u>-</u>	<u>-</u>	<u>-</u>
End of period	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>

See accompanying notes to the financial statements.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

Redevelopment General Fund

Statement of Revenues, Expenditures, and Changes in Fund Balance - Budget and Actual

For the Period from July 1, 2011 through October 7, 2011

	<u>Budgeted Amounts</u>		<u>Actual Amounts</u>	<u>Variance with Final Budget Positive (Negative)</u>
	<u>Original</u>	<u>Final</u>		
Revenues:				
Intergovernmental revenues from the City of Palo Alto	<u>\$ 8,500</u>	<u>\$ 8,500</u>	<u>\$ 9,377</u>	<u>\$ 877</u>
Expenditures:				
Community development: Planning and community reimbursements to the City of Palo Alto	<u>8,500</u>	<u>8,500</u>	<u>9,377</u>	<u>(877)</u>
Net change in fund balance	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u>-</u>	<u><u>\$ -</u></u>
Fund balance, beginning of period			<u>-</u>	
Fund balance, end of period			<u><u>\$ -</u></u>	

See accompanying notes to the financial statements.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

Notes to Basic Financial Statements

For the Period from July 1, 2011 through October 7, 2011

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**(a) Organization and Purpose**

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

On September 19, 2001, the Edgewood Redevelopment Project Area (Edgewood Plaza) was designated as a survey area and the process for the adoption of the redevelopment plan was initiated. The redevelopment plan for Edgewood Plaza was not ultimately adopted by the City Council. The City has not designated any other redevelopment project areas for revitalization.

The Agency is an integral part of the City 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.

On September 6, 2011, pursuant to Health & Safety Code Section 33140, the City Council of the City of Palo Alto passed Ordinance No. 5126 dissolving the Agency, effective October 7, 2011 (see Note 3).

(b) Financial Statement Presentation

The Agency's basic financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The Governmental Accounting Standards Board (GASB) 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.

Government-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.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

Notes to Basic Financial Statements

For the Period from July 1, 2011 through October 7, 2011

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**(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 Agency reported the following major governmental fund in the accompanying financial statements:

Redevelopment 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 flow takes 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* 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.

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

Notes to Basic Financial Statements

For the Period from July 1, 2011 through October 7, 2011

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**(f) Net Assets**

Net assets are the excess of all the Agency's assets over all its liabilities. Net assets, which are determined only at the Agency-wide level, were zero at October 7, 2011.

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 the repayments be treated as transfers in the year made.

NOTE 3 – DISSOLUTION OF THE REDEVELOPMENT AGENCY

In June 2011, the California legislature adopted Assembly Bill x1 26 ("AB x1 26" or the "Dissolution Bill"). The Dissolution Bill immediately suspends all new redevelopment activities and incurrence of indebtedness, and dissolves redevelopment agencies. In response to the newly enacted legislation, the City concluded that the Agency has not identified a qualifying redevelopment project area and has not conducted any redevelopment activities, including redeveloping or acquiring land, entering into contracts, issuing bonds or incurring housing obligations, since its formation. As a result, pursuant to Health & Safety Code Section 33140, the City Council of the City of Palo Alto adopted Ordinance No. 5126 on September 6, 2011 to dissolve the Agency effective October 7, 2011.

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

**Independent Auditor's 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***

We have audited the financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto (Agency), a component unit of the City of Palo Alto (City), California, as of October 7, 2011 and for the period from July 1, 2011 through October 7, 2011, which collectively comprise the Agency's basic financial statements, and have issued our report thereon dated November 26, 2012. Our report includes an explanatory paragraph indicating that the Agency was dissolved, effective October 7, 2011. 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

Management of the Agency is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the City's internal control over financial reporting related to the Agency 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 related to the Agency. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting related to the Agency.

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 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily 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. 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*.

This report is intended solely for the information and use of the Governing Board of the Agency, management, pass-through entities, and the State Controller's Office and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

CABLE TV FRANCHISE
Statements of Franchise
Revenues and Expenditures

For the Years Ended
December 31, 2011 and 2010

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

The Members of the
Cable TV Franchise

Independent Auditor's Report

We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2011 and 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis of designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Franchise's internal control over the financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 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 financial statements referred to above present fairly, in all material respects, the revenues and expenditures of the Franchise for the years ended December 31, 2011 and 2010, 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.

Macias Gini & Cannelo LLP

Walnut Creek, California
November 26, 2012

CABLE TV FRANCHISE
Statements of Franchise Revenues and Expenditures
For the Years Ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Revenues:		
Franchise fees	<u>\$ 1,594,217</u>	<u>\$ 1,551,464</u>
Expenditures:		
Franchise administration	74,147	61,418
Consulting fees	<u>4,512</u>	<u>14,384</u>
Total expenditures	<u>78,659</u>	<u>75,802</u>
Net receipts	<u><u>\$ 1,515,558</u></u>	<u><u>\$ 1,475,662</u></u>

	<u>2011</u>		<u>2010</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$ 750,929	49.5%	\$ 730,938	49.5%
City of Menlo Park	401,155	26.5%	390,098	26.4%
City of East Palo Alto	146,251	9.6%	141,683	9.6%
Town of Atherton	107,056	7.1%	104,044	7.1%
County of Santa Clara	78,879	5.2%	78,097	5.3%
County of San Mateo	<u>31,288</u>	<u>2.1%</u>	<u>30,802</u>	<u>2.1%</u>
Total	<u><u>\$ 1,515,558</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 1,475,662</u></u>	<u><u>100.0%</u></u>

See accompanying notes to the financial statements.

