



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

**The Honorable City Council
Attn: Finance Committee
Palo Alto, California**

December 13, 2005

Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2005 and Management Letter

We recommend that the City Council accept the attached financial statements and management letter.

Discussion

The City Charter requires the City Council (through the City Auditor) to engage an independent certified public accounting firm to conduct the annual external audit and report the results of the audit in writing to the City Council. Maze & Associates, an accountancy corporation based in Walnut Creek, California, conducted the audit of the City's financial statements as of June 30, 2005. The Independent Auditor's Report (the "opinion letter") and Single Audit Report (the audit of federal funds received by the City) are included in the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2005.

Maze & Associates also completed the following reports for the City of Palo Alto:

- Memorandum on Internal Control Structure for the year ended June 30, 2005 (the "management letter") – Attachment A
- Independent Auditor's Report on Compliance with the Proposition 111 2004-2005 Appropriation Limit Increment (the "Gann limit letter") – Attachment B
- Public Improvement Corporation Component Unit Financial Statements for the year ended June 30, 2005 – Attachment C
- Regional Water Quality Control Plant Financial Statements for the year ended June 30, 2005 – Attachment D
- Cable TV Franchise Statements of Revenues and Expenditures for the years ended December 31, 2004 and 2003 – Attachment E
- Redevelopment Agency of the City of Palo Alto Component Unit Financial Statements for the year ended June 30, 2005 – Attachment F

Cory Biggs from Maze & Associates will be available at the December 13th Finance Committee meeting to answer questions. I would like to express appreciation to Maze & Associates, and Trudy Eikenberry and her staff in the Administrative Services Department for their hard work to ensure a clean audit.

Respectfully submitted,

Sharon W. Erickson
City Auditor

**CITY OF PALO ALTO
MEMORANDUM ON
INTERNAL CONTROL STRUCTURE
FOR THE YEAR ENDED JUNE 30, 2005**

MAZE & ASSOCIATES

October 7, 2005

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

ACCOUNTANCY CORPORATION
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Under generally accepted auditing standards, auditors are encouraged to report various matters concerning an entity's internal control structure noted during an audit, and are required to report certain of those matters. Matters that are required to be reported are significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

As part of our audit of the financial statements of the City of Palo Alto for the year ended June 30, 2005, we considered the City's internal control structure in determining the scope of our audit procedures for the purpose of rendering an opinion on the financial statements. While our purpose was not to provide assurances on the internal control structure, certain matters came to our attention that we want to report to you. These matters, along with our recommendations, are described in the accompanying memorandum.


A material weakness is a significant deficiency in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses as defined above. However, none of the matters described in the accompanying memorandum is believed to be a material weakness.

The accompanying memorandum on internal control structure is intended solely for the use of management and the City Council. This restriction is not intended to limit the distribution of this letter and the accompanying memorandum which, upon acceptance by the City Council, are a matter of public record. To the extent that the City Council intends to rely upon this letter and the accompanying memorandum, such reliance should take into account the limited basis on which our recommendations were developed, as described above, and the limitations inherent in the internal control structure. In addition, the City Council should understand that the criteria used by us in considering the internal control structure could differ significantly from the criteria the City Council may be using for its purpose.

We wish to express our appreciation for the courtesies and cooperation extended to our representatives during the course of their work. We would be pleased to discuss these recommendations in greater detail or otherwise assist in their implementation.

Very truly yours,



CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Retiree Healthcare Funding

As a follow-up to prior year's comments to the Council and conversations with staff concerning GASB 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, we have included additional comment below concerning the funding options available to the City.

We understand the City is obtaining a new study actuary. A key assumption in the actuary study is the rate of return on plan assets. Plan assets limited by Government Code Section 53601 and the City's Investment Policy, which do not permit investments in equity securities and limits fixed income securities to 10 year maturities, will bear a rate of return that will be much less than that earned by a retirement trust portfolio. Assets held in a trust are governed by a separate investment policy not subject to Government Code Section 53601, and the assumed rate of return would be substantially higher than that of a short term fixed income portfolio. This in turn means cash contribution required by the City would be substantially less. This trust option represents a substantial costs savings to the City. However, you will need to inform the actuary about your funding option as that will impact the assumed rate of return needed for the study and a will significantly impact the annual required contribution needed from the City.

If the City establishes a trust, then GASB 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, will apply and the implementation date for new financial reporting and funding requirements moves up one year earlier to fiscal 2006-2007.

Management Response:

The City is proactively preparing for implementation of GASB 45 by attending training classes and hiring an actuarial firm. The results of the actuarial study will be reported to Finance Committee at mid-year with staff and actuarial recommendations. Once staff receives direction, other appropriate City departments will be involved with the analysis and implementation.

