



## CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

February 13, 2017

The Honorable City Council  
Palo Alto, California

### **Finance Committee Recommendation to Accept Macias Gini & O'Connell's (MGO) Audit of the City of Palo Alto's Financial Statements as of June 30, 2016**

The Office of the City Auditor recommends acceptance of Macias Gini & O'Connell's (MGO) Audit of the City of Palo Alto's Financial Statements as of June 30, 2016, and Management Letter. At its meeting on November 15, 2016, the Finance Committee approved and unanimously recommended the City Council accept this report. The Finance Committee minutes are included in this packet.

Respectfully submitted,

Harriet Richardson  
City Auditor

#### **ATTACHMENTS:**

- Attachment A: Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2016, and Management Letter (PDF)
- Attachment B: Finance Committee Meeting Minutes Excerpt (November 15, 2016) (PDF)

Department Head: Harriet Richardson, City Auditor





# CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

November 15, 2016

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, 2016 and Management Letter

### RECOMMENDATION

We recommend the Finance Committee review and forward to the City Council for approval the City of Palo Alto's audited financial statements for the fiscal year ended June 30, 2016, and the accompanying reports provided by Macias Gini & O'Connell LLP.

### DISCUSSION

The City Charter requires that the City Council, through the City Auditor, engage an independent certified public accounting firm to conduct the annual financial audit. The selected firm reports the results of the audit, in writing, to the City Council. Macias Gini & O'Connell LLP, a certified public accounting firm, conducted the audits of the City's financial statements for the fiscal year ended June 30, 2016.

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

- Independent Auditor's Reports 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
- Regional Water Quality Control Plant, Independent Auditor's Report and Financial Statements for the year ended June 30, 2016 – Attachment B
- Palo Alto Public Improvement Corporation (a Component Unit of the City of Palo Alto), Annual Financial Report for the year ended June 30, 2016 – 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 the year ended June 30, 2016 – Attachment D
- Independent Accountant's Report on Applying Agreed-Upon Procedures Related to the Article XIII-B Appropriations Limit for the year ended June 30, 2016 – Attachment E
- Cable TV Franchise, Independent Auditor's Report and Statements of Franchise Revenues and Expenditures for the years ended December 31, 2015 and 2014 – Attachment F

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.

Respectfully submitted,



Harriet Richardson  
City Auditor

**ATTACHMENTS:**

- Attachment A: Report to the City Council (PDF)
- Attachment B: Regional Water Quality Control Plant (PDF)
- Attachment C: Public Improvement Corporation (PDF)
- Attachment D: GO Bonds for Library Projects Report (PDF)
- Attachment E: GANN (PDF)
- Attachment F: Cable TV Franchise (PDF)

Department Head: Harriet Richardson, City Auditor



**CITY OF PALO ALTO**

Report to the City Council

For the Year Ended June 30, 2016



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**CITY OF PALO ALTO  
Report to the City Council  
For the Year Ended June 30, 2016**

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

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, California (City), as of and for the year ended June 30, 2016. Professional standards require that we provide you with information about responsibilities under generally accepted auditing standards, *Government Auditing Standards* and the Uniform Guidance, as well as certain information related to the planned scope and timing of our audit. Professional standards also require that we communicate to you the following information related to our audit. The information on page 1 through 4 satisfies these requirements.

In planning and performing our audit of the City's financial statements in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing 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.

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

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

Walnut Creek, California  
November 2, 2016

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**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2016**

## 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, 2016. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and the Uniform Guidance 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 April 6, 2016. Professional standards also 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. As described in Note 1(n) to the City's basic financial statements, the City implemented four new Governmental Accounting Standards Board (GASB) pronouncements: Statement No. 72, *Fair Value Measurement and Application*; Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets that are not within the Scope of GASB Statement No. 68 and amendments to certain provisions of GASB Statements No. 67 and 68*; Statement No. 76, *Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*; and Statement No. 79, *Certain External Investments Pools and Pool Participants*.

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 price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The City's investments are classified as level 2 of the fair value hierarchy established by GASB Statement No. 72 and are valued using prices determined by the use of matrix pricing techniques maintained by the pricing vendors for these securities. The City's investment in the money market mutual fund, California Local Agency Investments Fund and California Asset Management Program are not subject to the fair value hierarchy.
- *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.

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2016**

- *Landfill post-closure Liability.* The City has estimated, based on a study conducted by consultants, the post-closure costs of the Palo Alto landfill based on what it would cost to perform all currently mandated post-closure care. Actual post-closure care costs may be higher due to inflation variances, changes in technology, or changes in State or federal regulations.
- *Valuation of the net other postemployment benefits (OPEB) asset.* The net OPEB asset is the amount of cumulative City contributions that exceeded the actuarially determined annual required contributions, which is based upon certain approved actuarial assumptions.
- *Annual required contributions to pension and other postemployment benefit plans.* The City is required to contribute to its pension and OPEB plans at an actuarially determined rate and to measure these benefit costs based upon certain approved actuarial assumptions.
- *Claims loss reserve.* The City is exposed to a variety of risks of loss due to general liability, workers' compensation and other claims and records an estimate of these losses based on actuarial studies performed by third party actuaries. These studies are prepared based on the City's prior claims history, which is used as a basis for extrapolating losses for known and incurred but not reported claims. Actual loss experience may vary from these estimates.

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

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 Plans 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 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. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

***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 2, 2016.

**CITY OF PALO ALTO**  
**Report to the City Council**  
**For the Year Ended June 30, 2016**

***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**

We applied certain limited procedures to Management’s Discussion and Analysis, the schedule of changes in the net pension liability and related ratios and the schedule of employer pension contributions, which is required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding 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 did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on the combining and individual nonmajor fund financial statements and schedules and the schedule of expenditures of federal awards, as required by Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, which accompany the financial statements but are not RSI. With respect to this supplementary information, 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.

We were not engaged to report on the introductory and statistical sections, which accompany the financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on them.

**CITY OF PALO ALTO  
Report to the City Council  
For the Year Ended June 30, 2016**

**CURRENT YEAR RECOMMENDATIONS**

None noted.

**STATUS OF PRIOR YEAR RECOMMENDATIONS**

None noted.

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

Independent Auditor's Report  
and Financial Statements

For the Year Ended  
June 30, 2016



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**CITY OF PALO ALTO**  
**REGIONAL WATER QUALITY CONTROL PLANT**  
For the Year Ended June 30, 2016

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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 financial statements 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, 2016, 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, 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 to 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.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the revenues, expenditures and quarterly billings of the Plant for the year ended June 30, 2016, in accordance with the financial reporting provisions of the Basic Agreement between the City, 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 to the financial statements.

