



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

January 13, 2014

The Honorable City Council
Palo Alto, California

Finance Committee Recommendation to Accept Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2013 and Management Letter

The Office of the City Auditor recommends acceptance of Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2013 and Management Letter. At its meeting on November 19, 2013, the Finance Committee approved and unanimously recommended the City Council accept this report. The Finance Committee minutes are included in this packet.

Respectfully submitted,

Houman Boussina
Acting City Auditor

ATTACHMENTS:

- Attachment A: Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2013 and Management Letter (PDF)
- Attachment B: Finance Committee Meeting Minutes Excerpt (November 19, 2013) (PDF)

Department Head: Houman Boussina, Acting City Auditor



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

November 19, 2013

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

Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2013 and Management Letter

RECOMMENDATION

We recommend the Finance Committee review and forward to the City Council for its approval the City of Palo Alto's audited financial statements for the fiscal year ended June 30, 2013 and the accompanying reports provided by Macias Gini & O'Connell LLP.

DISCUSSION

The City Charter requires the City Council (through the City Auditor) to engage an independent certified public accounting firm to conduct the annual external audit and report the results of the audit in writing to the City Council. Macias Gini & O'Connell LLP, a certified public accounting firm based in Sacramento, California, conducted the audits of the City's financial statements for the fiscal year ended June 30, 2013.

The Comprehensive Annual Financial Report (CAFR) and Single Audit Report including the following Independent Auditor's Reports are provided to the Finance Committee by the Administrative Services Department:

- Independent Auditor's Report on the Financial Statements (CAFR)
- 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 (Single Audit Report)
- Independent Auditor's Report on Compliance for Each Major Program and on Internal Control over Compliance Required by OMB Circular A-133 (Single Audit Report)

We are providing copies of the following financial statements and reports as prepared by MGO:

- Report to the City Council (the "Management Letter") – Attachment A
- Independent Accountant's Report on Applying Agreed-Upon Procedures Related to the Article XIII-B Appropriations Limit for the year ended June 30, 2013 – Attachment B
- Pedestrian/Bicycle Facilities Grants Metropolitan Transportation Commission Transportation Development Act Funds, Article III Independent Auditor's Reports, Financial Statements and Supplementary Information for the year ended June 30, 2013 – Attachment C

- 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 year ended June 30, 2013 – Attachment D
- Public Improvement Corporation (a Component Unit of the City of Palo Alto) Annual Financial Report for the year ended June 30, 2013 – Attachment E
- Regional Water Quality Control Plant Independent Auditor's Report for the year ended June 30, 2013 – Attachment F
- Cable TV Franchise Independent Auditor's Report and Statements of Franchise Revenues and Expenditures for the years ended December 31, 2012 and 2013 – Attachment G

I would like to express appreciation to Macias Gini & O'Connell, and Laura Kuryk and her staff in the Administrative Services Department for their hard work and cooperation during the audit.

ATTACHMENTS:

- Attachment A: Report to the City Council FY 2013 (PDF)
- Attachment B: Palo Alto GANN FY 2013 (PDF)
- Attachment C: Palo Alto Transportation Development Act Funds FY 2013 (PDF)
- Attachment D: Palo Alto General Obligation Bonds FY 2013 (PDF)
- Attachment E: Palo Alto Public Improvement Corporation FY 2013 (PDF)
- Attachment F: Palo Alto Regional Water Quality Control Plant FY 2013 (PDF)
- Attachment G: Palo Alto Cable TV Franchise FY 2013 (PDF)

Department Head: Houman Boussina, Acting City Auditor

CITY OF PALO ALTO

Report to the City Council

For the Year Ended June 30, 2013

**CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013**

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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
Palo Alto, California

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Palo Alto, California (City) as of and for the year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control 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 or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Following this letter, we have included a report on required communications to the governing body, 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 Finance 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 & Counsel LLP

Walnut Creek, California
November 8, 2013

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CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013

REQUIRED COMMUNICATIONS

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Palo Alto (City) as of and for the year ended June 30, 2013. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards and *Government Auditing Standards*, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated July 30, 2013. Professional auditing standards require that we communicate to you the following information related to our audit.

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. The City implemented four new Governmental Accounting Standards Board (GASB) pronouncements, consisting of GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*; GASB Statement No. 61, *The Financial Reporting Entity: Omnibus*; GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*; and GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*. 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.

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.

CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013

REQUIRED COMMUNICATIONS (Continued)

- *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.

Certain financial statements disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the disclosure of the City's Pension Plan in Note 11, the Retiree Health Benefits in Note 12 and the commitments and contingencies in Note 16.

The financial statement disclosures are neutral, consistent, and clear.

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.

The City identified a note receivable in the amount of \$3,000,000 that was expensed in the year made (i.e., fiscal year 2009) rather than treating it as an asset and, accordingly, reversed the expenditure during the current year and restored the note receivable. The restoration of the note receivable should have been reported as a restatement of beginning fund balance, however, it is immaterial to the financial statements.

During the audit, it has come to our attention that the City Auditor's Office has identified accounting misstatements and internal control deficiencies over the reporting of inventories throughout the City. We met with the City Auditor's Office and with management to assess the impact of these findings to the City's financial statements. We believe the misstatements identified in the City's inventory balances do not materially misstate the financial statements.

CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013

REQUIRED COMMUNICATIONS (Continued)

Disagreements with Management

For purposes of this letter, a disagreement with management is 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 8, 2013.