CABLE TV FRANCHISE
Notes to Financial Statements
For the Years Ended December 31, 2011 and 2010

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 Cablevision of California, Inc. 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, the Members entered into a Joint Operating Agreement in which 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 the City to administer the cable and video franchise enforcement and monitoring process for state franchise holders.

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

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.

CABLE TV FRANCHISE
Notes to Financial Statements
For the Years Ended December 31, 2011 and 2010

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 spend part of the settlements amount on various projects including installing and maintaining the institutional network equipment. As of December 31, 2011, remaining total amount on deposit, including \$6,653 in interest receivable, was \$922,879.

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

Independent Auditor's Report

For the Year Ended
June 30, 2012

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

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

Independent Auditor's Report

We have audited the accompanying Statements of Net Expenditures and Net Changes in Commitments and Quarterly Billings (financial statements) of the City of Palo Alto Regional Water Quality Control Plant (Plant), an enterprise operation of the City of Palo Alto (City), for the year ended June 30, 2012. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over the Plant's financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 described in Note 2, 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 the 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 is 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, 2012, on the basis of accounting described in Note 2.

This report is intended solely for the information and use 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 and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & Cannel LLP

Walnut Creek, California
November 26, 2012

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CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
Statement of Net Expenditures and Net Changes in Commitments
For the Year Ended June 30, 2012

	Total	City of Mountain View	City of Los Altos	City of Palo Alto
Direct Expenditures:				
Source control program	\$ 1,217,444	\$ 447,897	\$ 114,561	\$ 654,986
Public outreach	102,311	37,640	9,628	55,043
Permitting and enforcement	972,411	278,342	16,636	677,433
Operations and maintenance	11,873,838	4,368,384	1,117,327	6,388,127
System improvement CIP (Note 3)	1,172,550	431,381	110,337	630,832
Total Direct Expenditures	<u>15,338,554</u>	<u>5,563,644</u>	<u>1,368,489</u>	<u>8,406,421</u>
Indirect Administrative Expenditures:				
Source control program	1,122,271	412,884	105,606	603,781
Public outreach	529	195	50	284
Permitting and enforcement	452,307	256,932	15,357	180,018
Operations and maintenance	2,074,838	763,333	195,242	1,116,263
Total Indirect Expenditures	<u>3,649,945</u>	<u>1,433,344</u>	<u>316,255</u>	<u>1,900,346</u>
Debt Service Expenditures:				
Refunding 1990 Series A Bonds	284,847	145,272	22,218	117,357
1999 Wastewater Treatment New Project	540,557	204,817	51,191	284,549
2009 State Water Resource Loan	555,726	210,565	52,627	292,534
Total Debt Service Expenditures	<u>1,381,130</u>	<u>560,654</u>	<u>126,036</u>	<u>694,440</u>
Total Expenditures	20,369,629	7,557,642	1,810,780	11,001,207
Deduct Joint Systems Revenues (Note 6)	<u>(279,242)</u>	<u>(102,733)</u>	<u>(26,277)</u>	<u>(150,232)</u>
Net Expenditures	20,090,387	7,454,909	1,784,503	10,850,975
Add Net Changes in Commitments	<u>1,809,126</u>	<u>665,577</u>	<u>170,239</u>	<u>973,310</u>
Net Expenditures and Net Changes in Commitments Due from Members	<u>\$ 21,899,513</u>	<u>\$ 8,120,486</u>	<u>\$ 1,954,742</u>	<u>\$ 11,824,285</u>

See accompanying notes to the financial statements.

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
Statement of Quarterly Billings
For the Year Ended June 30, 2012

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
Billings by Quarter, Beginning:		
July 1, 2011	\$ 1,739,365	\$ 488,555
October 1, 2011	2,032,474	558,498
January 1, 2012	1,739,365	488,555
April 1, 2012	<u>2,006,622</u>	<u>544,546</u>
Total quarterly billings	7,517,826	2,080,154
Net expenditures and net changes in commitments	<u>8,120,486</u>	<u>1,954,742</u>
Deficiency of total billings over (under) net expenditures and net changes in commitments	<u><u>\$ (602,660)</u></u>	<u><u>\$ 125,412</u></u>

See accompanying notes to the financial statements.

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT

Notes to the Financial Statements
For the Year Ended June 30, 2012

NOTE 1 – THE REPORTING ENTITY

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 share 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.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 4), 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 \$3,775,622 at June 30, 2012, less commitments of \$1,966,496 at June 30, 2011. 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 on 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 the Financial Statements (continued)
For the Year Ended June 30, 2012

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The percentages used for the year ended June 30, 2012, to allocate expenditures, commitments and revenues were:

	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
Public outreach, source control program, operations and maintenance, system improvement CIP, commitments and joint system revenues	36.79%	9.41%	53.80%
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%
2009 State Water Resources Loan	37.89%	9.47%	52.64%
Permitting and enforcement	37.57%	2.25%	60.18%

The City is allocated 53.80% 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 its excess to other entities. Fiscal year 2012 allocations are as follows:

East Palo Alto Sanitary District	6.42%
Stanford University	6.13%
Town of Los Altos Hills	1.17%
Remaining City Percentages	<u>40.08%</u>
Total	<u><u>53.80%</u></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 3 – 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 operations. Per an addendum to the agreement dated March 16, 1998, the Members agreed that capital additions should not exceed \$1.9 million in 1998-99 (base year). For futures 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 \$1,172,550 for fiscal year 2012.