New Accounting Pronouncement: GASB #42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries

GASB 42 is effective in fiscal 2005-2006 and addresses capital asset impairment and clarifies and establishes accounting requirements for insurance recoveries. The City's significant investment in electric and gas infrastructure makes these new rules particularly pertinent. A summary of the significant provisions of the GASB are presented below

- A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Governments are required to address prominent events or changes in circumstances affecting capital assets to determine whether impairment has occurred. Impairment causes may include:
 - Evidence of physical damage,
 - Enactment or approval of laws or regulations or other changes in environmental factors,
 - Technological changes or evidence of obsolescence,
 - Changes in the manner or duration of use of a capital asset, and
 - Construction stoppage.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

- A capital asset generally should be considered impaired if both the decline in service utility is large in magnitude, and the event or change in circumstance is outside the normal life cycle of the capital asset.
- Impairment losses on capital assets with continued usage should be measured using several approaches including a service units approach, deflated depreciated replacement cost, or a restoration cost approach. If evidence is available to demonstrate that the impairment will be temporary, the capital asset should not be written down. Impaired capital assets that are idle should be disclosed, regardless of whether the impairment is considered permanent or temporary.
- Insurance recoveries should be netted with the impairment loss, but restoration or replacement of the capital asset using the insurance recovery should be reported as a separate transaction.

The City has an extensive capital asset base spread among diverse geographic locations. Accordingly, it should study the possible impact of this Statement and prepare now for its implementation. We will work with staff to ensure a complete evaluation of the impacts of these new rules and a smooth implementation.

Management Response:

Staff will work closely with external auditors to prepare for the implementation of GASB 42. Required changes will be incorporated with the FY 05-06 CAFR.

Special Emphasis Area – Police Payroll

The City Auditor requested we place special emphasis on the original calculation and subsequent corrections to certain Police payroll over the last year and half due. Errors in Police payroll occurred due to the implementation of the financial accounting system that were subsequently corrected. These corrections affected net pay and caused concern on the part of employees that their pay, as corrected, still contained errors. Because of these issues, the City Auditor requested that we emphasis and focus our payroll tests on Police pay to determined whether payroll after correction by the Administrative Services Department was accurate. A summary of our tests and results follows:

We selected the pay of 24 officers of various ranks occurring during pay periods between January 2004 through January 2005. We tested the original pay and applicable corrections made, based on personnel records, timesheets and applicable Memoranda of Understanding. We noted two errors:

- One officer had worked eight and half hours of overtime on December 18, 2005 which was paid out on January 14, 2005. The Officer should have received the pay at time and one-half as required under the Memorandum of Understanding. The Officer was paid for one hour at time and one-half, but the remaining seven and one-half hours were at her regular rate. The City should have paid the Officer as stated in the Memorandum of Understanding for overtime. This was the only calculation error we noted in our sample of 24 officers.
- For another selection, we could not trace an officer's current wage rate to his Personnel Action Form. However, we were able to satisfy ourselves that the pay increase was due to the officer's annual wage rate increase as required under the terms of the Memorandum of Understanding.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

We completed these tests as part of our interim work and communicated these results to the City Auditor at that time.

Management Response:

Overtime: The employee or a timekeeper is responsible for online timecard entry. The employee keyed in the incorrect wage type (pay code) and was approved by employee's department. Staff contacted the employee and approver and asked them to review their entry on 12/18/04. They were asked to do an amended hardcopy timecard to reverse the incorrect entry and code the 8.5 hours to the correct wage type of overtime.

Wage Rate: Staff agrees with the recommendation and Human Resources has changed the business procedure to include printing and filing of wage increases.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE
STATUS OF PRIOR YEAR RECOMMENDATIONS

Recommendation 04-1: New Accounting Standards for Other Post Employment Benefits (OPEB)

Current Status – In Process

Recommendation 04-2: New Cash and Investment Disclosures for Next Year

Current Status – Implemented

Recommendation 04-3: Audit Area of Special Emphasis - Golf Course

Current Status – Implemented

Recommendation 04-4: System Implementation Issues

Current Status – Implemented

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**INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH THE PROPOSITION 111
2004-2005 APPROPRIATION LIMIT INCREMENT**

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

We have applied the procedures below to the Appropriations Limitation Worksheet for the City of Palo Alto for the year ended June 30, 2005. These procedures, which were suggested by the League of California Cities and presented in their Article XIII B Appropriations Limitation Uniform Guidelines were performed solely to assist you in meeting the requirements of Section 1.5 of Article XIII B of the California Constitution. The sufficiency of the procedures is solely the responsibility of the specified users of this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. This report is intended for the information of management and the Honorable Mayor and Members of the City Council; however, this restriction is not intended to limit the distribution of this report, which is a matter of public record.

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

- A. We obtained the Appropriations Limitation Worksheet and determined that the 2004-2005 Appropriations Limit of \$89,269,644 and annual adjustment factors were adopted by resolution of City Council. We also determined that the population and inflation options were selected by a recorded vote of the City Council.
- B. For the Worksheet, we recomputed the 2004-2005 Appropriations Limit by multiplying the 2003-2004 Appropriations Limit by the 2004-2005 Adjustment Factors.
- C. For the Appropriations Limitation Worksheet, we agreed the Per Capita Income, County and City Population Factors to California State Department of Finance Worksheets.

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

Maze + Associates

June 10, 2005

**CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2005**

**CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
 COMPONENT UNIT FINANCIAL STATEMENTS
 FOR THE YEAR ENDED JUNE 30, 2005**

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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 component unit financial statements of the governmental activities and each major fund of the Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2005 as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly in all material respects the financial position of the governmental activities and each major fund of the Palo Alto Public Improvement Corporation as of June 30, 2005, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

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

Maze + Associates

October 7, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS

For four consecutive years the Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, has followed the provisions of Government Accounting Standards Board Statement 34 (GASB 34), "Basic Financial Statements-and Management's Discussion & Analysis-for State and Local Governments". GASB 34 represents a profound and far-reaching change in accounting and reporting for municipalities; it is an effort to make these statements clearer and more understandable to readers.