***Basis of Accounting***

As discussed in Note 2 to the financial statements, the financial statements are prepared in accordance with the financial reporting provisions of the Basic Agreements between the City, City of Mountain View and the City of Los Altos, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

***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 & O'Connell LLP*

Walnut Creek, California  
November 2, 2016

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

Statement of Net Expenditures  
For the Year Ended June 30, 2016

	Total	City of Mountain View	City of Los Altos	City of Palo Alto
Direct Expenditures:				
Source control program	\$ 1,258,597	\$ 483,931	\$ 126,237	\$ 648,429
Public outreach	126,741	48,732	12,712	65,297
Permitting and enforcement	1,073,337	287,272	17,039	769,026
Operations and maintenance	13,246,594	5,093,316	1,328,633	6,824,645
System improvement CIP (Note 3)	2,792,222	1,073,609	280,060	1,438,553
Total Direct Expenditures	<u>18,497,491</u>	<u>6,986,860</u>	<u>1,764,681</u>	<u>9,745,950</u>
Indirect Administrative Expenditures (Note 4):				
Source control program	797,056	306,468	79,945	410,643
Public outreach	1,048	403	105	540
Permitting and enforcement	390,059	265,175	15,729	109,155
Operations and maintenance	2,724,168	1,047,442	273,234	1,403,492
Total Indirect Administrative Expenditures	<u>3,912,331</u>	<u>1,619,488</u>	<u>369,013</u>	<u>1,923,830</u>
Debt Service Expenditures (Note 5):				
Refunding 1990 Series A Bonds	284,015	144,848	22,153	117,014
1999 Wastewater Treatment New Project	540,402	204,758	51,176	284,468
2009 State Water Resource Loan	555,726	210,565	52,627	292,534
Total Debt Service Expenditures	<u>1,380,143</u>	<u>560,171</u>	<u>125,956</u>	<u>694,016</u>
Total Expenditures	23,789,965	9,166,519	2,259,650	12,363,796
Deduct Joint Systems Revenues (Note 6)	<u>(261,564)</u>	<u>(100,571)</u>	<u>(26,235)</u>	<u>(134,758)</u>
Net Expenditures	<u>\$ 23,528,401</u>	<u>\$ 9,065,948</u>	<u>\$ 2,233,415</u>	<u>\$ 12,229,038</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, 2016

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
Billings by Quarter, Beginning:		
July 1, 2015	\$ 2,080,802	\$ 547,739
October 1, 2015	2,446,120	617,739
January 1, 2016	2,171,414	551,866
April 1, 2016	<u>2,458,726</u>	<u>611,874</u>
Total quarterly billings	9,157,062	2,329,218
Net expenditures	<u>9,065,948</u>	<u>2,233,415</u>
Excess of total billings over net expenditures	<u>\$ 91,114</u>	<u>\$ 95,803</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, 2016

**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, 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 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, 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, 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. Revenues from services, fines and penalties are allocated to each of the Members in the same proportions as those of expenditures. 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 regulations from Environmental Protection Agency. The percentages used for the year ended June 30, 2016, to allocate expenditures 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 and joint system revenues	38.45%	10.03%	51.52%
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	37.75%	2.24%	60.01%

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

Notes to the Financial Statements (continued)  
For the Year Ended June 30, 2016

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The City is allocated 51.52% 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 2016 allocations are as follows:

East Palo Alto Sanitary District	6.68%
Stanford University	7.00%
Town of Los Altos Hills	1.51%
Remaining City percentages	<u>36.33%</u>
Total	<u><u>51.52%</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 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 future years, the base year amount will be adjusted annually based on increases to the Consumer Price Index-Urban Wage Earners and Clerical Workers for the San Francisco-Oakland-San Jose area. For fiscal year 2015-16, the adjusted capital additions limit is \$2,931,879. Actual System Improvement CIP expenditures amounted to \$2,792,222 for fiscal year 2016. As of June 30, 2016, the remaining capital additions limit accumulated but unspent is \$13,896,335, of which commitments of \$1,671,676 have been carried forward to fiscal year 2017.

**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 expense and amortization of bond discount reduced by any interest income earned from investments with the 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.

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

Notes to the Financial Statements (continued)  
For the Year Ended June 30, 2016

**NOTE 5 – DEBT SERVICE EXPENDITURES (Continued)**

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 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. The principal amount of the debt outstanding as of June 30, 2016 are allocated as follows:

	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	2009 State Water Resources Loan	Total
City of Palo Alto	\$ 1,301,255	\$ 447,027	\$ 2,606,447	\$ 4,354,729
City of Mountain View	1,292,049	911,937	2,588,005	4,791,991
City of Los Altos	322,928	139,473	646,831	1,109,232
East Palo Alto Sanitary District	260,524	212,785	521,836	995,145
Stanford University	179,366	73,313	359,275	611,954
Town of Los Altos Hills	53,878	3,576	107,919	165,373
Total	<u>\$ 3,410,000</u>	<u>\$ 1,788,111</u>	<u>\$ 6,830,313</u>	<u>\$ 12,028,424</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).

**NOTE 6 – JOINT SYSTEM REVENUES**

The Plant's joint system revenues for the year ended June 30, 2016 total \$261,564, which consisted of the following:

Septic hauling services	\$ 210,831
Other miscellaneous revenues	3,010
Salt water marsh services	7,500
Utility service to other utility funds	40,223
	<u>\$ 261,564</u>

**NOTE 7 – RELATED PARTY TRANSACTIONS**

During fiscal year 2016, the Plant paid the City \$2,619,123 for utility costs. Such costs are included in the Statement of Net Expenditures as source control program, permitting and enforcement, and operations and maintenance expenditures. Vehicle replacement charges of \$51,157 were paid to the City's Equipment Replacement Fund, which is included in the Statement of Net Expenditures as operations and maintenance expenditures.



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**PALO ALTO PUBLIC IMPROVEMENT  
CORPORATION**

(A Component Unit of the City of Palo Alto)

Annual Financial Report  
For the Year Ended June 30, 2016



Certified  
Public  
Accountants

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
For the Year Ended June 30, 2016

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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 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, 2016, 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.

### *Opinions*

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the major fund of the Corporation as of June 30, 2016, 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.

A handwritten signature in black ink that reads "Macias Gini & O'Connell LLP". The signature is written in a cursive, slightly slanted style.

Walnut Creek, California  
November 2, 2016

**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, 2016

The Palo Alto Public Improvement Corporation (Corporation), a component unit of the City of Palo Alto (City), follows the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34 (GASB 34), *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*. The Corporation is controlled by the City 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 YEAR 2016 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 Certificates of Participation (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, 2016, the 2002B Downtown Parking Improvements COPs comprise the Corporation's outstanding debt.

At the government-wide level, interest and fiscal agent charges were \$80 thousand for fiscal year 2016, a decrease of \$10 thousand from the prior year. The interest on leases on the assets securing this COP issue was \$83 thousand, a decrease of \$9 thousand from the prior year. The interest on leases from the City exceeded interest and fiscal agent charges by \$3 thousand, thereby resulting in an increase in net position of \$3 thousand over the prior year.

The Corporation ended fiscal year 2016 with total assets of \$1.4 million, a decrease of \$0.1 million from the prior year. Total assets consist of \$251 thousand in cash and investments and \$1.1 million of leases receivable from the City of Palo Alto. Total liabilities were \$1.2 million, a decrease of \$0.1 million from the prior year, and included \$185 thousand of current liabilities as well as \$975 thousand 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, 2016, the Corporation had one fund, the Debt Service Fund, which reported a \$251 thousand restricted fund balance.

**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, 2016

## **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 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, 2016, the Corporation has one outstanding debt related to the 2002B Downtown Parking Improvement projects with an outstanding balance of \$1.1 million.

## **ECONOMIC OUTLOOK AND MAJOR INITIATIVES**

The economy of the City 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 financial statements should be directed to the Finance Department of the City of Palo Alto, 250 Hamilton Avenue, Palo Alto, CA 94301.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Statement of Net Position  
June 30, 2016

**Assets**

Cash and investments held for operations	\$ 13,635
Cash and investments held by trustee	237,331
Investment in leases to the City of Palo Alto	1,135,000
Total assets	<u>1,385,966</u>

**Liabilities**

Interest payable	24,592
Long-term debt:	
Due in one year	160,000
Due in more than one year	975,000
Total liabilities	<u>1,159,592</u>

**Net Position**

Restricted for debt service	<u>\$ 226,374</u>
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See accompanying notes to financial statements.