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT

Notes to the Financial Statements (continued)
For the Year Ended June 30, 2012

NOTE 4 – INDIRECT ADMINISTRATIVE 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 Services 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 5 – 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 (split for the portions used for the “New Project” and refunding of the 1990 Series A Bonds) and the 2009 State Water Resources loan.

In prior years, the City, City of Mountain View, City of Los Altos, Town of Los Altos Hills, East Palo Alto Sanitary District and Stanford University 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. In October 2009, the City approved the 2009 State Water Resources Loan to finance the Ultraviolet Disinfection Project.

	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	2009 State Water Resources Loan	Total
City of Palo Alto	\$ 1,783,980	\$ 612,308	\$ 3,147,985	\$ 5,544,273
City of Mountain View	1,771,358	1,249,108	3,125,712	6,146,178
City of Los Altos	442,722	191,040	781,222	1,414,984
East Palo Alto Sanitary District	357,170	291,459	630,257	1,278,886
Stanford University	245,905	100,419	433,920	780,244
Town of Los Altos Hills	73,865	4,898	130,341	209,104
Total	<u>\$ 4,675,000</u>	<u>\$ 2,449,232</u>	<u>\$ 8,249,437</u>	<u>\$ 15,373,669</u>

As required by the Indenture, the City established a debt service reserve fund for the Bonds (the “Reserve Account”), with a minimum funding level requirement in the Reserve Account (the “Reserve Requirement”). At the time it issued the Bonds, the City satisfied the Reserve Requirement with a deposit into the Reserve Account of a surety bond (the “Surety Bond”) in the amount of \$1,647,300 issued by Ambac Indemnity Corporation (renamed to Ambac Assurance Corporation in 1997).

On November 9, 2010, Ambac Financial Group Inc. (Ambac Financial) filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York. Ambac Financial is a holding company whose affiliates provide financial guarantees and financial services to its customers. Ambac Indemnity Corporation, now known as Ambac Assurance Corporation, is a subsidiary of Ambac Financial. Ambac has issued a reserve fund surety bond of \$1,647,300 that expires on June 1, 2024 and is on deposit in the Reserve Fund account securing the Bonds.

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT

Notes to the Financial Statements (continued)
 For the Year Ended June 30, 2012

NOTE 5 – DEBT SERVICE EXPENDITURES (Continued)

According to the Trust Agreement for these bonds, in the event that such surety bond for any reason terminates or expires, and the remaining amount on deposit in the Reserve Fund account is less than the required reserve, the City is to address such shortfall by delivering to the trustee a surety bond or a letter of credit meeting the criteria of a Qualified Reserve Facility under the Trust Agreement, or depositing cash to the General Account in up to twelve equal monthly installments. Information about Ambac Financial is available on Form 10-K and Form 10-Q filed by Ambac Financial; the City refers to this information for reference only, and does not intend to incorporate any such information herein. The City is not certain about the effect of the bankruptcy proceedings, if any, on the Surety Bond.

NOTE 6 – JOINT SYSTEM REVENUES

The Plant's joint system revenues for the year ended June 30, 2012 total \$279,242, which consisted of the following:

Salt water marsh services	\$ 7,500
Laboratory services from the City's Water Fund	44,841
Septic hauling services	156,701
Other revenues	70,200
	\$ 279,242

NOTE 7 – RELATED PARTY TRANSACTIONS

During fiscal year 2012, the Plant paid the City \$2,056,838 for utility costs. Such costs are included in the Statement of Net Expenditures and Net Changes in Commitments as source control program, permitting and enforcement, and operations and maintenance expenditures.

Vehicle replacement charges of \$25,971 were paid to the City's Equipment Replacement Fund, which is included in the Statement of Net Expenditures and Net Changes in Commitments as operations and maintenance expenditures.

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

Independent Auditor's Reports,
Financial Statements, and
Independent Accountant's Report

For the Year Ended June 30, 2012

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

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

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

Independent Auditor's Report

We have audited the accompanying financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund (the Fund), a fund of the City of Palo Alto (City), as of and for the year ended June 30, 2012, 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 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis of designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over the Fund's financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 2(a) to the financial statements, the financial statements of the Fund are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and the nonmajor governmental funds of the City that is attributable to the activities of the Fund. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2012 and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2012, and the changes in financial position thereof for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 26, 2012 on our consideration of the City's internal control over the Fund's 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 the City's 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.

Management has not presented the management's discussion and analysis that governmental accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Macias Gini & Cannel LLP

Walnut Creek, California
November 26, 2012

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
Balance Sheet
June 30, 2012

Assets:

Restricted cash and investments (Note 3) with the City Treasury - CAMP	<u>\$ 21,968,232</u>
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Liabilities and Fund Balance:

Liabilities:

Accounts payable and accrued liabilities	\$ 617,994
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Fund Balance:

Restricted for capital projects	<u>21,350,238</u>
Total liabilities and fund balance	<u>\$ 21,968,232</u>

See accompanying notes to financial statements.