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
Report to the City Council
For the Year Ended June 30, 2013

CURRENT YEAR RECOMMENDATIONS

None noted.

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. 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 Chief Information Officer (CIO), 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 CIO has budgeted for the development of a disaster recovery plan. The project was initiated in March 2013 and is expected to be completed by June 2014.

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's CIO, 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:

Corrected. The City's Information Security Manager (ISM) conducted the feasibility study of implementing a gas-based fire suppression system and found that impractical due to the physical architecture limitations of the server room. The cost to retrofit the room would be excessive and would cause unrealistic delays in service.

**CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013**

STATUS OF PRIOR YEAR RECOMMENDATIONS (CONTINUED)

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

In order to mitigate the risk of the water-based system, the following countermeasures have been implemented:

- The ISM verified the server room has a dry-pipe fire suppression system with high temperature sprinkler heads and requires the activation of both a smoke sensor and the high temperature before water is released into the pipes.
- Automated temperature and humidity monitoring devices have been installed.
- A disaster recovery plan development project has begun and is expected to be completed by June 2014.
- Several core IT systems are currently being moved to off-site premises.

**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. The City's ISM has conducted a preliminary security assessment to identify areas of improvement. The ISM has initiated an Information Security Risk Assessment project to conduct a comprehensive assessment based on ISO 27001/2 by June 2014. The risk assessment will also include network penetration testing.

CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013

STATUS OF PRIOR YEAR RECOMMENDATIONS (CONTINUED)

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.

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. The ISM's draft password policy, as reported in Finding 6, is planned for release in June 2014. Additionally, the ISM has developed an information privacy policy and is in the process of developing information security policies that are aligned to ISO 27001 standards. The written and formal policies are expected to be released in June 2014.

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.

CITY OF PALO ALTO
Report to the City Council
For the Year Ended June 30, 2013

STATUS OF PRIOR YEAR RECOMMENDATIONS (CONTINUED)

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

Current Year Status:

Corrected. The City's ISM, in December 2012, conducted a PCI-DSS risk-assessment. As a result of the assessment, several additional security measures have been implemented including:

- Encrypting PCI stored data.
- Replacement of the network firewall with two Barracuda Next Generation firewalls.
- Development of password, information privacy and information security policies.
- Conducting PCI-DSS compliance training to the City's technical staff.

CITY OF PALO ALTO, CALIFORNIA

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

For the Year Ended June 30, 2013

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

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

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, 2013. These procedures, which were agreed to by the City and the League of California Cities (as presented in the publication entitled *Article XIII B Appropriations Limit Uniform Guidelines*), 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 audit, 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 8, 2013

CITY OF PALO ALTO, CALIFORNIA
Appropriations Limit Worksheet
For the Year Ended June 30, 2013

Appropriations limit, fiscal year 2011-2012		\$ 118,995,555
Adjustment factors:		
Population growth	$\frac{1.24+100}{100}$	1.0124
Inflation	$\frac{3.77+100}{100}$	<u>1.0377</u>
Appropriations limit, fiscal year 2012-2013		<u><u>\$ 125,012,860</u></u>

CITY OF PALO ALTO, CALIFORNIA

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

Independent Auditor's Reports,
Financial Statements and
Supplementary Information

For the Year Ended June 30, 2013

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grants
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 For the Year Ended June 30, 2013

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Sacramento

Oakland

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Independent Auditor's Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of the Pedestrian/Bicycle Facilities Grants (Grants) made to the City of Palo Alto, California (City), by the Metropolitan Transportation Commission, Transportation Development Act Funds, Article III as of and for the year ended June 30, 2013, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Grants as of June 30, 2013, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As described in Note 1 to the financial statements, the financial statements of the Grants 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 Grants. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2013, and changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters***Other Information***

Our audit was conducted for the purpose of forming an opinion on the financial statements. The accompanying schedule of construction projects with capital outlay expenditures (Schedule) is presented for purposes of additional analysis and is not a required part of the financial statements. The Schedule 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. Such 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 Schedule is fairly stated, in all material respects, in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 8, 2013 on our consideration of the City's internal control over the Grants' 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* in considering the City's internal control over the Grants' financial reporting and compliance.

Macias Gini & Cannelo LLP

Walnut Creek, California
November 8, 2013

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grants
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 Balance Sheet
 June 30, 2013

Assets

Due from the Metropolitan Transportation Commission	\$	15,000
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**Liabilities, Deferred Inflows of Resources
and Fund Balance Deficit**

Liabilities:

Due to the City of Palo Alto	\$	15,000
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Deferred inflows of resources:

Unavailable Revenue		15,000
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Fund balance deficit:

Unassigned		(15,000)
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Total liabilities, deferred inflows of resources and fund balance deficit	\$	15,000
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See accompanying notes to the financial statements.

CITY OF PALO ALTO, CALIFORNIA
 Pedestrian/Bicycle Facilities Grants
 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, 2013

Revenues		
Grant	\$	-
Expenditures		
Capital outlay		<u>15,000</u>
Excess (deficiency) of revenues over (under) expenditures		(15,000)
Fund Balance - beginning of year		<u>-</u>
Fund Balance (Deficit) - end of year	\$	<u><u>(15,000)</u></u>

See accompanying notes to the financial statements.