**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Statement of Activities  
For the Year Ended June 30, 2016

**Expenses**

Interest and fiscal agent charges	\$ 80,275
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**Program revenues**

Interest on leases from the City of Palo Alto	83,525
---	--------

Net program revenues	<u>3,250</u>
----------------------	--------------

**General revenues**

Investment earnings	<u>151</u>
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Change in net position	3,401
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Net position, beginning of the year	<u>222,973</u>
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Net position, end of the year	<u><u>\$ 226,374</u></u>
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See accompanying notes to financial statements.

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

Balance Sheet

Debt Service Fund

June 30, 2016

**Assets**

Cash and investments held for operations	\$ 13,635
Cash and investments held by trustee	237,331
Investment in leases to City of Palo Alto	1,135,000
Total assets	<u>\$ 1,385,966</u>

**Deferred Inflows of Resources**

Unavailable lease receipt from the City of Palo Alto	\$ 1,135,000
--	--------------

**Fund balance**

Restricted for debt service	<u>250,966</u>
Total deferred inflows of resources and fund balance	<u>\$ 1,385,966</u>

**Reconciliation of fund balance to net position**

Fund balance restricted for debt service	\$ 250,966
Adjustment to remove deferred inflows of resources from the balance sheet	1,135,000
Some liabilities, including bonds payable, are not due and payable in the the current period and therefore are not reported in the Fund:	
Interest payable	(24,592)
Long-term debt due within one year	(160,000)
Long-term debt due in more than one year	<u>(975,000)</u>
Net position of governmental activities	<u>\$ 226,374</u>

See accompanying notes to financial statements.

**PALO ALTO PUBLIC IMPROVEMENT CORPORATION**  
**(A Component Unit of the City of Palo Alto)**  
Statement of Revenues, Expenditures and Changes in Fund Balance  
Debt Service Fund  
For the Year Ended June 30, 2016

## Revenues:

Lease receipts from the City of Palo Alto:

Principal	\$ 150,000
Interest	83,525
Investment earnings	151
Total revenues	233,676

## Expenditures:

Debt service:

Principal repayment	150,000
Interest and fiscal agent charges	83,525
Total expenditures	233,525
Net change in fund balance	151
Fund balance, beginning of the year	250,815
Fund balance, end of the year	\$ 250,966

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

Net change in fund balance - debt service fund	\$ 151
--	--------

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.	150,000
Some amounts reported in the statement of revenues, expenditures and changes in fund balances reflect the collection of an asset which are not includable as revenues and expenditures on the statement of activities.	
Change in deferred inflows of resources	(150,000)
Change in interest payable	3,250
Change in net position of governmental activities	\$ 3,401

See accompanying notes to financial statements.

**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, 2016

**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 (City). 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, 2016.

**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 investment earnings, 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 during the year ended June 30, 2022. The Corporation therefore records the present value of the lease and considers the leased improvement to have been sold for this amount when leased.

**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, 2016

**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, 2016, 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) Deferred Inflows of Resources**

A deferred inflow of resources is defined as an acquisition of net position or fund balances applicable to a future reporting period and will not be recognized as an inflow of resources (revenue) until that time. On the governmental fund balance sheet, the lease receipts from the City corresponding to the debt are recorded as deferred inflows of resources since the balances are not current financial resources. The City considers revenues susceptible to accrual to be available if the revenues are collected within ninety days after year-end, except for property taxes, which are available if collected within sixty days after year-end.

**(f) Fund Balances**

At June 30, 2016, the Corporation's governmental fund's 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.

**(g) Effects of New Pronouncements**

During the year ended June 30, 2016, the Corporation implemented Governmental Accounting Standards Board Statement No. 72, *Fair Value Measurement and Application*. This statement addresses accounting and financial reporting issues related to fair value measurements. See Note 3 to the financial statements for related disclosure.

**(h) 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 COPs issues, a trustee holds and invests the Corporation's cash held for purposes of bond reserves.

**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, 2016

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

**(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:

Investment Type	Amount	Maturity Date
Money Market Mutual Fund	\$ 237,331	34 days

**(b) Credit Risk**

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. As of June 30, 2016, the Fund's investments in money market mutual funds are rated AAAM by Standard & Poor's.

**(c) Fair Value Hierarchy**

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure fair value of the assets. Level 1 inputs are quoted prices in an active market for identical assets; Level 2 inputs are significant other observable inputs; and Level 3 inputs are significant unobservable inputs. The Corporation's investments in money market mutual funds are not subject to the fair value hierarchy.

**(d) 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 (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.

**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, 2016

**NOTE 3 – CASH AND INVESTMENTS HELD BY TRUSTEE (continued)**

Authorized Investment Type	Maximum Maturity	Minimum Credit Quality	Maximum Percentage of Portfolio	Maximum Investment in One Issuer
U.S. Government Securities	10 years (*)	N/A	No Limit	No Limit
U.S. Government 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	P-1/A-1+	15%	\$3 million (B)
Local Agency Investment Fund	N/A	N/A	No Limit	\$50 million per account
Short-Term Repurchase Agreements	1 year	N/A	No Limit	No Limit
City of Palo Alto Bonds	N/A	N/A	No Limit	No Limit
Money Market Deposit Accounts	N/A	N/A	No Limit	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

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

(\*) The maximum maturity is based on the Investment Policy that is approved by the City Council and is less restrictive than the California Governmental Code.

**NOTE 4 – CERTIFICATES OF PARTICIPATION**

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

	Balance June 30, 2015	Retirements	Balance June 30, 2016	Amount due in one year
<b>Governmental Activity Debt:</b>				
<b>Certificates of Participation</b>				
2002B Downtown Parking				
6.50%; due 03/01/2022	\$ 1,285,000	\$ 150,000	\$ 1,135,000	\$ 160,000

**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, 2016

**NOTE 4 – CERTIFICATES OF PARTICIPATION (Continued)**

On January 16, 2002, the Corporation issued the 2002B Downtown Parking Improvements Certificates of Participation (2002B COPs) 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 are due semi-annually on March 1 and September 1 and are payable from lease revenues received from the City.

The 2002B COPs are 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 shown below:

<u>For the Year</u> <u>Ending June 30,</u>	<u>Principal</u>	<u>Interest</u> <u>Payment</u>	<u>Total</u> <u>Payment</u>
2017	\$ 160,000	\$ 73,776	\$ 233,526
2018	170,000	63,376	233,776
2019	185,000	52,326	233,376
2020	195,000	40,300	237,326
2021	205,000	27,626	235,300
2022	220,000	14,300	234,300
	<u>\$ 1,135,000</u>	<u>\$ 271,704</u>	<u>\$ 1,407,604</u>



**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, 2016



Certified  
Public  
Accountants



**CITY OF PALO ALTO**  
**GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND**  
**(A Fund of the City of Palo Alto)**  
For the Year Ended June 30, 2016

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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, 2016, 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, 2016, 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, 2016, 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. Our opinion is not modified with respect to this matter.

***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated November 2, 2016 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 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.

A handwritten signature in black ink that reads "Macias Gini E O'Connell LPA". The signature is written in a cursive, slightly slanted style.

Walnut Creek, California

November 2, 2016

**CITY OF PALO ALTO**  
**GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND**  
**(A Fund of the City of Palo Alto)**  
Balance Sheet  
June 30, 2016

**Assets**

Restricted cash and investments (Note 3)	<u>\$ 710,783</u>
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**Fund Balance**

Restricted for capital projects	<u>\$ 710,783</u>
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See accompanying notes to financial statements.