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
Statement of Revenues, Expenditures and
Changes in Fund Balance
For the Year Ended June 30, 2012

Revenues:

Interest on cash and investments	\$ 54,961
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Expenditures:

Capital outlay:	
Downtown Library	468,194
Mitchell Park Library and Community Center	9,704,597
Main Library New Construction and Improvements	935,379
Temporary Facility	96,304
Total capital outlay	11,204,474
Debt service - other fees	6,333
Intergovernmental expenditures	3,456,075
Total expenditures	14,666,882

Net change in fund balance	(14,611,921)
Fund balance, beginning of the year	35,962,159
Fund balance, end of year	\$ 21,350,238

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 the Financial Statements
For the Year Ended June 30, 2012

NOTE 1 – BACKGROUND

On November 4, 2008, more than two thirds of registered voters of the City of Palo Alto (City) approved Measure N and authorized the issuance and sale of 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, 2012, \$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	Expenditures Not Charged to Bond Proceeds	As of June 30, 2012		
			Cumulative Bond Eligible Expenditures	Encumbrances Outstanding	Project Balance Remaining
Downtown Library Improvements	\$ 5,559,772	\$ 350,934	\$ 4,147,555	\$ 60,671	\$ 1,351,546
Mitchell Park Library	50,204,483	1,077,560	27,912,126	12,558,648	9,733,709
Library and Community Center Temporary Facility	794,976	155,116	504,597	25,772	264,607
Main Library New Construction and Improvements	2,103,825	255,460	1,677,257	426,568	-
Temporary Facility	500,000	-	96,435	323,012	80,553
Total	\$ 59,163,056	\$ 1,839,070	\$ 34,337,970	\$ 13,394,671	\$ 11,430,415

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES**(a) Basis of Presentation**

The accompanying financial statements present only the financial position and the changes in financial position of the General Obligation Bonds Capital Projects Fund (Fund) and do not purport to, and do not, present fairly the City’s financial position as of June 30, 2012, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
Notes to the Financial Statements
For the Year Ended June 30, 2012

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES

(b) Basis of Presentation

A capital projects fund (governmental fund) is used to account for the City's General Obligation Bond Projects activities. Capital projects funds are used to account for financial resources (e.g., bond proceeds and investment income) that are restricted, committed, or assigned to expenditures for capital outlays, including the acquisition of land or acquisition and construction of major governmental facilities. This fund is a set of self-balancing accounts which comprise its assets, liabilities, fund balance, revenues and expenditures.

(c) 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. The City considers revenues susceptible to be available if the revenues are collected within ninety days after year-end, except for property taxes, which are collected within sixty days after year-end.

(d) Fund Balance

Fund balance is reported in specific classifications (nonspendable, restricted, committed, assigned and unassigned), which create a hierarchy primarily based on the extent to which the Fund is bound to the constraints of the specific purposes for which funds can be spent. The Fund only has restricted fund balance at June 30, 2012.

Restricted fund balance includes amounts when constraints placed on use of resources are either: (1) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments; or (2) imposed by law through constitutional provisions or enabling legislation. The City will spend the most restricted dollars in accordance with restrictions imposed before less restricted resources in the following order: (a) committed; (b) assigned and (c) unassigned.

(e) Intergovernmental Expenditures

The Fund transferred \$3.5 million to the City in order to allocate the bond premium of the 2010 General Obligation Bonds to the City's debt service fund during the year ended June 30, 2012.

(f) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts and disclosures. Accordingly, actual results may differ from those estimates.

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
Notes to the Financial Statements
For the Year Ended June 30, 2012

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 revenues 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 are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code, which includes 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. CAMP'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.

(b) 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 Fund's investments to market interest rate fluctuations is provided by the following table that shows the distribution of the Fund's investments by maturity:

<u>Investment Type</u>	<u>Amount</u>	<u>Maturity Date</u>	<u>Credit Rating</u>
California Asset Management Program	\$ 21,968,232	53 days	AAAm

(c) 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. As an external investment pool, the California Asset Management Program was rated AAAM as of June 30, 2012.

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

**Independent Auditor’s 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***

We have audited the financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund (the Fund), a fund of the City of Palo Alto, as of and for the year ended June 30, 2012, and have issued our report thereon dated November 26, 2012. Our report includes an explanatory paragraph describing that the financial statements of the Fund present the financial position and changes in financial position of only that portion of the governmental activities and the nonmajor funds of the City that is attributable to the activities of the Fund and an explanatory paragraph describing management’s omission of the management’s discussion and analysis required by accounting principles generally accepted in the United States of America. 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

Management of the City is responsible for establishing and maintaining effective internal control over the Fund’s financial reporting. In planning and performing our audit, we considered the City’s internal control over the Fund’s financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over the Fund’s 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 would not necessarily 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*.

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.

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

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

Independent Accountant's Report on Compliance with Measure N

We have examined the City of Palo Alto's (City) compliance with certain provisions of Measure N for the year ended June 30, 2012, 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, 2011, 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, 2012.

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.

Macias Gini & Connell LLP

Walnut Creek, California
November 26, 2012

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CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund to the City of Palo Alto)
Status of Current Year and Prior Year Findings
For the Year Ended June 30, 2012

Current Year Findings:

No matters were noted.

Status of Prior Year Findings:

No matters were noted.



FINANCE COMMITTEE DRAFT MINUTES

Special Meeting
December 4, 2012

Chairperson Shepherd called the meeting to order at 5:05 P.M. in the Council Conference Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Burt, Price, Scharff arrived at 5:07 P.M., Shepherd (Chair)

Absent:

Oral Communications

None

Agenda Items

1. Recommendation Regarding Adoption of Ordinance Authorizing Closing of the Budget for the Fiscal Year Ending June 30, 2012, Including Re-appropriation Requests, Closing Completed Capital Improvement Projects, Authorizing Transfers to Reserves and Approval of Comprehensive Annual Financial Report (CAFR).