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

FISCAL 2005 FINANCIAL HIGHLIGHTS-CORPORATION-WIDE BASIS AND FUND BASIS

GASB 34 requires the issuance of Corporation-wide financial statements as well as fund financial statements. The Corporation-wide financial statements report the balance of the Corporation's long-term debt issue, while the individual fund statement does not.

In fiscal year 2002, the Corporation issued its 2002A Civic Center Refinancing COPs in the amount of \$3.5 million to refund its 1992 Civic Center Project COPs, reducing debt service requirements by \$372 thousand and producing an accounting gain of \$137 thousand. It also issued its 2002B Downtown Parking Improvements COPs in the amount of \$3.55 million. In fiscal year 2005 a partial redemption was done by placing excess construction and debt service reserve funds into an escrow account to defease \$900 thousand of 2002B Downtown Parking Improvements COP's. These issues plus the 1998 Golf Course Capital Improvements COPs issue comprise all its outstanding debt.

Interest expense on these COPs issues was \$573 thousand in fiscal year 2005, an increase of \$51 thousand from prior year. The interest on leases on the assets securing these COPs issues was \$534 thousand, and increase of \$35 thousand from prior year; this revenue and \$43 thousand in interest income resulted in an income of \$4 thousand in fiscal year 2005, a decrease of \$24 thousand from prior year.

The Corporation ended fiscal year 2005 with total assets of \$10.8 million, a decrease of \$1.6 million from prior year. Total assets included \$1.4 million in cash, a decrease of \$1.1 million from prior year and \$6.8 million in present value of leases receivable from the City of Palo Alto, a decrease of \$0.6 million from prior year. It had liabilities of \$10.8 million a decrease of \$1.6 million from prior year, including \$10.6 million in long-term debt.

At the Fund level, the Corporation reported a negative \$1.0 million in revenues over expenditures, which was principally due to defeasance of debt financed by the 2002B Downtown Parking Improvements Certificates of Participation bond proceeds. Prior year was a negative \$1.4 million for a difference of \$0.4 million.

As of June 30, 2005, the Corporation has two funds, Debt Service Fund, which reported a \$1.4 million fund balance and the Capital Projects Fund, which reported a \$0.1 million fund balance same as from prior year and a decrease from prior year of \$0.9 million respectively.

OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS

The Basic Financial statements are in two parts:

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

The Basic Financial Statements

The Basic Financial Statements comprise the Corporation-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 position-long-term and short-term.

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

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

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

DEBT ADMINISTRATION

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

The Corporation's COPs issues are discussed in detail in Note 4 to the financial statements. The Corporation issued two COPs issued in fiscal 2002, one of which refunded an earlier issue

ECONOMIC OUTLOOK AND MAJOR INITIATES

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

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

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

CITY OF PALO ALTO - PUBLIC IMPROVEMENT CORPORATION

**STATEMENT OF NET ASSETS
AND STATEMENT OF
ACTIVITIES**

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

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

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

The Corporation's Governmental Activities include the activities of its Debt Service and Capital Projects Funds.

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

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

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2005

ASSETS

Cash and investments held by trustee (Note 3)	\$1,435,925
Interest receivable	15,350
Construction in progress	2,546,438
Investment in leases to City of Palo Alto (Note 2D)	<u>6,819,792</u>
Total Assets	<u>10,817,505</u>

LIABILITIES

Interest payable	177,155
Long-term debt (Note 4):	
Due in one year	710,000
Due in more than one year	<u>9,915,000</u>
Total Liabilities	<u>10,802,155</u>

NET ASSETS

Unrestricted	<u>15,350</u>
Total Net Assets	<u><u>\$15,350</u></u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

EXPENSES	
Interest and fiscal agent charges	\$573,427
Total Program Expenses	573,427
REVENUES	
Interest on leases from City of Palo Alto	534,303
Net Program Expenses	(39,124)
GENERAL REVENUES	
Interest from cash and investments	43,111
Change in Net Assets	3,987
Net assets at the beginning of year	11,363
Net assets at the end of year	\$15,350

See accompanying notes to financial statements

FUND FINANCIAL STATEMENTS

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

All of the Corporation's Funds were determined to be Major Funds in fiscal 2005.

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

Capital Projects Fund - This fund accounts for the Corporation's project capital outlays.