**CITY OF PALO ALTO**  
**GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND**  
**(A Fund of the City of Palo Alto)**  
Statement of Revenues, Expenditures and  
Changes in Fund Balance  
For the Year Ended June 30, 2016

**Revenues**

Investment income	\$ 15,857
-------------------	-----------

**Expenditures**

## Capital outlay:

Downtown Library	4,086
Mitchell Park Library and Community Center	813,134
Rinconada Library construction and improvements	600,831
Temporary Facility	14,290
Temporary Library at Art Center Auditorium	19,587
	1,451,928
Total capital outlay	1,451,928

## Debt service:

Interest and fiscal charges	228
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Total expenditures	1,452,156
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Deficiency of revenues under expenditures	(1,436,299)
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**Other Financing Uses**

Intergovernmental transfers to the City of Palo Alto	(3,018,485)
--	-------------

Net change in fund balance	(4,454,784)
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Fund balance, beginning of the year	5,165,567
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Fund balance, end of year	\$ 710,783
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See accompanying notes to financial statements.



**CITY OF PALO ALTO**  
**GENERAL OBLIGATION BONDS CAPITAL PROJECTS FUND**  
**(A Fund of the City of Palo Alto)**  
Notes to the Financial Statements  
For the Year Ended June 30, 2016

**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 2010 (2010 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 2010 Library Bonds included par of \$55,305,000 and a premium on issue of \$3,766,208 for a total of \$59,071,208. During the fiscal year ended June 30, 2013, the City issued General Obligation Bonds, Election of 2008, Series 2013A (2013A Library Bonds) for the remaining authorized amount of \$20,695,000. The premium on issue was \$1,011,615 for the total proceeds of \$21,706,615.

Specific projects approved by the City Council to be funded by the 2010 and 2013A Library Bonds proceeds are as follows:

	As of June 30, 2016	
	Reimbursement From Bond Funds	Encumbrances Outstanding
Downtown Library Improvements	\$ 4,167,260	\$ 36,803
Mitchell Park Library	44,732,971	219,298
Library and Community Center		
Temporary Facility	522,702	-
Temporary Main Library	534,746	127,382
Rinconada Library New Construction		
and Improvements	22,399,874	229,053
Total	\$ 72,357,553	\$ 612,536

**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, 2016, 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, 2016

**NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(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 accrual to be available if the revenues are collected within ninety days after year-end, except for property taxes, which are available if 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, 2016.

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) Effects of New Pronouncements**

During the year ended June 30, 2016, the City implemented Governmental Accounting Standards Board Statement No. 72, *Fair Value Measurement and Application*. This statement addresses accounting and financial reporting issues related to fair value measurements. See Note 3 to the financial statements for related disclosure.

**(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, 2016

**NOTE 3 – RESTRICTED CASH AND INVESTMENTS**

**(a) Project Fund Investment Policy**

Pursuant to terms of the 2010 and 2013A 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) Pool. CAMP Pool 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 Pool's investments are limited to investments permitted by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code.

**(b) Fair Value Hierarchy**

The City categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure fair value of the assets. Level 1 inputs are quoted prices in an active market for identical assets; Level 2 inputs are significant other observable inputs; and Level 3 inputs are significant unobservable inputs. The Fund's investments in CAMP Pool is not subject to the fair value hierarchy and are measured at net asset value.

**(c) 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. As of June 30, 2016, the Fund's investments in the amount of \$710,783 are invested in CAMP Pool with a weighted average maturity of 45 days.

**(d) Credit Risk**

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 of June 30, 2016, the Fund's investments in CAMP Pool are rated AAAM by Standard & Poor's.

**NOTE 4 – INTERGOVERNMENTAL TRANSFERS TO THE CITY OF PALO ALTO**

During the year ended June 30, 2016, the Fund transferred excess project savings of \$3,018,485 to the City's Library Projects Debt Service Fund. On June 27, 2016, the transferred funds were used for debt service payments for the 2010 and 2013A Library Bonds.

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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 *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, 2016, and the related notes to the financial statements, and have issued our report thereon dated November 2, 2016.

**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. Accordingly, we do not express an opinion on the effectiveness of the City’s internal control.

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

A handwritten signature in black ink that reads "Macias Gini E O'Connell LPA". The signature is written in a cursive, slightly slanted style.

Walnut Creek, California  
November 2, 2016



### 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, 2016 as follows:

- a) Proceeds from the sale of general obligation bonds (Bonds) were used only for the purposes specified in Measure N;
- b) Proceeds from 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 no later than November 1, 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, 2016.

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.

Walnut Creek, California  
November 2, 2016

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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, 2016

*Current Year Findings:*

No matters were noted.

*Status of Prior Year Findings:*

No matters were noted.

**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, 2016



Certified  
Public  
Accountants





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

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, 2016. These procedures, which were agreed to by the City and recommended by the California Committee on Municipal Accounting (CCMA) (as presented in the CCMA White Paper titled *Agreed-upon Procedures Applied to the Appropriations Limitation Prescribed by Article XIII-B of the California Constitution*), 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 prior year’s limit to total adjustments, and compared the resulting amount to the current year’s limit.

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

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

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

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

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

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

This report is intended solely for the information and use of the City Council and City management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

*Macias Gini & O'Connell LLP*

Walnut Creek, California  
November 2, 2016

**CITY OF PALO ALTO, CALIFORNIA**  
**Appropriations Limit Worksheet**  
**For the Year Ended June 30, 2016**

2014-2015 appropriations limit, as adopted	\$ 135,167,260
Adjustment factors:	
Population	1.0113
Inflation	1.0382
Total adjustment factors (rounded)	<u>1.0499</u>
Total adjustments	<u>6,749,126</u>
2015-2016 appropriation limit, as adopted	<u><u>\$ 141,916,386</u></u>

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

For the Years Ended  
December 31, 2015 and 2014



Certified  
Public  
Accountants



**CABLE TV FRANCHISE**  
For the Years Ended December 31, 2015 and 2014

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## 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, 2015 and 2014, 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.

### *Opinion*

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, 2015 and 2014, 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 to the financial statements.

***Basis of Accounting***

As discussed in Note 1 to the financial statements, the financial statements are prepared 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, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to that matter.

***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.

A handwritten signature in black ink that reads "Macias Gini & O'Connell LLP". The signature is written in a cursive, slightly slanted style.

Walnut Creek, California

November 2, 2016

**CABLE TV FRANCHISE**Statements of Franchise Revenues and Expenditures  
For the Years Ended December 31, 2015 and 2014

	<u>2015</u>	<u>2014</u>
<b>Revenues:</b>		
Franchise fees	<u>\$ 1,892,859</u>	<u>\$ 1,829,378</u>
<b>Expenditures:</b>		
Franchise administration	42,762	46,838
Consulting fees	<u>20,324</u>	<u>4,752</u>
Total expenditures	<u>63,086</u>	<u>51,590</u>
<b>Net receipts</b>	<u><u>\$ 1,829,773</u></u>	<u><u>\$ 1,777,788</u></u>

	<u>2015</u>		<u>2014</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
<b>Allocation of Net Receipts:</b>				
City of Palo Alto	\$ 891,371	48.7%	\$ 864,439	48.6%
City of Menlo Park	489,704	26.8%	474,995	26.7%
City of East Palo Alto	192,530	10.5%	182,051	10.2%
Town of Atherton	134,488	7.3%	127,302	7.2%
County of Santa Clara	96,111	5.3%	99,360	5.6%
County of San Mateo	<u>25,569</u>	<u>1.4%</u>	<u>29,641</u>	<u>1.7%</u>
Total	<u><u>\$ 1,829,773</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 1,777,788</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, 2015 and 2014

**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 (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 (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 (AT&T), third party contractor, which was granted a non-exclusive franchise to construct, operate, maintain and repair a cable television system within the Members jurisdictions. In 2002, the Franchise Agreement was transferred from AT&T to Comcast Corporation (Comcast).

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 City's Agency Fund. 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 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, 2015 and 2014

**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 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 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, 2015 and 2014, the remaining balance on deposit with the City, including \$3,065 and \$4,142, respectively, in interest receivable, was \$1,101,977 and \$1,200,217, respectively.