David Bullock, Macias, Gini and O'Connell Certified Public Accountant said, beginning with the Management Letter, there was an Unqualified or Clean Opinion, implemented into the audit, meaning there were no qualifications made when financial statements were rendered. The Management Letter stated the findings, while the Required Communications Document outlined standards, like the responsibility of the auditor. Mr. Bullock expressed an opinion on the Fairness of Findings, according to generally accepted accounting principles and said his firm did not look at internal controls in general, but looked at internal controls to insure there were proper checks and balances. He communicated that any changes in consistency were made in fund balances but this year there were no changes or corrections. They looked at disagreements with management but there were none. Then they looked at the Current Year Recommendations and last year there were eight, five of which were still in progress. Two other recommendations dealt with Capital Assets Policy with regard to software updates and retention payable. They had a finding in the Federal Awards of Assistance single audit and said some reporting requirements made to past recipients went unnoticed. A major change dealt with Pension Reporting



FINANCE COMMITTEE DRAFT MINUTES

Requirements and he said this was going to impact the City significantly. Any time there was a new pronouncement, agencies were given time to implement them. Governmental Accounting Standards Board (GASB), an agency responsible for generally accepted accounting principles outlined how governments recorded their pensions going forward from now. In the past funding progress was reported in foot notes. He said GASB was moving from Measurement Based Accounting method to Economic Based Accounting. That changed the discount rate because currently there was leeway given to people who used the Long Term Rate of Return. This caused the interest rate to go down, which changed the calculation of the obligation. In addition, the Liability was becoming a Disclosure, but now it was recognized on the Financial Statements. This did not hit the General Fund Statements, which dealt with current assets and liabilities, but it changed the big picture on the government wide financial statements.

Council Member Price asked if entities were going to have to use the same accounting practices.

Mr. Bullock said there was going to be consistency among governments and there were six different measurement methods that agencies could use. The Entry Age Norm was going to be used by all and a lot of the assumptions were going to have new parameters. An example of a parameter was having different amortizations schedules or adjusting interest rates based off the future outlook. These changes offered less leeway on those assumptions.

Council Member Price commented that there was more standardization.

Chair Shepherd said Council handled the decision there were eight different choices.

Mr. Bullock said it showed the liability of decisions made.

Vice Mayor Scharff asked what the practical effect was that worsened things.

Mr. Bullock said it depended on the how conservative the calculations were over the years and he did not think bond ratings were going to go down.

Mr. Perez explained the exit fee for California Public Employees Retirement System (CalPERS) and said it connected people to the 30 year United States Treasury bond. The standard operation for June 30, 2011 was at 4.82



FINANCE COMMITTEE DRAFT MINUTES

percent, the current outstanding liability rate was 7.5 percent, and in an actuality basis it was \$117 million for miscellaneous, 79 percent funded. Staff was trying to make more of an annual contribution and they had two tiers in place, with a third on its way. The pension cost went up, resembling a bell curve and it took time to see the effects of the downward bell curve. This change was going to hit salary and the numbers around the percentage of the workforce hard.

Council Member Burt asked when Council would discuss the changes.

Mr. Perez said CalPERS needed to present the projected cost for the third tier first. Staff had some data and made some assumptions for cost at age 60; the miscellaneous age was 46, so the turnover was likely going to be high. He said if Staff were not able to handle the situation, they would seek help from Bartel Associates.

Council Member Burt asked about when Staff looked at the average age of retirement, were they calculating at the average vesting age as well.

Mr. Perez said yes, the average entry age was 36.

Council Member Burt wanted to clarify with Staff on what he meant with the average entry age and the chronological age because the average year for a vested person was 10 years if the person had a 30 year career. If they entered the old formula, then they would be under the old system guidelines, whereas if a person entered the system later, they would be under a later formula and would be under the new contract.

Mr. Perez said the average age a person entered the CalPERS system with another agency was not included in this data.

Council Member Burt confirmed that the figures included only average entries into the Palo Alto system only.

Mr. Perez said these figures reflected the Palo Alto system. He said they were going to meet with the Actuary next week and would ask those questions at that time.

Chair Shepherd thought this discussion would be better continued next year.

Mr. Perez said Staff would not be able to guarantee the all cost changes but would start the discussion.



FINANCE COMMITTEE DRAFT MINUTES

Chair Shepherd said the uniform reporting would help show the State what the problem was with the cities. She said a Burlingame Council Member said the Actuary was \$80 million and their General Fund Budget was \$40 million; she said that made Palo Alto look healthy.

Mr. Bullock said in addition to the Comprehensive Annual Financial Report (CAFR) and the single audit, there was the Library Bond audit, the Cable Television audit, the Regional Water Control Plant audit, and Transportation Development Act (TDA) Funds audit. He said there were two components units: the Redevelopment Agency, which was dissolved, and the Public Improvement Corporation.

Jim Pelletier, City Auditor said he was releasing an audit of Employee Health Benefits tomorrow and there was a finding in that audit. Last year's CAFR had an error that was not fully corrected.

Vice Mayor Scharff asked what the finding was.

Yuki Matsuura, Senior Performance Auditor said the error included eligibility criteria for health benefits, criteria dealing with receipt of 100 percent coverage for retiree health, and eligibility of partial benefits.

Vice Mayor Scharff asked if that included people that retired after five years at age 50.

Ms. Matsuura said it depended on which group the employee belonged to. For example management and union represented employees were in different categories.

Vice Mayor Scharff said 100 percent health benefits were no longer offered and said the calculation was determined by the hire date with the City.

Ms. Matsuura said there was detailed information available about which employee group people belonged to.