CITY OF PALO ALTO, CALIFORNIA
Pedestrian/Bicycle Facilities Grants
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III
Notes to the Financial Statements
For the Year Ended June 30, 2013

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 Grants (Grants) have 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 60 days after year-end).

(c) *Fund Balance (Deficit)*

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, 2013, the Grants reported a fund balance deficit of \$15,000. The fund balance deficit will be cured once the grant reimbursement becomes available to repay the funds advanced from the City.

(d) *Due to the City of Palo Alto*

Cash has been advanced to the Grants' 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 receipt of reimbursement from the Metropolitan Transportation Commission.

CITY OF PALO ALTO, CALIFORNIA
Pedestrian/Bicycle Facilities Grants
Metropolitan Transportation Commission
Transportation Development Act Funds, Article III
Notes to the Financial Statements (Continued)
For the Year Ended June 30, 2013

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 Grants
 Metropolitan Transportation Commission
 Transportation Development Act Funds, Article III
 Schedule of Construction Projects with Capital Outlay Expenditures
 For the Year Ended June 30, 2013

The following schedule identifies the projects with capital outlay expenditures during fiscal year 2013:

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, 2012	Current Year Capital Outlay Expenditures	Cumulative Capital Outlay Expenditures as of June 30, 2013	Status of Project
TDA 11-12 Bicycle Detection at Traffic Signals	12001042	\$ 55,597	\$ -	\$ 55,597	\$ -	\$ -	\$ -	On-going
TDA 12-13 Fabian Way Enhanced Bike Lane Improvements	13001027	-	43,359	43,359	-	15,000	15,000	On-going
		\$ 55,597	\$ 43,359	\$ 98,956	\$ -	\$ 15,000	\$ 15,000	

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**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**

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

We have audited, in accordance with the 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, the accompanying financial statements of the Pedestrian/Bicycle Facilities Grants (Grants) made to the City of Palo Alto, California (City), by the Metropolitan Transportation Commission, Transportation Development Act Funds, Article III as of and for the year ended June 30, 2013, and the related notes to the financial statements, and have issued our report thereon dated November 8, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the City’s internal control over the Grants’ financial reporting to determine the auditing procedures that are appropriate in the circumstances 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 Grants’ financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City’s internal control over the Grants’ 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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Grants' 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.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control over compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Macias Gini & Connell LLP

Walnut Creek, California
November 8, 2013

**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, 2013

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

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Independent Auditor's Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund (Fund), a fund of the City of Palo Alto, California (City), as of and for the year ended June 30, 2013, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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, 2013, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note 2(a) to the financial statements, the financial statements present only the Fund and do not purport to, and do not, present fairly the financial position of the City as of June 30, 2013, and the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 8, 2013 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 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* in considering the City's internal control over the Fund's financial reporting and compliance.

Macias Gini & Connell LLP

Walnut Creek, California
November 8, 2013

CITY OF PALO ALTO
GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND
(A Fund of the City of Palo Alto)
Balance Sheet
June 30, 2013

Assets

Restricted cash and investments (Note 3)	<u>\$ 33,898,552</u>
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Liabilities and Fund Balance

Liabilities:

Accounts payable and accrued liabilities	\$ 1,345,298
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Fund Balance:

Restricted for capital projects	<u>32,553,254</u>
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Total liabilities and fund balance	<u>\$ 33,898,552</u>
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See accompanying notes to the 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, 2013

Revenues	
Investment income	\$ 33,642
Expenditures	
Capital outlay:	
Downtown Library	15,039
Mitchell Park Library and Community Center	8,842,373
Main Library new construction and improvements	615,093
Temporary Facility	132,996
Total capital outlay	9,605,501
Debt service - costs of issuance	540,399
Total expenditures	10,145,900
Excess (Deficiency) of Revenues over (under) Expenditures	(10,112,258)
Other Financing Sources (Uses)	
Proceeds from the issuance of bonds	20,695,000
Premium on bonds issued	1,011,615
Intergovernmental transfer to the City of Palo Alto's Library Project Debt Service Fund	(391,341)
Total other financing source (uses)	21,315,274
Net change in fund balance	11,203,016
Fund balance, beginning of the year	21,350,238
Fund balance, end of year	\$ 32,553,254

See accompanying notes to the 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, 2013

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 (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 Library Bonds are the first of two series of bonds to be sold and issued under the authorization to finance portion of the Project. During the fiscal year ended June 30, 2013, the remaining \$20,695,000 was authorized and issued.

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, 2013		
			Cumulative Bond Eligible Expenditures	Encumbrances Outstanding	Project Balance Remaining
Downtown Library Improvements	\$ 4,565,826	\$ 356,987	\$ 4,162,594	\$ 45,630	\$ 357,602
Mitchell Park Library	49,668,561	1,738,307	36,754,499	8,845,323	4,068,739
Library and Community Center Temporary Facility	795,387	155,529	504,597	23,861	266,929
Main Library New Construction and Improvements	25,134,783	428,630	2,292,350	20,391,916	2,450,517
Temporary Facility	542,218	42,355	229,431	4,888	307,899
Total	\$ 80,706,775	\$ 2,721,808	\$ 43,943,471	\$ 29,311,618	\$ 7,451,686

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES**(a) Reporting Entity**

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, 2013, and the changes in its financial position for the year then ended in accordance 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, 2013

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, 2013.