**NOTE 3 – SUBSEQUENT EVENTS**

*Distribution to Members*

Subsequent to the fiscal year ended December 31, 2015, the Franchise distributed the franchise fee for the quarter ended December 31, 2015 of \$457,705 to its members in January 2016.

*Franchise Settlements*

In 2016, the City concluded a franchise compliance audit performed by the City Auditor's Office. The City Auditor discovered that AT&T and Comcast did not consistently calculate the fees due in accordance with Digital Infrastructure and Video Competition Act (aka, "DIVCA") and the municipal code of each of the cable joint powers members. As a result of the audit, the City received a settlement from AT&T in the amount of \$75,647. The City is currently negotiating a settlement with Comcast and expects a settlement in the range of \$50,000 to \$100,000.



# FINANCE COMMITTEE TRANSCRIPT

Special Meeting  
Tuesday, November 15, 2016

Chairperson Filseth called the meeting to order at 6:06 P.M. in the Community Meeting Room, 250 Hamilton Avenue, Palo Alto, California.

Present: Filseth (Chair), Holman, Schmid, Wolbach

Absent:

## Oral Communications

None.

## Action Items

1. Macias Gini & O'Connell's Audit of the City of Palo Alto's Financial Statements as of June 30, 2016, and Management Letter

Council Member Schmid: Oh sorry. It seems logical that we do Number 2 before Number 1. Number 1 asks us to approve the audit. The Audit refers to the Comprehensive Annual Financial Report (CAFR). It would seem that if we have any questions about that, that we get them resolved before we approve the audit.

Chair Filseth: Sorry. Let me ask the City Auditor, the Audit is mostly about two or three very specific things, isn't it?

Harriet Richardson, City Auditor: The Audit Reports are whether or not the financial statements are fairly reported in all material aspects, and then you have the financial statements there, which MGO is here to discuss and we have Finance Staff here to answer questions where you can get into the details, and that's really how we've done it in the past.

Council Member Schmid: If I could just make the point that in the audit letter it specifically refers under the aspects of accounting practices...

James Keene, City Manager: Do you have the page number for that?

# TRANSCRIPT

Council Member Schmid: It's on Packet Page 12 and 13. It refers to notes 11 and 12 in the CAFR Report. It seems to me those are issues we will be discussing and it would be good to hear the audit input on that, since it describes in there how they have had interactions with the Staff about the preparation of those footnotes.

Chair Filseth: My inclination is that it would be preferable, since we have M.G.O. here, to proceed with Item 1, but let me ask Staff for a comment on that one as well.

Lalo Perez, Chief Financial Officer: Lalo Perez, Chief Financial Officer. That's how we've done it. There is also no reason, if the Committee wanted to hold off on the final vote of the audit until you went through Item 2, that's fine too. M.G.O. has agreed to stay. They typically do for Item 2 as well, but it's not an issue for us.

Chair Filseth: So you folks are planning on staying for Item 2?

James Keene, City Manager: Yeah, I was going to argue we stay the course until I heard this, because otherwise we would be paying them more money, but since they're going to be here...

Chair Filseth: The only reason I can think of is if there is anybody, any speakers from the public that want to speak to Item 1 but don't want to stay around for Item 2. But it's only Neilson. Why don't we do that then. Why don't we reorder and do Item Number 2 before Item Number 1? Is everybody okay with that?

Mr. Perez: You're the lead on that but my suggestion would be that you might want to hear from the auditor to first hear what they have found, and then we can proceed to the Staff presentation on 2. It kinds of goes in sequence, and then come back to that.

Chair Filseth: Are you okay with that?

James Keene, City Manager: Yeah.

Chair Filseth: Let's do that then. Neilson, we beg your forbearance.

Neilson Buchanan: I'm sitting here remembering my professional career which involves some 21 audits of a public entity, so I'm very reminiscent of how much fun it is to put these things to bed. I want to preface this by, I



# TRANSCRIPT

have absolutely no doubt that the audit's in pristine condition, but I want to ask a question, and unfortunately, when you ask a question at a time like this, people always kind of worry there is something untoward that I might be thinking about the audit, and I don't. I want to ask a question purely for information point of view and all I'll be asking the Committee to do is to ask Staff to follow up on my puzzlement. My puzzlement has to do with the parking assessment district for the University Avenue. Over the course of the last two to three years, working on permit parking, big questions have come up on the interface between the residential property parking and the commercial core. I have done everything within my capabilities to try to understand how decisions are made, what decisions are made, how pricing is going to interface, so the only thing I would ask you to ask the auditors in the prevue of their financial review, are the funds that flow from the participants in the Parking Assessment District that seem to come through the City, the City takes off a small administrative fee and then it seems to go on to the bond holders. All I really would like to know and I would like the Council to know is that part of what the auditors have reviewed in the tons of different accounts and cash flows. So that's, hopefully I'm expressing it in a simple enough fashion. Now the reason I asked for that is in the next 120 days or so the City Council is going to get a parking fee study coming through, and that's going to trigger exactly how is all the pricing differentials and incentives for all parking, including Caltrain and the neighborhoods, and the more we know about this question the better that discussion is going to be. So once again, I don't mean to make any representation that something is not right, but I do want to represent that it is really hard to figure out how the parking assessment district operates, who's got authority to set fees, who owns title of the garages. I have gone to every meeting possible asking those questions, and all I've gotten is conflicting information. Thank you.

Ms. Richardson: Good evening Mr. Chair and members of the Committee, Harriett Richardson, City Auditor. In accordance with the City Charter and the Palo Alto Muni Code requirements, our office staff assists the City Auditor, coordinates the City's Annual Financial Audit. Macias, Gini & O'Connell, also called MGO for short, conducted the audit for the sixth year. We just recently renewed their contract, so they're in the first year of a new contract period that we did through requests for proposal process. They are presenting nine reports tonight. They issued an unmodified opinion for all of the City's basic financial statements, which means that they concluded that the statements presented are presented fairly in all material respects. So the auditors did not have any findings or recommendations this year and there were no outstanding recommendations from prior fiscal years. I would like to point out that the audits that M.G.O conducts focus on financial reporting and whether there are any material misstatements, where the audits that my office conducts address operational risk, compliance and

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strategic objectives that may or may not have financial impact; however, during the course of the audit we do meet with M.G.O. and talk about the recently completed audits from my office and audits that are in progress and other issues that we may be aware of that could potentially impact the City's financial statements. I would like to thank David Bullick and Irene Chan from M.G.O. as well as Cindy Pon for coming here tonight in place of David, for their diligence and hard work in completing the audit. I would also like to thank Lalo Perez, David Ramberg and Laura Kuryk and her staff in Administrative Services Department (ASD) for the assistance they provide to M.G.O. to complete the audit on time, but more importantly, for the work they do year-round to ensure that we receive an unmodified opinion on our financial statements as well as no audit findings. So now I will turn it over to Irene, right here. This is Irene and this is Cindy, from M.G.O. and they are here to present their results of the Report to you.