Vice Mayor Scharff said if a person was to leave in five years, they would not get the pension from the City for the health benefits. He thought that in 10 years a person would get half and in 20 years a person would get full benefits.

Ms. Matsuura said that was correct.



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Mr. Pelletier said it depended on the hire date.

Mr. Perez said it was a date issue, not a number issue because it depended on the contract and resolution date submitted with CalPERS and Staff entered the date of the contract.

Mr. Pelletier wanted to point out this was an issue in the audit.

Council Member Burt wanted to address why retirees after five years were eligible for benefits, but a person was at the same time not eligible.

Molly Stump, City Attorney said the City Auditor's Staff was accurate because the issue referred to eligibility of some health benefits and the level of benefits was a secondary question.

Vice Mayor Scharff asked how that applied if the number was zero.

Mr. Perez said if a person did not make the five year vesting, the number was zero, or if a person left before the age of 50, even if a person had five years or if the person did not retire from Palo Alto, they would not get benefits.

Council Member Burt asked if new employees received any benefit after five years.

Mr. Perez said a person had to be employed for 10 years.

Council Member Burt said the discussion was based on all employees but there were also legacy employees.

Mr. Perez said Staff could write a report stating exactly what a person would get on tier one, tier two, and so on and asked if there were any questions on the CAFR.

Council Member Burt asked about the 2011 recommendations for water exposure for the Information Technology (IT) Department assets and wanted to know if there was an implementation date established. He did not know how many facility areas the recommendations referred to and Staff did not appear to have a plan with a defined completion date.

Mr. Perez said, regarding the last discussion with Jonathan Reichental, Chief Information Officer, there were too many fiscal servers. He was in the



FINANCE COMMITTEE DRAFT MINUTES

process of reconfiguring the room and was working with Public Works on how to make changes. Mr. Reichental was definitely aware of this.

Council Member Burt asked if the second floor was the most crucial.

Mr. Perez said yes, it was one of them, but he could check and bring them up to date.

Council Member Burt asked if it was all under the same circumstance as water-based fire suppression.

Mr. Perez said he could not answer with certainty but said all floors had a sprinkler system.

Council Member Burt said in terms of disaster resiliency, the City was in jeopardy. A plan was a reduction in servers but there was no plan on a location.

Mr. Perez said he knew it was an area of concern.

Council Member Burt said the rest was physical space. It was the responsibility of other departments to provide the space for IT and it was a collaborative effort. On the second floor he saw an effort to reduce and implement a suppression system.

Mr. Perez requested to follow up because he did not know the answer at this time.

Council Member Burt asked if there were any others that had appropriate comments on status of implementation.

Mr. Perez referred to Raj Patel, Information Technology Security Manager who was heavily involved in planning. Part of the problem was lack of resources. Mr. Reichental was hiring an IT Governance position to assist with the systems that were needed and looking at the businesses that were needed, and then accessing projects in the queue and in other systems. The best thing to do was to move it out of Administrative Services Department (ASD) and for it to have its own department. The resources were going to be provided as he needed them because it was critical.

Vice Mayor Scharff was concerned because a lot of the discussion revolved around IT and projects that were not happening. He said he was also



FINANCE COMMITTEE DRAFT MINUTES

concerned that Mr. Reichental was not getting the support he needed. He requested a report stating items that were done by a certain date.

Mr. Perez said he asked for a contract for temporary staffing to address these issues.

Vice Mayor Scharff said topics like these tend to be forgotten and wanted a follow up in the form of an Informational Report.

Chair Shepard asked if Mr. Reichental was connected to Finance or with Policy and Services.

Mr. Perez said Mr. Reichental was connected with the Finance Committee. He said it might be a capital program to redo the rooms.

Chair Shepherd asked what the routine was for updating Council.

Mr. Perez said the Year-end Audit or the Budget Process would address this.

Council Member Price asked if Mr. Reichental could be present to speak about these issues to the Finance Committee. She thought it was helpful to hear directly about the projects, the timing, and the resources.

Mr. Pelletier added that since the contract was managed under the Auditor's Office, one option was, in addition to follow up, that he could also follow up on open recommendations from this Audit and provide the Finance Committee with a status report.

Chair Shepherd said the Finance Committee includes the City Auditor.

Mr. Pelletier said the City Auditor's Office could do a formal follow-up with IT, asking them questions about the status so it could be formally documented as part of the process.

Chair Shepherd asked about recommendations on the close of the Fiscal Year (FY) and authorization of the reapportionment.

Laura Kuyrk, Accounting Manager discussed the overview for FY 2012 and discussed Economic Revenue Sources. On the expense side, the salary and benefits were taking effect in the budget. There were significant concession in the form of salary and benefit reductions that increased employee contribution to pensions and medical. With regard to the Financial