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 \$0.4 million to the City in order to allocate the bond proceeds to the City's debt service fund to be used for future debt service payments.

(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, 2013

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 Library Bonds 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 (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	\$ 33,818,677	37 days	AAAm
Cash held with U.S. Bank	79,875	N/A	N/A

(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, 2013.

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

**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**

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

We have audited, in accordance with the 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, the financial statements of the City of Palo Alto General Obligation Bonds Capital Projects Fund (Fund), a fund of the City of Palo Alto, California (City), as of and for the year ended June 30, 2013, and the related notes to the financial statements, and have issued our report thereon dated November 8, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the City's internal control over the Fund's financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express 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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

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 or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Macias Gini & Connell LLP

Walnut Creek, California
November 8, 2013

Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

Independent Accountant's Report on Compliance with Measure N

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

We have examined the City of Palo Alto's (City) compliance with certain provisions of Measure N for the year ended June 30, 2013, 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, 2013, 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, 2013.

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 8, 2013

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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, 2013

Current Year Findings:

No matters were noted.

Status of Prior Year Findings:

No matters were noted.

**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, 2013

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
For the Year Ended June 30, 2013

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Independent Auditor's Report

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

We have audited the accompanying financial statements of the governmental activities and the major fund of the City of Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto, California (City), as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the major fund of the Corporation as of June 30, 2013, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 4 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 & Cunnell LLP

Walnut Creek, California

November 8, 2013

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Management's Discussion & Analysis (Unaudited)
For the Year Ended June 30, 2013

The City of 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 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 one debt issue outstanding and has turned the proceeds over to the City, which pledged certain lease payments as collateral for this debt as discussed in Note 4 to the financial statements.

FISCAL 2013 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 while the individual fund statements do not.

In fiscal year 2002, the Corporation 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.

As of June 30, 2013, the 2002B Downtown Parking Improvements COPs comprise the Corporation's outstanding debt.

Interest and fiscal agent charges were \$107 thousand for fiscal year 2013, a decrease of \$39 thousand from the prior year. The interest for leases on the assets securing this COP issues was \$110 thousand, a decrease of \$114 thousand from the prior year. The interest on leases from the City exceeded interest expense by \$3 thousand, thereby resulting in an increase in net position of \$3 thousand over the prior year.

The Corporation ended fiscal year 2013 with total assets of \$1.8 million, a decrease of \$0.1 million from the prior year. Total assets consist of \$251 thousand in cash and investments and \$1.6 million of leases receivable from the City of Palo Alto. Total liabilities were \$1.6 million, a decrease of \$0.1 million from the prior year, and included \$164 thousand of current liabilities as well as \$1.4 million of long-term debt due in more than one year.

At the fund level, the Corporation's revenues nearly equaled the expenditures. As of June 30, 2013, the Corporation had one fund, the Debt Service Fund, which reported a \$251 thousand restricted fund balance.

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Management's Discussion & Analysis (Unaudited)
For the Year Ended June 30, 2013

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 position and the statement of activities. The statement of net position 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 position 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 along with the notes to the financial 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.

As of June 30, 2013, the Corporation has one outstanding debt related to the 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 CORPORATION'S FINANCIAL MANAGEMENT

These Basic Financial Statements are intended to provide citizens, taxpayers, investors, and creditors with a general overview of the Corporation'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 Position
June 30, 2013

Assets

Cash and investments held for operations	\$ 12,813
Cash and investments held by trustee	237,966
Investment in leases to the City of Palo Alto	<u>1,560,000</u>
Total assets	<u>1,810,779</u>

Liabilities

Interest payable	33,800
Long-term debt:	
Due in one year	130,000
Due in more than one year	<u>1,430,000</u>
Total liabilities	<u>1,593,800</u>

Net Position

Restricted for debt service	<u><u>\$ 216,979</u></u>
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See accompanying notes to the basic 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, 2013

Expenses

Interest and fiscal agent charges	\$ 106,817
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Program revenues

Interest on leases from the City of Palo Alto	109,525
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Net program revenues	<u>2,708</u>
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General Revenues

Investment losses	<u>(54)</u>
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Change in net position	2,654
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Net position, beginning of the year	<u>214,325</u>
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Net position, end of the year	<u><u>\$ 216,979</u></u>
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See accompanying notes to the basic financial statements.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
 Balance Sheet
 Debt Service Fund
 June 30, 2013

Assets

Cash and investments held for operations	\$ 12,813
Cash and investments held by trustee	237,966
Investment in leases to City of Palo Alto	1,560,000
Total assets	<u>\$ 1,810,779</u>

Liabilities and Fund Balance

Liabilities:	
Deferred revenue	\$ 1,560,000
Fund balance:	
Restricted for debt service	250,779
Total liabilities and fund balance	<u>\$ 1,810,779</u>

Reconciliation of fund balance to net position

Fund balance restricted for debt service	\$ 250,779
Accrual adjustment to remove deferred revenue from the balance sheet	1,560,000
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	(33,800)
Long-term debt due within one year	(130,000)
Long-term debt due in more than one year	<u>(1,430,000)</u>
Net position of governmental activities	<u>\$ 216,979</u>

See accompanying notes to the basic 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, 2013

Revenues:

Lease receipts from the City of Palo Alto:

Principal	\$ 125,000
Interest	109,525
Investment losses	(54)
Total revenues	234,471

Expenditures:

Debt service:

Principal repayment	125,000
Interest and fiscal agent charges	109,525
Total expenditures	234,525
Net change in fund balance	(54)
Fund balance, beginning of the year	250,833
Fund balance, end of the year	\$ 250,779

Reconciliation of net change in fund balance to net change in net position

Net change in fund balances-total governmental funds	\$ (54)
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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 position the repayment reduces long-term liabilities.	125,000
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Some amounts reported in the statement of revenues, expenditures and changes in fund balances reflect the collection of an asset which are not includable as revenues on the statement of activities.