Irene Chan, Senior Manager, Macias Gini & O'Connell: Thank you Harriett. Good evening Council Members. Irene Chan, Senior Manager from M.G.O., the Engagements Manager as well. So thank you for inviting us here to present to you the results of the audits. We'll start off with the attachments in your meeting packets. You have actually six attachments there, first off with the Report to the City Council. That is the required communication from us to the governing board. It summarizes the results of the audits and if there is any current year findings that will be included in there too. I will go over in details a little bit after this. The second attachment is the original Water Quality Control Plan financial statements that discuss the operating cost of the plans and how the costs are allocated among the members. The third attachment is the Public Improvement Cooperation. That's related to your 2002 Certificate of Participation that pays for the cap reimprovements for your downtown parking garages. Following that is the General Obligation (GO) Bonds for the library projects audits that you (inaudible) and approved it in 2008 for the construction of the City's libraries and the financial statements of the project activities funded by the bond proceeds. Again, the appropriation limit that's on the spending limit on the appropriation established at the beginning of the year and cable TV franchise, the audit of the franchise fee and also the distribution of the net receipts to the members. On the second item, that includes just the CAFR. The CAFR itself, obviously it's a City-wide financial statement that talks about the financial positions of the City. During this year there isn't too much of exciting activities going on, it's rather quiet. There is a footnote that discusses some activities like paying off the partial of the 2010 and 2013 GO Bonds that you guys approved last year as well. There is a footnote that discusses pension, postemployment benefits of the City's employees. So like Harriett mentioned, I am happy to say that based on our audit, the results we offer, we basically gave unmodified opinions. Everything is clean. There is no

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current year finding that results from the audit. Out of the prior year finding has been corrected as of last year, so there isn't anything reported as well. So with that said, I will go over details of the Report to the City Council with you. If you go to the attachments, the required communication starting on page 1, and there are really two portions I would say. The first part of it talks about the quality aspects of the financial statements. It talks about what the standard coming in this year as new standards, and also estimates to your financial statement what sensitive information included on your CAFR. The second part talks about the results of the audit, any issue that we have encountered.

Mr. Perez: Sorry Irene. For the Finance Committee members it starts on Page 12. Thank you Irene.

Ms. Chan: Thanks Lalo. So this year there are four new General Accounting Standards Board (GASB) standards that became effective for the Fiscal Year 2016. There isn't too big of impacts to the financial statement. You see the GASB rates 72, 73, 76 and 79. After that is the list of sensitive estimates that is used on your financial statement. So those are estimates based on management methodology to determine for the balances of the year. Very typical is the fair value of the City's investments. GASB 72 this year adds some additional guidance on how to measure these fair value and they added a new disclosure, basically shows additional information on how the fair value was measured. You can actually see that in the Footnote 3 in the CAFR. Other estimates include the allowances of your receivables based on the collectability of the notes and loans outstanding, the useful life of certain fixed assets, and some other estimates are based on the actuary studies. As Council Member Schmid talked about that there is a sensitive disclosure that is considered sensitive would be note 11 for your pension plan, 12 for your post-employment benefits to the employees and the community contingency note 16. So that's the first half of the required communication. The second half of that talks about the issue that we have encountered with the management, such as if there are any difficulties or if there is any material misstatements based on the results and I am glad to say there are no difficulties we encountered. We really appreciate the assistance from the management throughout the course of the audit. To me the audit is pretty efficient and went pretty well. I would say that there is a pretty quiet year before the new GASB came up for the Other Post Employment Benefits (OPEB), which is coming up for the City's Fiscal Year 2018. So that concludes my presentations. I guess I will open up for questions if you guys have any.

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Mr. Perez: Chair Filseth, before you proceed to questions, may I address the speakers commence, that way if the speaker decides he doesn't want to wait, he has that option?

Chair Filseth: Yes.

Mr. Perez: Thank you for that. It is a very complex area and we have had the discussion multiple times including what some of the members of the Parking Committee, the University Avenue that have come and spoken to you. So there are three parts, just to quickly remind you of them. There is the parking assessment, which is the assessment that issued the bonds to build the garages. That is the money we collect from the partials and it goes directly to the bonds. That's one of the easiest things that an auditor could review because it is segregated funding, there are disclosure requirements and it's pretty clean and said. The second one is Parking Permit Fund. Now that you have a lot of latitude, a lot of control. You as the Council can set the fees based on recommendations that we give you. We have an increase of fees for the University Parking District, for example, in several years. You could set them at any rate that you wanted to. You could use those funds for whatever you wanted to. We segregate them in a special fund and we call them out in our financials, in our budget, and therefore, in our financials. It's totally understood why it's difficult to follow, but there seems to be a confusion between the assessment and the permit fees. They are two distinctively different pots of funds. Then the third one is the parking in-lieu, which again, that is limited to the use and it has been designated for the construction of garages in the downtown district and you have somewhere in the \$4 million balance for that. So I would be more than happy to sit down with Mr. Buchanan and get into some of the details or questions he has, and I am sure that Harriett would be able to do the same on the audit side and go through those details, but I can understand the challenge to getting this all understood, because it is very complex and three separate entities per se.

Chair Filseth: The third one is the parking in-lieu fees is for the construction of future garages, but doesn't have anything to do with the existing garages, is that correct?

Mr. Perez: That is exactly correct, and that's why it gets very confusing, because the term "assessment" seems to be used among all three of those pots of funds, and that's when it becomes very confusing, because if Staff's here assessment, we automatically go to the bond issuance and the garages that were built, but then people are really talking about the permit fees fund, which is a different entity. So right now the majority of the use of the funds for the parking fees are for operation and maintenance of the parking

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lots and garages, so that even complicates it even more, because it's the same garages that were built, but that's not what's paying for the garages to be built, it's paying for the operation and maintenance and for staffing to support the administration of the fees and managing the contracts and agreements for the operational maintenance.

Mr. Keene: So I think, as Lalo said, he's more and the Staff is more than willing to dive deeper outside of this meeting. I would just say that I think one of the things that will get, I don't know if it will ever get completely clear, between what is what we're doing appropriately according to accepted financial practices, and what is legal, versus what different constituencies might think of as fair, because we certainly have some folks on the business community side of stuff who pound on us about how they see the connection on the permit fees and on the Parking Assessment District and kind of get it all mangled up. They are making an argument about fairness, which is, you know, a perspective, and I just want to separate that out from, so the kind of the CAFR kind of concerns that connect back to the parking assessment district component here.

Chair Filseth: Thank you very much for the explanation. Questions on the Audit Report? Council Member Schmid.

Council Member Schmid: I guess the key question is, who controls, who uses the parking that has been constructed. Now my understanding is back in, was it the 80's or the 90's, everyone who participated in the parking assessment payments were given free parking for a number of square footage that was entered into the Assessment District, which created something like 9,000 you know, parking rights. Is that part of the issue here is we have created, through the Parking Assessment District, parking rights that do not necessarily have spaces?

Ms. Richardson: That question came up during the parking funds audit, so we looked at that and it didn't actually give them rights to that many spaces. They paid into the fund for a portion of the cost based on the percentage of spaces they had, but it didn't actually give them rights to that many spaces, and I know that sometimes Staff Reports indicates that there's prepaid spaces for that many, and that Planning has looked at whether or not they should revisit the way they approach that, but it doesn't actually give them rights to that many spaces. If it did we would need to have several more garages to accommodate all those spaces.

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Council Member Schmid: Yeah, I just note whenever there is a rebuilding, redevelopment in the downtown, they come and start by saying "we have guaranteed X number of spaces" and that's always been accepted.

Ms. Richardson: That's been accepted and I know that Planning has been looking at that because that's not really the intent, that they are guaranteed that many spaces.

Council Member Schmid: Okay, so you would be a good reference if that issue arises?

Ms. Richardson: It will probably come up again.

Council Member Schmid: Thank you.

Chair Filseth: Questions and comments, I think, from the Committee on the audit?

Council Member Schmid: Well, let me (inaudible) certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure affecting the financial statements were the disclosures of the City's pension plans in note 11, the retiree health benefits in note 12. Now you mentioned in your letter that you had dialogs with the Staff about how they dealt with and treated certain of the information in there, and I notice in CAFR there are a couple of sections under Note 11 and 12 that have numbers. Now those numbers are sensitive and controversial. Can you tell us anything about, I guess your job was to make sure that things were done correctly and sensitively to the data that was given. Can you tell us about your dialogs with the Staff on this?