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Summary, there were Tax Revenue Sources in FY 2012 that were star performers: the Sales Tax and Transient Occupancy Tax (TOT). The year over year changes for the General Fund Tax Revenue Categories, in the category of the Sales Tax had a 6.7 percent increase from \$20,746,000 million in FY 2011 to \$22,132,000 in FY 2012. The TOT had a 19.8 percent increase year over year from \$8,082,000 to \$9.6 million. The Utility User Tax stayed flat, while the Documentary Transfer Tax showed a slight decrease. The Paramedic Fees and Plan and Zoning Fees increases were the primary drivers of the revenue increase that allowed the transfer of funds to the Infrastructure Fund. The combination of increased revenue and the expenses that were slightly lower resulted in a net surplus of \$4.4 million for the FY 2012. Combining that figure with the Budget Stabilization Reserve (BSR) balance of \$31.3 million created the opportunity of a transfer of \$7.6 million out of BSR Fund and into the Infrastructure Reserve Fund. The remaining BSR balance of \$28.1 million represented the 18.5 percent of FY 2013 budgeted expenses. The FY 2012 General Fund expenses were slightly less than the Mid-year Budgeted Amounts, which included increases for Retiree Medical Expenses, as well as an adjustment for Labor Concessions. The FY 2012 estimated Labor Concessions was \$3.6 million for the General Fund. In the year over year deficit and surplus for the Enterprise Funds, all funds were at a net surplus position, except for the Refuse and Airport Funds. The Refuse Funds expenses exceeded revenues by \$474,000 because there was an increased Contract Service Costs due more Smart Stations and a retirement of assets, like the closing of the landfill. The Refuse Rate Stabilization Reserve (RSR) balance improved from a \$5 million negative position to a \$4.1 negative position. The negative RSR was created to recognize landfill post-closure liability. The Airport Fund had expenses of \$148,000 and no revenue; the expenses were funded by a General Fund loan. As of June 30, 2012, the amount of the loan was \$300,000 with approximately \$138,000 leftover to spend. There was an additional loan of \$310,000 budgeted for FY 2013. The CalPERS Rates were submitted, which solidified the rates for the June 30th, FY 2014, which changed the projection for FY's 2015 and 2016.

Vice Mayor Scharff asked for clarification on what the rates meant.

Mr. Perez said the majority of employees were paying the employee share, which was used to calculate the Annual Required Contribution. Staff took the rate of 1.6 percent and embedded that into the Long-range Financial Forecast Report scheduled to be presented to Council on January 18, 2013



FINANCE COMMITTEE DRAFT MINUTES

where they can explain the change in dollars.

Vice Mayor Scharff asked what the number 30 referred to.

Mr. Perez said for every dollar of wages, 30 cents went toward pension.

Vice Mayor Scharff clarified that the 30 cents was what the City paid. He said the numbers would be higher if the employees did not pay their portion.

Mr. Perez thought it was important to give credit to the employees to try to reduce the overall costs for the City. In the first year, Staff urged the City Council not to put funds into the Infrastructure Reserve because they were not sure where the Safety Labor Agreements were headed and because the budgets were unstable. The Sales Tax was just shy of the FY 2008 number. He said a future presentation by Staff will show a better picture of compensation, benefits, and returns on revenue. Staff expected to continue the returns and have a balanced budget. He thought it was good to transfer the remaining dollars to Infrastructure Reserve Fund now, which showed Staff was taking strides to get back on track.

Council Member Burt asked about the timeline when employees paid their share because they did not all start paying at the same time.

Mr. Perez answered that October was the time line for the majority of miscellaneous employees. Employees went from paying two percent to seven or eight percent and the Safety Managers paid nine percent.

Council Member Burt asked if Staff was changing how the groups were defined.

Mr. Perez asked if Council Member Burt was interested in what changed the number.

Council Member Burt said there was a significant jump from 2013 to 2015.

Mr. Perez said there were two contributions to the jump in numbers, one was the rate of return, and the other was the latest update in retirement, demographics, and life expectancy.

Council Member Burt asked if that drove up the employer rates.

Mr. Perez said the rate of return can drive the number up or down.



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Council Member Burt recalled that CalPERS was moving toward the change, rather than leveling out and that there were year to year changes.

Mr. Perez said yes, that was not imbedded in these amounts.

Council Member Burt asked how the June 30, 2012 year affected these numbers and did the average level out the numbers.

Mr. Perez needed to clarify with the Actuary on that question. He said it was a major component of the change and wanted to confirm the time period covered before answering.

Council Member Burt looked at the 2012 Adjusted and Actual Budget and asked if the FY 2011 had one exceptional transaction that drove the number up.

Mr. Perez said yes and Staff was not expecting to see those types of transactions. Staff was comparing FY 2012 with the FY 2013 and in 2013 the numbers were trending better than budgeted; they were probably going to adjust the budget at mid-year.

Council Member Burt asked if considering the variables, if it was possible to extrapolate a year.

Mr. Perez said the first quarter was tough because Staff did not have a full data set. He said he felt better looking at a mid-year trend.

Council Member Burt said the percentages were more helpful and asked about FY 2013.

Joe Saccio, Assistant Director of Administrative Services said Staff was trying to be more aggressive in the estimates with the revenue.

Council Member Burt wanted clarification for the word "aggressive".

Mr. Saccio said aggressive meant less conservative. He attended a lot of conferences on forecasting and the data indicated that the growth, revenue, and job creation looked like it was growing. He thought there was going to be a number of adjustments at mid-year above the adopted budget. The TOT was taking a steep upward slope and there was only one item that was suffering. The Long Range Financial Forecast was delivered in December and will have numbers above the projected forecast.



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Council Member Burt asked if the TOT was at 85 percent and said it was an effective four day per week business week.

Mr. Perez said the major hotels said the weekends were big.

Council Member Burt said there was a lot of work that drove up supply and demand and asked if Staff was aware when new hotels would open.

Mr. Saccio thought there were at least two that were going to open in 2013 and 2014.

Vice Mayor Scharff asked what the names of the hotels were.

Mr. Saccio said he did not know.

Council Member Burt appreciated that Staff did not include the projection of the hotels in the Financial Report Projections.

Mr. Perez said it was not in the base but it was in the discussion and he offered to create scenarios for projection.

Council Member Burt talked about a City Council discussion in 2008 on how to fund the police building and said they talked about using revenue from new hotels. He wanted to know when Staff could move forward with a discussion on revenue from new hotels.