Change in deferred revenue	(125,000)
Change in interest payable	2,708
Change in net position of governmental activities	\$ 2,654

See accompanying notes to the basic financial statements.

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
 Notes to the Basic Financial Statements
 For the Year Ended June 30, 2013

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, 2013.

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation

Government-wide Statements: The statement of net position 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. The emphasis of fund financial statements is on major individual funds, of which the Corporation only reports one debt service fund.

(b) Major Fund

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.

(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.

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Notes to the Basic Financial Statements
For the Year Ended June 30, 2013

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES (continued)

(d) Net Position

The government-wide financial statements utilize a net position presentation. Net position is further categorized as net investment in capital assets, restricted and/or unrestricted. As of June 30, 2013, the entire net position was considered restricted.

Restricted Net Position – 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, 2013, 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.

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 held for purposes of bond reserves.

(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>Weighted Average Maturity</u>
Money Market Mutual Funds	<u>\$ 237,966</u>	57 days

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Notes to the Basic Financial Statements
For the Year Ended June 30, 2013

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

(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, 2013 for the Money Market Mutual Funds is AAAM, 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 statutes. 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.

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment in One Issuer
U.S. Government Securities	10 years	N/A	No Limit	No Limit
U.S. Government Agency Securities	10 years	N/A	No Limit (A)	No Limit
Certificates of Deposit	10 years	N/A	20%	10% of the par value of portfolio
Bankers Acceptances	180 days	N/A	30%	\$5 million
Commercial Paper	270 days	AAA	15%	\$3 million (B) \$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	No Limit	No Limit
Mutual Funds	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.

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
(A Component Unit of the City of Palo Alto)
Notes to the Basic Financial Statements
For the Year Ended June 30, 2013

NOTE 4 – CERTIFICATES OF PARTICIPATION

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

	Balance June 30, 2012	Retirements	Balance June 30, 2013	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
2002B Downtown Parking				
Improvements				
4.55 - 6.50%, due 03/01/2022	\$ 1,685,000	\$ 125,000	\$ 1,560,000	\$ 130,000

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.

The COPs are payable and secured by lease revenues received by the Corporation from any City of Palo Alto 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
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	170,000	63,375	233,375
2019-2022	805,000	134,550	939,550
Total	\$ 1,560,000	\$ 549,575	\$ 2,109,575

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

Independent Auditor's Report

For the Year Ended
June 30, 2013

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

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Independent Auditor's Report

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

We have audited the accompanying Statements of Net Expenditures and Net Changes in Commitments and Quarterly Billings of the City of Palo Alto Regional Water Quality Control Plant (Plant), an enterprise operation of the City of Palo Alto, California (City), for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the Plant's financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting 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, as described in Note 2 of the financial statements. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 2 of the financial statements, the financial statements are prepared by the City of Palo Alto on the basis of the financial reporting 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, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of this agreement.

The effects on the financial statements of the variances between the contractual basis of accounting described in Note 2 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter discussed in the “Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles” paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of the Plant as of June 30, 2013, or changes in financial position for the year then ended.

Unmodified Opinion on Contractual Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the revenues, expenditures, commitments and billings of the Plant for the year ended June 30, 2013, in accordance with the financial reporting 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, described in Note 2.

Restriction on Use

This report is intended solely for the information and use of the City Council and management of the Cities of Palo Alto, 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 & Connell LLP

Walnut Creek, California
November 8, 2013

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
Statement of Net Expenditures and Net Changes in Commitments
For the Year Ended June 30, 2013

	Total	City of Mountain View	City of Los Altos	City of Palo Alto
Direct Expenditures:				
Source control program	\$ 1,094,080	\$ 417,282	\$ 107,876	\$ 568,922
Public outreach	78,814	30,060	7,771	40,983
Permitting and enforcement	1,099,393	415,680	24,627	659,086
Operations and maintenance	11,478,909	4,378,056	1,131,820	5,969,033
System improvement CIP (Note 3)	3,113,356	1,187,434	306,977	1,618,945
Total Direct Expenditures	<u>16,864,552</u>	<u>6,428,512</u>	<u>1,579,071</u>	<u>8,856,969</u>
Indirect Administrative Expenditures (Note 4):				
Source control program	773,799	295,127	76,297	402,375
Public outreach	1,191	454	117	620
Permitting and enforcement	378,990	143,296	8,489	227,205
Operations and maintenance	2,369,804	903,843	233,663	1,232,298
Total Indirect Expenditures	<u>3,523,784</u>	<u>1,342,720</u>	<u>318,566</u>	<u>1,862,498</u>
Debt Service Expenditures (Note 5):				
Refunding 1990 Series A Bonds	284,305	144,996	22,176	117,133
1999 Wastewater Treatment New Project	546,724	207,154	51,775	287,795
2009 State Water Resource Loan	555,726	210,565	52,627	292,534
Total Debt Service Expenditures	<u>1,386,755</u>	<u>562,715</u>	<u>126,578</u>	<u>697,462</u>
Total Expenditures	21,775,091	8,333,947	2,024,215	11,416,929
Deduct Joint Systems Revenues (Note 6)	<u>(191,919)</u>	<u>(73,198)</u>	<u>(18,923)</u>	<u>(99,798)</u>
Net Expenditures	21,583,172	8,260,749	2,005,292	11,317,131
Net Changes in Commitments	<u>(3,775,620)</u>	<u>(1,440,022)</u>	<u>(372,276)</u>	<u>(1,963,322)</u>
Net Expenditures and Net Changes in Commitments Due from Members	<u>\$ 17,807,552</u>	<u>\$ 6,820,727</u>	<u>\$ 1,633,016</u>	<u>\$ 9,353,809</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, 2013