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
BALANCE SHEET
JUNE 30, 2005

	Debt Service	Capital Projects	Totals
ASSETS			
Cash and investments held by trustee (Note 3)	\$1,340,452	\$95,473	\$1,435,925
Interest receivable	15,156	194	15,350
Investment in leases to City of Palo Alto (Note 2D)	6,819,792		6,819,792
Total Assets	\$8,175,400	\$95,667	\$8,271,067
LIABILITIES			
Deferred revenue	\$6,819,792		\$6,819,792
Total Liabilities	6,819,792		6,819,792
FUND BALANCES			
Reserved for:			
Debt service	1,355,608		1,355,608
Capital projects		\$95,667	95,667
Total Fund Balances	1,355,608	95,667	1,451,275
Total Liabilities and Fund Balances	\$8,175,400	\$95,667	
Accrual adjustment to remove deferred revenue from the balance sheet			
Deferred revenue			6,819,792
Construction in Progress used in governmental activities is not a financial resource and therefore not reported in funds			2,546,438
Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds			
Long-term debt			
Interest payable			(177,155)
Due within one year			(710,000)
Due in more than one year			(9,915,000)
NET ASSETS OF GOVERNMENTAL ACTIVITIES			\$15,350

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 BALANCES
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Totals</u>
REVENUES			
Lease receipts from City of Palo Alto:			
Principal	\$690,000		\$690,000
Interest	590,978		590,978
Interest from cash and investments	<u>35,225</u>	<u>\$7,886</u>	<u>43,111</u>
Total Revenues	<u>1,316,203</u>	<u>7,886</u>	<u>1,324,089</u>
EXPENDITURES			
Debt service:			
Principal repayment	690,000		690,000
Interest and fiscal agent charges	595,491		595,491
Capital projects		<u>11,940</u>	<u>11,940</u>
Total Expenditures	<u>1,285,491</u>	<u>11,940</u>	<u>1,297,431</u>
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>30,712</u>	<u>(4,054)</u>	<u>26,658</u>
OTHER FINANCING SOURCES (USES)			
Payment to bond escrow agent	(1,038,946)		(1,038,946)
Transfers in	940,073		940,073
Transfers (out)		<u>(940,073)</u>	<u>(940,073)</u>
Total Other Financing Sources (Uses)	<u>(98,873)</u>	<u>(940,073)</u>	<u>(1,038,946)</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(68,161)</u>	<u>(944,127)</u>	<u>(1,012,288)</u>
Fund balances at beginning of year	<u>1,423,769</u>	<u>1,039,794</u>	<u>2,463,563</u>
Fund balances at end of year	<u>\$1,355,608</u>	<u>\$95,667</u>	<u>\$1,451,275</u>

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
STATEMENT OF REVENUES, EXPENDITURES AND
CHANGES IN FUND BALANCES
GOVERNMENTAL FUNDS TO THE
STATEMENT OF ACTIVITIES - FOR THE YEAR ENDED JUNE 30, 2005

Net change in fund balances-total governmental funds	(\$1,012,288)
Amounts reported for governmental activities in the statement of activities are different because:	
<p style="margin-left: 20px;">Bond proceeds provide current financial resources to governmental funds, but issuing debt increases long-term liabilities in the Statement of Net Assets. Repayment of bond principal is an expenditure in the governmental funds, but in the Statement of Net Assets the repayment reduces long-term liabilities.</p>	
Fund balance is increased by the amount of debt repayment	1,590,000
Capital outlay and capitalized interest costs are treated as an expenditures in governmental funds, but recorded as Construction in Progress on the Statement of Net Assets	11,940
<p style="margin-left: 20px;">Some amounts reported in the Statement of Revenues, Expenditures and Changes in Fund Balances reflect the collection of an asset which are not includable as revenues on the Statement of Activities</p>	
Change in deferred revenue	(607,729)
Change in Interest payable	<u>22,064</u>
Change in net assets of governmental activities	<u><u>\$3,987</u></u>

See accompanying notes to financial statements

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements

NOTE 1 - DESCRIPTION OF REPORTING ENTITY

General Description

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

The Corporation is an integral part of the City of Palo Alto. It primarily services the City and its governing body is composed of the City Council. Therefore, the financial data of the Corporation has also been included as a blended component unit within the City's comprehensive annual financial report for the year ended June 30, 2005.

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

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

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

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

B. Major Funds

The Corporation's major governmental type funds be identified and presented separately in the Fund financial statements. 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 determined that all its funds are major funds.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Corporation reported the following major governmental funds in the accompanying financial statements:

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

Capital Projects Fund - This fund accounts for the Corporations project capital outlays.

C. Construction in Progress Net Financing Costs

Interest incurred on debt used to finance projects are netted with interest earned on unspent proceeds of the debt. These "Net Financing Costs" are capitalized and added to construction in progress during the construction period to reflect the true project costs, including financing costs.

D. Investment in Leases

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

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

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE

A. Interest Rate Risk

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

Investment Type	Amount	Maturity Date
CAMP	\$37,712	N/A
U.S. Agency Obligations:		
FNMA	588,187	January 28, 2008
FHLMC	713,530	October 3, 2005
Money Market Mutual Funds	96,496	N/A
Total Investments held by Trustee	\$1,435,925	

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements

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

Mutual Funds are available for withdrawal on demand and at June 30, 2005 matured in an average of 1 day.

B. *Credit Risk*

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. The actual ratings as of June 30, 2005 for all U.S. Agency Obligations and Mutual funds are Aaa as provided by Moody's Investment Rating system. As an external investment pool, the California Asset Management Program was not rated as of June 30, 2005.

C. *Investment Policy*

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

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements

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

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

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

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

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

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

Debt Agreements:

(C) Utility Revenue Bonds 2002 Series A and 1999 Series A allow General Obligations of states with a Minimum Credit Quality Rating of A2/A by Moody's and S&P.