Cynthia Pon, Partner, Macias Gini & O'Connell: In terms of sensitivity, what is meant by this is that the amounts and the disclosures related to the pension disclosure and the retiree health disclosures, there are actual assumptions or other variables that if there are changes in any of those variables, the amounts in the financial statements and the disclosures will change significantly. So for example, currently the pension discount rate is at 7.65 percent, so you know, if there is a change in California Public Employee Retirement System (CalPERS) actuarial discount rate from 7.65 percent to 6.65 or 8.65, the amounts in the City's financial statements will change accordingly as well. So that's what is meant by, in terms of significance is that these amounts and disclosures will fluctuate, depending on management's estimates of these variables included imbedded in these assumptions.

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Council Member Schmid: Now actually I thought that in our discussions and approval of the pension, we had accepted a rate of 7.5 as the discount rate. There is extensive argument about whether that rate was too high and yet in your Report and the CAFR it says 7.65?

Ms. Pon: 7.65.

Council Member Schmid: Where did that come from?

Ms. Pon: The delta is that there is a discussion I believe on Page, I forgot what page of the Report.

Council Member Schmid: Page 87.

Ms. Pon: That there has been a change this year. In the past, it was 7.5, but it was net of the Administrative Fee of 0.15. What CalPERS did this last year was they updated the amounts to comply with GASB statement 67, 68, and included the Administrative Fee as part of the discount rate. So in the past it was net, now it's gross.

Council Member Schmid: The last communication we got from CalPERS was that they were adding an addendum that they were going to lower the discount rate each time there was a performance above it. That's the only change that I think we were informed of. The fact that they have actually raised the rate during a time when their performance has been disastrous is quite striking. There was no discussion of...

Ms. Pon: I think there is a difference between the funding requirements that CalPERS provided, study to the City every year saying "this is the funding requirement, this is the annual required contribution" for various entities, participants of their plan versus the accounting requirements where they could throw in, say, well this is your net pension liability versus your unfunded actuarial accrued liability. So there is a change in the way pension accounting is being reported with GASB 68 this last two years now versus in the past an organization would show a liability if an organization did not pay the annual required contribution for that year. So in the past if you didn't pay that mortgage you would have a liability. Now they say, well every year they're trying to measure what is the net pension liability for the year and this is what's now being reported on the financial statements. As such we've been seeing a lot of our clients with more volatility in their statement of net position or what used to be called the balance sheet. You know, there is more volatility now and as a result the expenses are also more volatile in terms of the full accrual presentation. But there isn't a change in the way an

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organization has been funding it, so when you look at the general fund, for example, the required contribution year over year, the contribution amount generally has been increasing, but there isn't that volatility that one now sees in the financial statements on an accrual basis.

Council Member Schmid: What is the role of the external auditor going through the accounts in...

Ms. Pon: We review the results from the actuarial reports. We perform census testing on the data that is provided to the actuary to come up with the concluded amounts. We evaluate the results as it relates to other comparable entities.

Council Member Schmid: But you do not evaluate the discount rate used?

Ms. Pon: We look to see if it is reasonable.

Council Member Schmid: The reason I raise this is they have had substantial internal discussions between their auditor and their own internal auditor has said it was time to change the discount rate. So you do not look at the discussion that our pension auditor or CalPERS auditor had?

Ms. Pon: Well, you know, it some way, another member of our organization does do that, because we, for the 2016, 2015, over the last few years our firm is also the CalPERS financial statement auditors, so we have looked at that, but it is a different office and a different team that's been doing that, but we do look at that as part of the CalPERS audit. Now that's a different hat.

Mr. Keene: I do think it's important to remember that there are some requirements in the financial reports and the disclosures that have to be followed that don't always hit all of the strategic policy or even longer term fiscal issues that we're having in parallel to this. I mean not only during our budget discussions, but, you know, Lalo will be talking to you this year about the fact that the current rate of return in CalPERS is significantly down and their schedule right now would call of them to not revisit resetting that figure until February of 2018, so one of the more interesting things for us, both policy wise and maybe even politically in a sense, is what do we want to do as a City to advocate for a faster adjustment downward on that investment return. I mean, that's where the real differences are going to come for us and, of course, we're just one city even in that regard. But, you know, I think the auditors are bound to adhere to certain requirements, but even then I think the main point of this was to identify that this is variable



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potentially volatile and that these liabilities could significantly change as we go forward. That's what I see the note saying.

Ms. Pon: And in terms of funding policy, we have other clients that fund more than the annual required contribution, but they are a minority versus a majority, but we do have clients that do fund more because they are looking down the horizon as well and saying, you know, when I have one time revenues it may be prudent for my city or my district to save that and put it into that, so in the future my annual required contribution rate won't be as high. So that's a policy decision that other organizations have been grappling with.

Council Member Schmid: Yeah, I would just make the note that you mentioned that this is sensitive, it is extremely sensitive to the City because we are entering into contracts each year that, for salary increases that have long-term pension and health care cost attached that have huge implications for our future, and that number which was in debate of a discount rate is very important, and I guess I would think that an external auditor, as you say you have lots of clients who are making choices paying different rates would indicate that this number is a number that should be looked at carefully.

Chair Filseth: I have a question or two on exactly this section as well, so I was going to say, is there anybody else who has questions on this specific topic? I want to make sure that, I don't know where the role of the auditor leaves off and the role of our Finance Department begins, and I don't want to spend too much time talking about our Finance Department when we have the auditor here, but I didn't quite understand the discussion about...

Council Member Schmid: What page are you on?

Chair Filseth: I'm on Page 87 here. The discussion of discount rate, there is a discussion of, sorry. I don't know what Packet Page.

Mr. Perez: Packet Page 200.

Chair Filseth: Packet Page 200, thank you. There is a discussion here of, should we use the municipal bond rate instead of the 7.65 percent discount rate, and I didn't quite understand that discussion.

Ms. Pon: Under the accounting standards 68, if the pension plan, when they project out their liabilities going forward and they deemed that they don't have enough funds on hand, then what will happen or what is required is

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that instead of using a long-term discount rate, they would need to blend it with a municipal bond rate, usually a lower rate, and they will be, I guess not required, to use a lower discount rate, but since the CalPERS did a stress test on their current situation and deemed that using the long-term rate as the current situation is appropriate.

Chair Filseth: Okay, I kind of guessed it was something like that. So the discount rate isn't exactly the same as CalPERS's expected return rate, right? The discount rate is what we have to discount the future value of the unfunded liability at to figure out what it's worth today, right? So why would we not use our cost of capital which I assume is the municipal bond rate which is going to be 3 or 4 percent, right?

Ms. Pon: Because in terms of CalPERS portfolio, it's more than just U.S. Government Municipal Bonds. They also have an extensive investment portfolio that's...

Chair Filseth: But isn't the critical number the City's cost of financing, not CalPERS return rate?

Ms. Pon: No.

Mr. Perez: Yes, I guess, to interject a little bit, and that's going to be on the accounting side. You're still not dealing with the trust side, right, and I think that's really where you want to focus on, the trust, because that's where you're going to make the payment. So it's important to know what it is on the accounting side for that number. If I may interrupt here, I can probably give you a quick briefing. I think it's appropriate. Every year CalPERS holds a forum and it was three weeks ago. I attended with a couple of members of my Staff and Human Resources (HR) and it was quite a change in scenery, you'll be happy to hear that Council Member Schmid. There was a very strong push by the agencies and by Staff of CalPERS that the world was not going to be 7.5 and a deep acknowledgement with the Board all present for the most part, I kind of looked for that. There were presentations done where pension trust experts were video clipped and shown to the audience by the Chief Investment Officer saying, look, everybody is talking about 4 to 6 percent returns. There's no way we can hit 7.5. We're admitting that to you right now.