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
Billings by Quarter, Beginning:		
July 1, 2012	\$ 1,833,238	\$ 499,301
October 1, 2013	2,121,864	515,677
January 1, 2013	1,833,238	499,301
April 1, 2013	<u>2,107,085</u>	<u>556,782</u>
Total quarterly billings	7,895,425	2,071,061
Net expenditures and net changes in commitments	<u>6,820,727</u>	<u>1,633,016</u>
Excess of total billings over net expenditures and net changes in commitments	<u>\$ 1,074,698</u>	<u>\$ 438,045</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, 2013

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. As of June 30, 2013, all commitments from the prior year in the amount of \$3,775,622 were completed. 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, 2013

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The percentages used for the year ended June 30, 2013, 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	38.14%	9.86%	52.00%
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	37.81%	2.24%	59.95%

The City is allocated 52.00% of total usage of the treatment plant. The City does not fully utilize its percentage allocation. Therefore, the City has entered into separate contracts to allocate portions of its excess to other entities. Fiscal year 2013 allocations are as follows:

East Palo Alto Sanitary District	6.41%
Stanford University	6.14%
Town of Los Altos Hills	1.28%
Remaining City Percentages	<u>38.17%</u>
Total	<u><u>52.00%</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 \$3,113,356 for fiscal year 2013.

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT

Notes to the Financial Statements (continued)
For the Year Ended June 30, 2013

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	\$ 1,669,500	\$ 573,771	\$ 3,017,767	\$ 5,261,038
City of Mountain View	1,657,688	1,170,493	2,996,416	5,824,597
City of Los Altos	414,312	179,017	748,906	1,342,235
East Palo Alto Sanitary District	334,250	273,115	604,186	1,211,551
Stanford University	230,125	94,099	415,971	740,195
Town of Los Altos Hills	69,125	4,590	124,949	198,664
Total	<u>\$ 4,375,000</u>	<u>\$ 2,295,085</u>	<u>\$ 7,908,195</u>	<u>\$ 14,578,280</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, 2013

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.

On May 1, 2013, Ambac Financial emerged from bankruptcy protection which had been filed under Chapter 11 of the Bankruptcy Code in November 2010. Ambac Assurance remains subject to rehabilitation proceedings undertaken by the Wisconsin Office of the Commissioner of Insurance. The City is not certain about the effect of the proceedings, if any, on the Surety Bond.

NOTE 6 – JOINT SYSTEM REVENUES

The Plant's joint system revenues for the year ended June 30, 2013 total \$191,919, which consisted of the following:

Salt water marsh services	\$ 7,500
Laboratory services from the City's Water Fund	44,547
Septic hauling services	135,126
Other revenues	4,746
	<u>\$ 191,919</u>

NOTE 7 – RELATED PARTY TRANSACTIONS

During fiscal year 2013, the Plant paid the City \$2,288,046 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 \$38,989 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.

CABLE TV FRANCHISE
Independent Auditor's Report
and Statements of Franchise
Revenues and Expenditures

For the Years Ended
December 31, 2012 and 2011

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Sacramento

Oakland

LA/Century City

Newport Beach

San Diego

Seattle

Independent Auditor's Report

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

We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2012 and 2011, and the related notes to the financial statements, which collectively comprise the Franchise's financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting 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 as described in Note 1 of the financial statements. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 1 of the financial statements, the financial statements are prepared by the City of Palo Alto on the basis of the financial reporting 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, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of this agreement.

The effects on the financial statements of the variances between the contractual basis of accounting described in Note 1 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter discussed in the “Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles” paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of the Franchise as of December 31, 2012 and 2011, or changes in financial position or cash flows for the years then ended.

Unmodified Opinion on Contractual Basis of Accounting

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, 2012 and 2011, in accordance with the financial reporting 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, described in Note 1.

Restriction on Use

This report is intended solely for the information and use of the governing bodies and management of 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, 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 8, 2013

CABLE TV FRANCHISE
 Statements of Franchise Revenues and Expenditures
 For the Years Ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Revenues:		
Franchise fees	<u>\$ 1,691,763</u>	<u>\$ 1,594,217</u>
Expenditures:		
Franchise administration	56,250	74,147
Consulting fees	<u>3,600</u>	<u>4,512</u>
Total expenditures	<u>59,850</u>	<u>78,659</u>
Net receipts	<u><u>\$ 1,631,913</u></u>	<u><u>\$ 1,515,558</u></u>

	<u>2012</u>		<u>2011</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$ 810,493	49.7%	\$ 750,929	49.5%
City of Menlo Park	429,336	26.3%	401,155	26.5%
City of East Palo Alto	114,205	7.0%	146,251	9.6%
Town of Atherton	160,212	9.8%	107,056	7.1%
County of Santa Clara	85,227	5.2%	78,879	5.2%
County of San Mateo	<u>32,440</u>	<u>2.0%</u>	<u>31,288</u>	<u>2.1%</u>
Total	<u><u>\$ 1,631,913</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 1,515,558</u></u>	<u><u>100.0%</u></u>

See accompanying notes to the financial statements.