(D) Utility Revenue Bonds 2002 Series A and 1999 Series A require a Minimum Credit Quality Rating of A-1/P-1 by Moody's and S&P and maturing no more than 360 days.

Utility Revenue Bonds 1995 limit the maximum maturity to 365 days.

(E) Utility Revenue Bonds 2002 Series A and 1999 Series A require a Minimum Credit Quality Rating of AAAm or AAAm-G by S&P.

(F) Utility Revenue Bonds 2002 Series A, Golf PIC COP 1998, University Avenue Parking Bond 2001 and University Avenue Parking Bond 2002 are allowed to invest in the California Asset Management Program.

The City 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 City fails to meet its obligations under these debt issues. The California Government Code requires these funds to be invested in accordance with City ordinance, bond indentures or State statute. All these funds have been invested as permitted under the Code.

**CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO**

Notes to Financial Statements

NOTE 4 - CERTIFICATES OF PARTICIPATION

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

	Balance June 30, 2004	Defeasances & Retirements	Balance June 30, 2005	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
1998 Golf Course				
4.00-5.00%, due 09/01/2018	\$5,965,000	\$285,000	\$5,680,000	\$295,000
2002A Civic Center Refinancing				
2.00-4.00%, due 03/01/2012	2,885,000	325,000	2,560,000	330,000
2002B Downtown Parking Improvements				
4.55-6.00%, due 03/01/2022	3,365,000	980,000	2,385,000	85,000
	<u>\$12,215,000</u>	<u>\$1,590,000</u>	<u>\$10,625,000</u>	<u>\$710,000</u>

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

On January 16, 2002 the Corporation issued the **2002B Downtown Parking Improvements Certificates of Participation** in the amount of \$3.555 million to finance the construction of certain improvements to the non-parking area contained in the City's Bryant/Florence Garage complex. Principal payments are due annually on March 1 and interest payments semi-annually on March 1 and September 1 and are payable from lease revenue received from the City from available funds.

On January 25, 2005 the City defeased \$900 thousand of the 2002B Downtown Parking Improvements Certificates of Participation. The City placed \$1.039 million in surplus cash from the Civic Center Refinancing and Downtown Parking Improvement Project Construction account in an irrevocable trust to provide for future debt payments. Accordingly, the trust account assets and the liability for the defeased Bonds are not included on the financial statements. The outstanding amount of the defeased debt at June 30, 2005 is \$870 thousand. The defeasance resulted in an overall debt service savings of \$1.511 thousand and an economic gain of \$462 thousand.

In August 1998, the Corporation issued the **Golf Course Capital Improvements and Refinancing Project Certificates of Participation, Series 1998** in the amount of \$7.750 million to refund and subsequently retire the 1978 Golf Course Lease Revenue Bonds issued by the City through the Palo Alto Golf Course Corporation, and to finance various improvements at the Palo Alto Public Golf Course, including upgrading five fairways and various traps, trees and greens, constructing new storm drain facilities, replacing the existing irrigation system, upgrading the driving range, and installing new cart paths. Under the terms of the 1998 COPs, the Corporation transferred \$473 thousand to an agent for the Golf Course Corporation which used the funds to retire 1978 Bonds.

CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
Notes to Financial Statements

NOTE 4 - CERTIFICATES OF PARTICIPATION (Continued)

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

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

For the Year Ending June 30	Governmental Activities	
	Principal	Interest
2006	\$710,000	\$501,000
2007	740,000	475,000
2008	770,000	446,000
2009	800,000	415,000
2010	840,000	381,000
2011-2015	3,450,000	1,354,000
2016-2020	2,890,000	523,000
2021-2022	425,000	42,000
Total	\$10,625,000	\$4,137,000

The Bond documents require a Trustee to hold a portion of proceeds in a reserve fund for debt service purposes only. At June 30, 2005, the Trustee held \$1.436 million reserved, as discussed in Note 3.

NOTE 5 - NET ASSETS AND FUND BALANCES

A. Net Assets

Net Assets are divided into three captions at the Government-wide level, and are described below:

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

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

B. Fund Balances

Fund balances consist of reserved and unreserved amounts. Reserved fund balances represent that portion of fund balance which is legally segregated for debt service and capital projects.

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

FINANCIAL STATEMENTS

**FOR THE YEAR ENDED
JUNE 30, 2005**

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2005**

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ACCOUNTANCY CORPORATION
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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying statements of Net Expenditures and Net Changes in Commitments and Quarterly Billings of the City of Palo Alto Regional Water Quality Control Plant, a component unit of the City of Palo Alto, for the year ended June 30, 2005 as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

In our opinion, the financial statements referred to above present fairly in all material respects the net expenditures and net changes in commitments of the Regional Water Quality Control Plant, and its quarterly billings to the Cities of Mountain View and Los Altos for the year ended June 30, 2005 on the basis of accounting described in Note 1.