Council Member Holman: That was pre-election.

Mr. Perez: Correct. Well you could argue that post-election the bond market is getting better, but we won't go there. The message was clear that they

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recognized that it was not sustainable and what was driving it down was the global markets, to your point, global equities, global bonds. They were doing well in their real estate, they were doing excellent in our U.S. equities and they did a survey, so I'll send you the results of the survey because it's out now, I just didn't happen to bring it with me. They were asking all of us through the league, though that session and various other forums, if you believe that it is time to change the rate of return assumption, are you willing to take it all at once, or phase it in? The issue has been that there's been a lot of pressure and the Board's reluctance to move on doing it all at once is because what happens is then agencies have to have a much bigger annual required contribution to make that payment, and so they're trying to get a gauge so they can present that information to the Board in terms of what should be done, because they acknowledge that we probably can't wait till February of 2018, and that was the message that we were saying as finance officers that were in there, because finance officers, HR staff, we're all mixed in this room, and us as finance officers are saying, why wait. We know you're not going to make it. You know you're not going to make it. Why postpone it? So that's why they are doing the survey. The Board is going to take this into discussions this week, they were presenting the results of the survey. So I think it's going to be a mixed bag. The good thing is that we're learning more and more that there are various ways to go forward with this. That we're not limited to what PERS parameters are set and so I think we're getting better education, better educated as I attend more of these sessions, as I spend more time with Mr. Bartel and I think we're going to provide you options on how we do this. Basically what we're doing is we going to a negative amortization when we continue to have these returns that are less than 7.5, so now CalPERS has shown them in our reports and they show you what the different amortization, what it does. So you have options on how you can prefund this because you can see that it makes sense. So our plan, not necessarily for tonight, is to bring you that information, bring you those options, have that part of the education process for all of us so we can see what options we have. That we don't necessarily have to wait for CalPERS to make a change on the rate. If they do make a change, though, we have to be prepared because it will alter whatever plans we make, because it's like refinancing your mortgage. You go from 30 to 15, but also then your variable rate changes, a double whammy potentially, so we will have to be well prepared and informed.

Chair Filseth: If I can summarize here then, what we're saying is that 7.65 percent, that number is already a little bit out of date, okay, and when you said this is a sensitive number, you meant sensitive in the technical sense, right? Okay, but at 7.65 percent, you know, the City owes half a billion dollars it doesn't have and if you change 7.65 percent to 5 percent, how big is the number?

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Ms. Pon: If you go to Page 90, there is a disclosure on the sensitivity chart, plus one and minus one percent from 7.65 percent.

Council Member Schmid: What page?

Ms. Pon: Um, Page 90.

Mr. Perez: Page 203 of your Packet, and it's on the upper part of the page.

Chair Filseth: You are going from 6.5 to 5?

Ms. Pon: Yeah. But in terms of, because this is as of a measurement date of June 30, 2015, so that's another element is terms of sensitivity, the data it takes, the time it takes to arrive and compute these amounts, it takes some time, so this information is as of 2015, or '14 rolling to '15 and at that point in time with a 7.65 the City miscellaneous plan has a net pension liability of \$206 million, in the safety plan and \$113 million, so if we have 1 percent lower, you're adding about another \$150 million plus or minus.

Chair Filseth: Okay so \$50 million per percent. That's just on pension not OPEB.

Ms. Pon: Not OPEB.

Council Member Schmid: Yeah, I would just add a comment. I looked at the first one of these reports when I arrived at the Council nine years ago and the unfunded liability has doubled since that time, and that's with "good returns" they were getting.

Chair Filseth: Well it was zero in 2001.

Ms. Pon: And it could have been negative in 2008, '09, '10.

Council Member Schmid: So these problems compound themselves. Everyone admits the problem, but now there is a political problem with how to tell people, and I guess my base question is, can the external auditor be a help to us in that situation, by identifying a potential problem?

Ms. Pon: I think presenting the information leaves for you to make the decisions and ask the questions.

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Council Member Schmid: Okay, is this the right place to ask questions? What are we going to do?

Chair Filseth: Maybe in two weeks. I going to offer a suggestion in two weeks when we start talking about the 2018 Budget, or the 2017 Budget might be... We have the Auditor here.

Mr. Keene: I mean, with all due respect...

Chair Filseth: We're going to need policy here.

Mr. Keene: Yeah, I mean I don't think any external auditor wants to be put on the spot for making the policy recommendations and she has a responsibility to dispense the required responsibilities within the practice, and GASB and all sorts of other reporting requirements to do that, and that's what she has done here. I would imagine that there isn't a problem at all though if we're sitting there and we're having a policy discussion, let's get real. Everything we're going to do, I mean, we can point our fingers at CalPERS as much as we can. The real question is, how much extra money do we want to be putting aside as a City? I mean, it doesn't matter. Nobody is going to come to our rescue on the outside, and so that's really a, that's a priority question, that's a revenue and expenditure extreme question, but I'm sure if we called up our external auditor and said, if we were to start paying down our unfunded liability, would you think that's a problem, I'm sure they would say we think that would be a good thing. They'd be happy to do that for us.

Chair Filseth: Yeah, I think it is what it is and what we do is up to us. I mean, this process sort of helps us sort of scale where we are. Questions on other parts of the audit? Council Member Wolbach? Council Member Holman.

Council Member Holman: This is a very simple one but I didn't understand what it was about. So on the landfill closure liability, actual cost, post closure care costs may be higher due to inflation variances, changes in technology. What do changes in technology have to do with the landfill closure costs? That's on Packet Page 13.

Ms. Pon: Because right now in terms of the landfill post closure estimate, this is also an estimate in terms of what the liability is. It's not something that you already have a bill and you know how much you are going to be paying, so that this, if there are changes in regulation or changes in technology that could improve the, or change the estimating technique, then the liability could be lower or it could be higher.

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Council Member Holman: But I still don't understand what changes in technology have to do with that. Regulations I understand, inflation variances I understand. Changes in technology I do not understand.

Ms. Pon: Improved monitoring.

Mr. Keene: Yeah, well, I don't know. Is this saying this is one directional, this issue? I would think it could go both ways.

Council Member Holman: I still don't understand why that's a fluctuating, why that's an effect. What changes in technology would be an effect or could have an effect?

Mr. Keene: Well, I could certainly see if we had some improved capping, more efficient venting, you know, how we would vent methane gases and, or whatever, or that certainly could have a positive effect. I'm not exactly sure on the technology side why we would have a negative effect that would generate increased costs. I could see on the regulatory side. We're not connecting on this?

Council Member Holman: I guess what I'm thinking of in changes in technology are not necessarily environmental technology. Is that what's intended here, environmental technology?

Mr. Keene: Mm-Hmm.

Council Member Holman: Okay, that helps.

Chair Filseth: So I actually didn't have anything else. It looks good. Thank you. So let's see, so what we said was we would proceed to the next item before we come back and make motions?

Council Member Schmid: I think we had the discussion that I wanted to make, so I would be happy to move ahead with the vote.

Chair Filseth: In that case do you want to move to accept Staff recommendation (inaudible). Do we want to move, do we have a Motion here? I'll move it then. Recommend the Staff recommendation without having further comments or discussion. All in favor. Motion passes unanimously. Thank you very much.

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**MOTION:** Chair Filseth moved, seconded by Council Member Schmid to recommend the City Council approve the City of Palo Alto's audited financial statements for the Fiscal Year ended June 30, 2016, and the accompanying reports provided by Macias Gini & O'Connell LP.

**MOTION PASSED:** 4-0