CABLE TV FRANCHISE
Notes to the Financial Statements
For the Years Ended December 31, 2012 and 2011

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 (Franchise Agreement). 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 Agreement. The activities are administered by the City and are accounted for within the General Fund and the Technology 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 the Financial Statements
For the Years Ended December 31, 2012 and 2011

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.

The settlements and grant have been deposited and are being held by the City and earning interest. The City has since spent a part of the balance on various projects including installing and maintaining the institutional network equipment. As of December 31, 2012, the remaining balance on deposit with the City, including \$5,913 in interest receivable, was \$912,016.



FINANCE COMMITTEE WORKING MINUTES

Regular Meeting
November 19, 2013

The Finance Committee met on this date in the Council Chambers at 6:59 P.M., 250 Hamilton Avenue, Palo Alto, California.

Present: Berman, Burt (Chair), Shepherd, Schmid

Absent:

1. Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2013 and Management Letter.

Houman Boussina, Acting City Auditor, reported Macias Gini and O'Connell (MGO) presented eight reports including the City's Comprehensive Annual Financial Report (CAFR). MGO issued an unmodified opinion for all the City's basic financial statements, which meant MGO concluded that the statements were presented fairly in all material respects. MGO did not have any recommendations; however, the report to the Council contained the status of prior year recommendations. Of five outstanding significant deficiencies MGO reported in the prior year, two were corrected and three were in progress. Some recommendations covered areas that were also addressed in audits conducted by the Office of the City Auditor. Staff met with MGO to discuss concerns regarding internal control deficiencies and financial misstatements in the City's inventory balances. MGO shared Staff's concerns regarding controls over inventory management, but concluded overall that the City's financial statements were not materially misstated. The audits conducted by MGO focused on financial reporting and material misstatements. Audits conducted by the Office of the City Auditor addressed risks involving operational compliance and strategic objectives that may not necessarily have a material impact on the City's financial statements.

David Bullock, Macias Gini and O'Connell, provided eight reports and one Management Letter and issued unmodified opinions. The language of modified opinions changed because of new audit standards implemented in 2013. The City issued two financial statements which were not in accordance with Generally Accepted Accounting Principles (GAAP), the Cable TV Franchise audit and the Regional Water Quality Control Plant audit. Both reports were prepared in order to meet contractual requirements. The City's CAFR information was reported on a GAAP basis. MGO made one finding

WORKING MINUTES

regarding the federal awards audit under the City's procurement process. The Planning Department was required to ensure that vendors were eligible for federal contracts. That finding was considered to be an internal control finding rather than a compliance finding. One prior year finding related to the schedule of federal awards not being complete. Staff made necessary corrections to ensure grants were reported properly. The Management Letter encapsulated any comments and required communications. In accordance with new accounting pronouncements, the City implemented four new standards, none of which were significant. Two other statements were required to be implemented in the following two years. One affected reporting of debt, and the other affected pension obligations to employees. There were two items not corrected in the financial statements. One related to notes and the other to inventory.

Council Member Schmid requested Mr. Bullock comment on questions raised in 2011 regarding Information Technology (IT) security.

Mr. Bullock indicated MGO's IT experts helped identify areas for IT improvements. MGO issued six findings in 2011, one of which had been corrected. Two findings were corrected in 2013. The City determined one finding would not be implemented because of a cost-benefit analysis and because the City had other mitigating controls. The remaining three findings were in progress.

Jonathan Reichental, Chief Information Officer and Director of Information Technology, reported the IT Department extensively discussed the issue of the fire suppression system and visited several data centers to gain information. The fire suppression system was a dry pipe set-up. The temperature in the room had to reach a certain level before the system was invoked. By the time the system was invoked, the servers would be destroyed by fire. If smoke occurred in the server location, the Fire Service would inspect the room and attempt to extinguish a fire well before water sprayed the room. He remained concerned that the City had an extensive amount of equipment in one location without sufficient recourse or back-up equipment at a different location. Staff was in the process of moving core systems into the cloud, which was essentially another location. Moving data to the cloud would provide the best method for disaster recovery.

Council Member Schmid inquired whether Staff believed the cloud environment provided adequate security for City data.

Mr. Reichental answered yes. Staff would not move data to the cloud without sufficient diligence and assessment. Many vendors now provided secure cloud services specifically for government-related data.

WORKING MINUTES

Council Member Schmid asked if Staff would resolve the two critical issues by mid-year 2014.

Mr. Reichental indicated the City would be in a better position. Staff would uncover additional risks during a risk assessment. Protecting City data would never be complete because cyber attacks continued and became more sophisticated.

Council Member Schmid inquired about sensitive issues regarding estimates and fair value of investments.