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

Maze Associates

October 7, 2005

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS
FOR THE YEAR ENDED JUNE 30, 2005

	<u>Totals</u>	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
DIRECT EXPENDITURES:				
Source control program	\$1,052,753	\$391,308	\$125,278	\$536,167
Public Outreach	73,387	27,278	8,733	37,376
Permitting and enforcement	827,263	220,710	14,041	592,512
Operations and maintenance	9,088,248	3,378,102	1,081,502	4,628,644
System improvement CIP (Note 2)	<u>1,535,199</u>	<u>570,633</u>	<u>182,689</u>	<u>781,877</u>
Total Direct Expenditures	<u>12,576,850</u>	<u>4,588,031</u>	<u>1,412,243</u>	<u>6,576,576</u>
INDIRECT ADMINISTRATIVE EXPENDITURES:				
Source control program	706,895	262,753	84,120	360,022
Public Outreach	1,263	469	150	644
Permitting and enforcement	347,835	203,733	12,961	131,141
Operations and maintenance	<u>1,384,124</u>	<u>514,479</u>	<u>164,710</u>	<u>704,935</u>
Total Indirect Expenditures	<u>2,440,117</u>	<u>981,434</u>	<u>261,941</u>	<u>1,196,742</u>
DEBT SERVICE EXPENDITURES:				
Refunding 1990 Series A Bonds	308,517	157,344	24,064	127,109
1999 Wastewater Treatment New Project	<u>549,348</u>	<u>208,148</u>	<u>52,023</u>	<u>289,177</u>
Total Debt Service Expenditures	<u>857,865</u>	<u>365,492</u>	<u>76,087</u>	<u>416,286</u>
TOTAL EXPENDITURES	15,874,832	5,934,957	1,750,271	8,189,604
DEDUCT JOINT SYSTEMS REVENUES (Note 5)	<u>(682,810)</u>	<u>(253,800)</u>	<u>(81,254)</u>	<u>(347,756)</u>
NET EXPENDITURES	15,192,022	5,681,157	1,669,017	7,841,848
ADD NET CHANGES IN COMMITMENTS	<u>580,668</u>	<u>215,834</u>	<u>69,099</u>	<u>295,735</u>
NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS	<u>\$15,772,690</u>	<u>\$5,896,991</u>	<u>\$1,738,116</u>	<u>\$8,137,583</u>

See notes to financial statements

CITY OF PALO ALTO
 REGIONAL WATER QUALITY CONTROL PLANT
 STATEMENT OF QUARTERLY BILLINGS
 FOR THE YEAR ENDED JUNE 30, 2005

	City of Mountain View	City of Los Altos
BILLINGS BY QUARTER BEGINNING:		
July 1, 2004	\$1,500,781	\$504,226
October 1, 2004	1,607,134	526,535
January 1, 2005	1,500,781	504,226
April 1, 2005	1,759,435	557,865
Total quarterly billings	6,368,131	2,092,852
Net expenditures and net changes in commitments	5,896,991	1,738,116
Excess of net expenditures and net changes in commitments over total billings	\$471,140	\$354,736

See notes to financial statements

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS**

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

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

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

Plant expenditures, commitments and joint system revenues, debt service and industrial waste compliance expenditures are shared by the Members based on agreed upon allocation percentages. The expenditures and commitments, including indirect administrative expenditures (see Note 3), are allocated to each of the Members based primarily on their respective percentages of the annual sewage flow and treatment needed for suspended solids, chemical oxygen demand and ammonia. Commitments represent operating encumbrances with suppliers for long-term projects, which have not yet been completed. Net changes in commitments represent commitments of \$3,531,775 at June 30, 2005 less commitments of \$2,951,107 at June 30, 2004. Revenues from services, fines and penalties are allocated to each of the Members in the same proportions as those of expenditures and commitments. Debt service payments are allocated based on percentages established at the time of bond issuance. Industrial waste compliance (Public Outreach and permitting and enforcement) charges are allocated to Members primarily based upon the number of industries and efforts required to maintain compliance with sewage use ordinances and other EPA regulations.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS**

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES (Continued)

The percentages used for the year ended June 30, 2005 to allocate expenditures, commitments and revenues were:

	City of Mountain View	City of Los Altos	City of Palo Alto
Public Outreach, operations and maintenance system improvement CIP, commitments and joint system revenues	37.17%	11.90%	50.93%
Debt Services expenditures:			
Refunding 1990 Series A Bonds	51.00%	7.80%	41.20%
1999 Wastewater Treatment New Project	37.89%	9.47%	52.64%
Permitting and enforcement	36.12%	2.30%	61.58%

The City is allocated 50.93% 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 2004-2005 allocations are as follows:

East Palo Alto Sanitary District	7.72%
Stanford University	5.52%
Town of Los Altos Hills	1.06%
Remaining City percentage	<u>36.63%</u>
Total	<u><u>50.93%</u></u>

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

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

NOTE 2 - SYSTEM IMPROVEMENT CIP (MINOR CAPITAL)

The basic agreement between the Members, dated October 10, 1968, provides that the administrator of the Plant is responsible for capital additions. These capital additions should be for the replacement of obsolete or worn-out units, or minor capital additions to improve the efficiency of the Plant's operation. Per an addendum to the agreement dated March 16, 1998, the Members agreed that capital additions could not exceed \$1.9 million in 1998-99 (base year). For future years, the base year amount will be adjusted annually based on increases to the Consumer Price Index-Urban Wage Earners and Clerical Workers for the San Francisco-Oakland-San Jose area. Actual System Improvement CIP expenditures amounted to \$1,535,199 for 2004-2005.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS**

NOTE 3 - INDIRECT ADMINISTRATION EXPENDITURES

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

NOTE 4 - DEBT SERVICE EXPENDITURES

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

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

At June 30, 2005, the outstanding principal of the 1999 Series A Bonds relating to the rehabilitation of the Wastewater Treatment system's sludge incinerators (1999 Wastewater Treatment New Project) and to refund the 1990 Series A Bonds amounted to \$9,711,713.