Chair Shepherd asked Council Member Burt if he wanted to put this up for discussion as an item on the Finance Committee or to be a contributor to retreat.

Mr. Perez said there were certain pieces that connected with the Finance Committee and said it made sense for the discussion to go through them.

Council Member Burt said the first step was to go to the retreat and possibly have a discussion with the Finance Committee. He thought the Finance Committee could try to get this discussion to be part of the retreat agenda.

Council Member Price asked when in the cycle of discussion on tax options and the increase to the TOT was going to be.

Mr. Perez said the discussion would start once Staff identified the list of needs and what they planned on accomplishing.



FINANCE COMMITTEE DRAFT MINUTES

Chair Shepherd said they sent out to the Request for Proposal (RFP) to get polling done, which included what people would vote for and how to tax to pay for that vote.

Mr. Perez said City Council poled before but it was better to have the discussion when they had more specific data.

Chair Shepherd wanted to know what percentage of the budget went to salary and benefits in order to help Council have the right discussions. The Cost of Service Study helped to analyze how to prioritize the services and she wanted to know if anything changed and can they reconfigure the salary and budget overall.

Mr. Perez said this discussion had to do with framing the City structure because 63 percent went into salary and benefits and 8 to 10 percent went into Enterprise Funds. The typical view was to address services and needs. He thought Staff and Council needed to look at what services they supported and how they supported them.

Chair Shepherd said she needed to have confidence that the incremental changes made that changed Palo Alto's future. She wanted to understand, in historical proportion, how health care benefits jumped exponentially. She thought it was good for Staff to exercise care with how Staff decided to bring items before Council so there was not a transaction for everything discussed.

Mr. Perez said Blue Shield Healthcare announced an 18 percent increase.

Chair Shepherd said this was the problem with projection. She wanted Staff to look at the historic trends to try to proportion the thinking. She wanted bring Infrastructure back for discussion as well.

Mr. Perez thought revisiting the policy for transfers was a good idea.

Mr. Saccio related what the Santa Monica City Manager said at a conference about the cost of pensions and medical costs and how Cities like Palo Alto and Santa Monica were not away from risk, in terms of employee costs. The speaker said costs were a structural deficit because the trends go up and down.

Chair Shepherd suspected there would be difficulties with investments.

Vice Mayor Scharff asked in terms of the long-range forecast, if Palo Alto had



FINANCE COMMITTEE DRAFT MINUTES

enough revenue to stay out of debt.

Mr. Perez projected that Palo Alto had a positive balance for the next year and but said CalPERS still needed to update their rates.

Council Member Price said the other part of the discussion was educating the community, asking them if they wanted the same services that Palo Alto provides.

Mr. Perez hoped that with all the tools that were available with social media, there were many options for communicating information.

Vice Mayor Scharff looked at the Paramedic Service Fees and the Planning and Zoning Fees and said it was not possible to make a profit. He asked when these fees went up and if it was necessary to lower the fees for next year.

Mr. Perez said volume was driving some of the fees and they were allowing for more lending; volume drove the dollar figure up.

Vice Mayor Scharff clarified that there was a certain number of people and a projected number for volume.

Ms. Stump said budgeting was a matter of perspective and there was an ability to adjust because of rising and falling fees and costs.

Vice Mayor Scharff said next year the fees needed to be lowered if the volume was expected to stay same.

Mr. Perez said Staff removes positions to reduce the cost because the revenue was not coming in. It was not a year by year projection once Staff looked at the trend and then justified the costs.

Council Member Burt asked about long-term pension and medical liability over the coming years and asked once the liabilities hit, if it was possible for Staff build-in long term liability into the costs.

Mr. Perez said Staff knew they were only paying a portion of the unfunded fees. He talked about funding additional dollars to invest to pay above what the required contribution was. He knew Palo Alto was only 78 percent funded. He needed to check into it.



FINANCE COMMITTEE DRAFT MINUTES

Council Member Price remarked about the Planning and Zoning Fees and said if the fees were really accelerated then was it going to drive customers away. She said there was some sensitivity with regard to permits and where people would develop.

Mr. Perez did not want to discourage the enhancement of property because it correlated with the Property Tax Revenues.

Council Member Price said there was a connection between where people developed and the fees paid for developing.

Mr. Perez said yes, especially when the Impact Fees were added.

Council Member Burt said there was a limit and there were market forces in effect. He asked if Palo Alto might raise the property TOT and thought the market allowed for another raise. He thought Palo Alto needed to be cognizant of market forces and to recognize its strengths.

MOTION: Vice Mayor Scharff moved, seconded by Chair Shepherd to forward the ordinance and associated exhibits to the City Council for its approval to:

- Close the Fiscal Year (FY) 2012 Budget;
- Authorize re-appropriation of FY 2012 funds into the FY 2013 Budget;
- Close completed capital improvement projects , and
- Transfer remaining balances to the appropriate reserves (Table 1 for General Fund and Exhibits 5 and 6 for Enterprise Funds), including the transfer of the General Fund surplus of \$7.6 million from the General Fund to the Infrastructure Reserve in the Capital Projects Fund.

Staff recommends the Finance Committee review and forward to the City Council for its approval the City's FY 2012 Comprehensive Annual Financial Report (CAFR).

In addition, direct the City Manager and Mayor to bring to the annual Council retreat whether to refer to the Finance Committee consideration of dedicating certain revenue streams to certain infrastructure projects.

MOTION PASSED: 4-0