Mr. Bullock reported the purpose of that portion of the audit was to identify those areas where numbers could be manipulated. MGO was required to report estimates contained in the financial statements, because estimates involved management's judgment. MGO highlighted areas in the financial statements where judgment was involved in recording estimates.

Council Member Schmid understood the City's investment policy was fairly secure in the sense that the City invested in dated, short-term securities.

Mr. Bullock stated investment policies for governments were typically simple and did not risk principal.

Council Member Schmid requested Mr. Bullock comment on the City's relationship with the California Public Employees' Retirement System (CalPERS) with respect to pension and retiree health accounts.

Mr. Bullock inquired if Council Member Schmid meant the risks CalPERS took with portfolios.

Council Member Schmid replied yes, the City's responsibilities and the security of CalPERS' assumptions.

Mr. Bullock commented that CalPERS was widely regarded. There were concerns about how CalPERS invested and reported funds. He could not comment on how CalPERS invested funds.

Vice Mayor Shepherd referred to the negative news reports regarding Fannie Mae and Freddie Mac investments, and asked if the City had any exposure to risk because of prior investments in Fannie Mae and Freddie Mac.

Mr. Bullock did not judge the quality of investments chosen by the City. MGO only ensured the investments were reported properly.

WORKING MINUTES

Vice Mayor Shepherd inquired whether MGO only utilized the book value of investments.

Mr. Bullock answered yes. To his knowledge, the City's portfolio did contain any asset-backed securities.

Vice Mayor Shepherd questioned whether Staff should present information to the Finance Committee (Committee) regarding investments.

Lalo Perez, Chief Financial Officer, explained that the Council adopted a policy of investing in only a certain grade of securities. If a security fell from that investment grade, then Staff would present information to the Council. With respect to Fannie Mae and Freddie Mac investments, he understood the Federal Government would grandfather any securities issued under the old format. The investment grade would change for the new format. Most likely the new format would not meet the City's investment policy, and Staff would not procure those types of securities.

Vice Mayor Shepherd suggested the Committee follow up at a future meeting.

Council Member Schmid was shocked to read on page 22 an inflation rate of 3.77 percent when he understood inflation was under 2 percent.

Mr. Bullock reported the appropriations limit was adopted by the City Council at the beginning of the year. That number was not the inflation rate presented by the Bureau of Labor Statistics. It was the California Per Capita Income change. The City followed the State's inflationary factor.

Council Member Schmid felt the rate was still a little high. With respect to the Mitchell Park encumbrances outstanding, he asked if MGO reviewed the percentage of completion when reviewing items such as encumbrances.

Mr. Bullock answered no. MGO reviewed the remaining amount on the contracts.

Council Member Schmid clarified that MGO did not review the remaining amount of funds to be spent.

Mr. Bullock explained that not all the funds may be contracted; therefore, MGO reviewed the contracts the City entered into and amounts expended to date. The remaining amount represented the amount of funds to which the City was obligated under the contract.

WORKING MINUTES

Council Member Schmid inquired whether MGO reviewed the time period through June 30, 2013.

Mr. Bullock indicated the number should be the amount remaining to be spent under contract as of June 30, 2013.

Chair Burt requested Mr. Bullock summarize changes scheduled for 2015 regarding pension obligation reporting.

Mr. Bullock stated in the CAFR MGO reported the schedule of funding progress, which was the City's position in the pension plan as of an actuarial date. The City reported the 2011 actuarial valuation in the 2013 report, because that was the most recent valuation available from CalPERS. The actuary estimated the City's obligation as of June 30, 2011. Under new requirements, CalPERS could no longer wait two years to report that information. In the 2013 report, the City would have to report the 2012 information. CalPERS was working to present that information more quickly to cities.

Chair Burt inquired whether that change was the one Mr. Perez expressed previously regarding two-year blending.

Mr. Perez indicated the two-year blending was a different change. CalPERS was receiving pressure to shorten the two-year delay in reporting information.

Mr. Bullock explained that the assets column contained an actuarial basis of assets with smoothing and other factors. That would no longer be the appropriate basis to measure. The City would utilize the actual net position of the City's portion of the CalPERS plan as of the date of the valuation. In other words, the City would compare the actuarial liability to the actual fair value of the assets held in the City's plan.

Chair Burt asked if the City would be comparing a future obligation to a present cash value.

Mr. Bullock responded yes. CalPERS would discount it back using the discount rate. The City's 2015 financial statements would contain the 2014 estimated obligation and the investments held at CalPERS as of June 30, 2014. That would be the measurement date, and that was what the City would report. To the extent liabilities exceeded assets, the difference would be reported on the government wide financial statements as the net pension liability. It would be a hard number on the City's financial statements. It would not be contained in fund statements for the governmental funds.

WORKING MINUTES

Enterprise Funds would also present it on a full accrual. The City would have more disclosure. There could be some changes in terms of the amortization period and other things that affected how the liability was calculated and how the contribution rates were determined. There would be a significant number of impacts to the financial statements.

Mr. Perez noted that Staff would present the latest actuarial reports to the Committee in December 2013.

MOTION: Council Member Schmid moved, seconded by Council Member Berman to recommend the Finance Committee review and forward to the City Council for its approval the City of Palo Alto's audited financial statements for the fiscal year ended June 30, 2013 and the accompanying reports provided by Macias Gini & O'Connell LLP.

MOTION PASSED: 4-0

ADJOURNMENT: This meeting was adjourned at 8:41 P.M.