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

	1999 Wastewater Treatment New Project	Refunding of 1990 Series A Bonds	Total
City of Palo Alto	\$2,428,884	\$836,678	\$3,265,562
City of Mountain View	2,411,699	1,706,823	4,118,522
City of Los Altos	602,766	261,044	863,810
Town of Los Altos Hills	100,567	6,693	107,260
East Palo Alto Sanitary District	486,286	398,259	884,545
Stanford University	334,799	137,215	472,014
Total	<u>\$6,365,001</u>	<u>\$3,346,712</u>	<u>\$9,711,713</u>

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

NOTE 5 - JOINT SYSTEM REVENUES

The plant's joint system revenues for the year ended June 30, 2005, totaled \$682,810. This consisted of \$15,000 for salt water marsh services, \$35,450 from the City's Water Fund for lab services, \$92,860 for septic tank hauling services and \$539,500 for other revenues.

**CITY OF PALO ALTO REGIONAL WATER QUALITY CONTROL PLANT
NOTES TO FINANCIAL STATEMENTS**

NOTE 6 - RELATED PARTY TRANSACTIONS

During fiscal 2005, the Plant paid the City \$1,880,086 for utility costs. Such costs are included in the statements of net expenditures and net changes in commitments as source control program, permitting and enforcement and operations and maintenance expenditures.

Vehicle replacement charges of \$24,444 were paid to the City of Palo Alto Equipment Replacement Fund. Of the total \$12,142, \$6,740 and \$5,562 are included in the statement of net expenditures and net changes in commitments as operations and maintenance expenditures, source control program and permitting and enforcement respectively.

CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED
DECEMBER 31, 2004 AND 2003

**CABLE TV FRANCHISE
STATEMENT OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003**

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INDEPENDENT AUDITOR'S REPORT

The Members of the
Cable TV Franchise

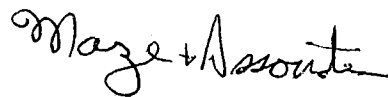
We have audited the accompanying Statements of Franchise Revenues and Expenditures of the Cable TV Franchise (Franchise) for the years ended December 31, 2004 and 2003 as listed in the table of contents. This financial statement is the responsibility of the City's management. Our responsibility is to express an opinion on this financial statement based on our audits.

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

As discussed in Note 1 to the financial statement, the statements referred to above were prepared for the purpose of complying with the provisions of the Joint Operating Agreement signed on October 13, 1988 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 services, and are not intended to be a presentation in accordance with generally accepted accounting principles in the United States of America.

In our opinion, the statements referred to above present fairly in all material respects the revenues and expenditures of the Franchise for the years ended December 31, 2004 and 2003 on the basis of accounting described in Note 1.

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



June 10, 2005

CABLE TV FRANCHISE
 STATEMENTS OF FRANCHISE REVENUES AND EXPENDITURES
 YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
REVENUES:		
Franchise fees	\$916,020	\$824,133
Total Receipts	916,020	824,133
EXPENDITURES:		
Franchise administration	65,964	62,171
Consulting fees	51,150	46,382
Total Expenditures	117,114	108,553
Net Receipts	\$798,906	\$715,580

DISTRIBUTED NET RECEIPTS:

	2004		2003	
	Amount	Percent	Amount	Percent
Allocation of Net Receipts:				
City of Palo Alto	\$400,780	50%	\$357,278	50%
City of Menlo Park	214,980	27%	189,718	26%
City of East Palo Alto	87,605	11%	82,884	12%
Town of Atherton	53,911	7%	47,333	7%
County of Santa Clara	24,392	3%	22,583	3%
County of San Mateo	17,238	2%	15,784	2%
Total	\$798,906	100%	\$715,580	100%

See accompanying notes to financial statements

**STATEMENT OF FRANCHISE
CABLE TV FRANCHISE
REVENUE AND EXPENDITURES
Notes to Financial Statement**

NOTE 1 - JOINT OPERATING AGREEMENT AND BASIS OF ACCOUNTING

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

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

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

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

The accompanying financial statement is intended to present the Franchise's Revenues and Expenditures pursuant to the Joint Operating Agreement and is not intended to be a complete presentation of the Franchise's financial position or results of operations.

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

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS

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

**STATEMENT OF FRANCHISE
CABLE TV FRANCHISE
REVENUE AND EXPENDITURES
Notes to Financial Statement**

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS (Continued)

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. The City will work with the Members to develop a plan for utilization of the settlement.

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

These amounts have been deposited and are being held in the City and are earning interest. As of December 31, 2004, the total amount on deposit amounted to \$1,236,356.

NOTE 3 - COMMITMENT AND CONTINGENCIES

In fiscal 2003, the City on behalf of the Cable Joint Powers agreement member, had pursued a franchise violation against Comcast for failure to complete certain rebuild requirements as specified in the franchise agreement. In November 2004, the City settled with Comcast for improvements to the cable system and equipment to access the I-Net. Settlement of this violation is not expected to impact franchise revenues included in this report.

**REDEVELOPMENT AGENCY OF
THE CITY OF PALO ALTO
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2005**

**REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2005**

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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

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

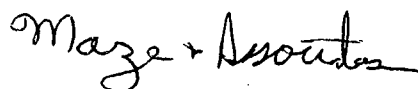
We have audited the accompanying component unit financial statements of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto, a component unit of the City of Palo Alto, as of and for the year ended June 30, 2005, as listed in the Table of Contents. These component unit financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In accordance with Government Auditing Standards, we have also issued reports October 7, 2005 on our consideration of the Agency's internal control structure and on its compliance with laws and regulations.

In our opinion the component unit financial statements referred to above present fairly in all material respects the financial position of the governmental activities and major fund of the Redevelopment Agency of the City of Palo Alto for the year ended June 30, 2005 and the changes in financial position for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

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



October 7, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

FISCAL 2005 FINANCIAL HIGHLIGHTS-AGENCY-WIDE BASIS AND FUND BASIS

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

During fiscal year 2005, the Agency incurred on-going costs in the amount of \$9 thousand, no change from prior year. The Agency received a transfer from the City of Palo Alto in the amount \$9 thousand to fund these costs, no change from prior year. As of June 30, 2005, the Agency had not yet adopted a project area nor received any tax increment revenues.

OVERVIEW OF THE AGENCY'S BASIC FINANCIAL STATEMENTS

The Basic Financial statements are in two parts:

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

The Basic Financial Statements

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

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

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

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

ECONOMIC OUTLOOK AND MAJOR INITIATES

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

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

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

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

FUND FINANCIAL STATEMENTS

The Redevelopment Agency (Agency) of the City of Palo Alto only has one fund in fiscal 2005, as follows:

REDEVELOPMENT AGENCY GENERAL FUND

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2005

LIABILITIES

Accounts payable

NET ASSETS

Unrestricted

=====

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2005

EXPENSES

Planning and Community Reimbursements to the City	<u>(\$8,500)</u>
---	------------------

Change in Net Assets	(8,500)
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GENERAL REVENUES

Transfers from the City of Palo Alto	<u>8,500</u>
--------------------------------------	--------------

Net assets at the beginning of year	<u> </u>
-------------------------------------	-----------------------------

Net assets at the end of year	<u><u> </u></u>
-------------------------------	------------------------------------

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
BALANCE SHEET
JUNE 30, 2005

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

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENTS OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCE
 FOR THE YEAR ENDED JUNE 30, 2005

	General Fund
OTHER FINANCING SOURCES (USES)	
Transfers in from the City of Palo Alto (Note 2)	\$8,500
Transfers (out) to the City of Palo Alto (Note 2)	(8,500)
Fund balance at beginning of year	_____
Fund balance at end of year	_____

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
 A COMPONENT UNIT OF THE CITY OF PALO ALTO
 STATEMENT OF REVENUES, EXPENDITURES
 AND CHANGES IN FUND BALANCES - BUDGET AND ACTUAL
 GENERAL FUND
 FOR THE YEAR ENDED JUNE 30, 2005

	<u>Budgeted Amount</u>		<u>Actual Amount Budgetary Basis</u>	<u>Variance with Final Budget Positive (Negative)</u>
	<u>Adopted</u>	<u>Adjusted</u>		
OTHER FINANCING SOURCES (USES)				
Transfers in from the City of Palo Alto	\$8,500	\$8,500	\$8,500	
Transfers out to the City of Palo Alto	<u>(8,500)</u>	<u>(8,500)</u>	<u>(8,500)</u>	
Total Other Financing Sources (Uses)	<u> </u>	<u> </u>	<u> </u>	
Fund balance at beginning of year			<u> </u>	
Fund balance at end of year			<u> </u>	

See accompanying notes to financial statements

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Component Unit Financial Statements
For the Year Ended June 30, 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES

A. *Organization and Purpose*

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

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

B. *Basis of Presentation*

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

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

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

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

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

C. *Major Funds*

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

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Component Unit Financial Statements
For the Year Ended June 30, 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)

REDEVELOPMENT AGENCY GENERAL FUND

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

D. Basis of Accounting

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

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

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

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

E. Budgets and Budgetary Accounting

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

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

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

F. Net Assets

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

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
Notes to Component Unit Financial Statements
For the Year Ended June 30, 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNT POLICIES (Continued)

G. *Fund Balances, Reserves and Designations*

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

NOTE 2 - TRANSACTIONS WITH THE CITY

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

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

Members of the Redevelopment Agency
of the City of Palo Alto
Palo Alto, California

We have audited the financial statements of the Redevelopment Agency of the City of Palo Alto as of and for the year ended June 30, 2005, and have issued our report thereon dated October 6, 2005. We have conducted our audit in accordance with generally accepted auditing standards in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Agency's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses, however we did communicate other matters to City Council in our separate Memorandum on Internal Controls dated October 7, 2005.

Compliance and Other Matters

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

This report is intended for the information of the Agency Board, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than the above parties.

Maze + Associates

October 7, 2005

A Professional Corporation