



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

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

December 16, 2003

Maze & Associates' Audit of the City of Palo Alto's Financial Statements as of June 30, 2003 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, 2003. 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, 2003.

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

- Memorandum on Internal Control Structure for the year ended June 30, 2003 (the "management letter") – Attachment A
- Independent Auditor's Report on Compliance with the Proposition 111 2002-03 Appropriation Limit Increment (the "Gann limit letter") – Attachment B
- Public Improvement Corporation Component Unit Financial Statements for the year ended June 30, 2003 – Attachment C
- Regional Water Quality Control Plant Financial Statements for the year ended June 30, 2003 – Attachment D
- Cable TV Franchise Statements of Revenues and Expenditures for the years ended December 31, 2002 and 2001 – Attachment E
- Bicycle/Pedestrian Projects Financial Statements for the years ended June 30, 2003 and 2002 – Attachment F
- Redevelopment Agency of the City of Palo Alto Component Unit Financial Statements for the year ended June 30, 2003 – Attachment G

Cory Biggs from Maze & Associates will be available at the December 16th 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 and cooperation during the audit.

Respectfully submitted,

Sharon W. Erickson

Sharon W. Erickson
City Auditor

CITY OF PALO ALTO
MEMORANDUM ON
INTERNAL CONTROL STRUCTURE
FOR THE YEAR ENDED JUNE 30, 2003

MAZE & ASSOCIATES

October 24, 2003

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

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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, 2003, 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

Recording Loans Receivable

During fiscal 2002-2003, the City loaned \$1.181 million to a non-profit organization for its use in financing a low-income housing project. This loan was funded by Community Development Block Grants and was selected for audit as part of our Single Audit compliance procedures. While our audit procedures did not reveal compliance exceptions to the transaction, we determined that the loan had not been recorded in the general ledger as part of the normal closing procedures. Staff have indicated that the intent is that loan terms are to be renegotiated prior to the December 31, 2003 due date and that these new terms may include forgiveness provisions. The City should record such loans until term renegotiations are completed.

Staff Response: Such loans will be recorded unless the provisions included in signed loan documents indicate that collection is unlikely.

Lucie Stern Community Center Cash Collections

As part of our approach of rotating audit emphasis each year we selected the Lucie Stern Community Center to review the internal control procedures and processes.

Background: The site received just over \$300,000 during the months of March and April of this year. This site processes credit card charges, checks and cash collected primarily for recreation class fees and facility booking (rental) income. A computer system is currently used to track class enrollment and facility booking dates. Fees received are entered into the system that produces invoices which act as a receipt for the customer. We noted multiple front counter staff has access to the only cash register. Deposits are manually prepared daily with undeposited receipts kept overnight in a locked mini-vault which is kept out of sight. The combination has been restricted to two employees and armed couriers take receipts daily to the bank.

While speaking with staff at the facility we were informed the system has a point-of-sale function which allows for the use of multiple integrated cash receipting terminals and that staff are considering changing to this approach. Under this concept, the City would eliminate the cash register and establish an integrated cash receipting system that would incorporate separate secure cash drawers for each staff member.

We agree with this change which would provide for better accountability and stronger controls over cash collections. No timetable was discussed for the implementation for these changes, however due to the dollar volume of activity at this center, we recommend implementation as soon as practical.

Staff Response: The City has already purchased all the necessary Class Software, licenses and hardware needed to transition to multiple integrated cash receipting terminals. The implementation is scheduled for this FY 03-04, however; a definitive timeline has not yet been determined. The Citywide transition to SAP was the Department's priority and it was determined that the Class Software would be implemented later in the year. It will be necessary to issue a contract with a consultant prior to the implementation process. Revenue Collections utilizes an individual point-of-sale system and will provide whatever assistance the department needs.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Investment Activity Report

The City's investment policy states that U.S. Government Agency securities that are callable should not exceed 20% of the par value of the portfolio. The Investment Activity Report for the period ending March 31, 2003 states that the percent of callable U.S. Government Agency securities is 16.41% of the par value of the portfolio, which is in compliance with the policy limitation. However, there is no indication in the Investment Activity Report which securities are callable. Since the investment policy contains this limitation, we recommend amending the format of future reports to indicate which securities are callable and subject to the limitation.

Staff Response: The report "Investment by Fund," or Attachment B of the Investment Activity Report, has been modified so that callable securities is identified (using the term "Callable") next to each investment.

The City's investment policy states that securities with maturities of greater than 5 years should not exceed 30% of the par value of the portfolio. By calculating the percent of investments with maturities greater than 5 years using the March 2003 Investment Activity Report we found the percentage to be 7.6%, which is in compliance with the policy limitation. However, Attachment C of the Investment Activity Report states the percentage was 10.81%. We understand that some of the investments used to calculate the percentage in Attachment C were not included on the Investment Activity Report, because they had a trade date in March, but were not actually settled until April. A reader of the Investment Activity Report would not be able to recalculate the percentage given the information provided in the report. We recommend for preparation of the Investment Activity Report only investments settled and stated in the report period be used for calculation of percentages in Attachment C.

Staff Response: We accept the recommendation of Maze and Associates. In future Investment Reports, only investments settled and listed in the report period will be used for calculating the percentage of securities with maturities of greater than 5 years in Attachment C.

The March 2003 Investment Activity Report does not appear to include the 2002 Utility Revenue Bonds 2002 Series A Debt Service Account mutual fund investment which had a balance of \$75,420. We recommend that the Investment Activity report include all fiscal agent accounts.

Staff Response: Treasury accepts the recommendation of Maze and Associates. In future Investment Reports, the debt service payment account will be included. All other debt issues accounts are already reported in the Investment Report's Attachment A.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Mutual Fund Investments in City's Pooled Cash and Fiscal Agent Accounts

The City currently invests a small portion of its pooled cash in the Fidelity Money Market Account, and a majority of fiscal agent cash in the First American Government Obligation Fund D. It is our understanding that the City does not receive or review the statements of investments for these funds in order to insure that the funds are invested in securities allowed by the City's investment policy, or allowed as a "permitted investment" as defined in each respective debt issue official statement. We recommend that the City request, for each type of mutual fund or money market fund, a statement of investments. These should be reviewed regularly to ensure the security composition of each fund is allowed.

Staff Response: When the Treasury Division initiated these accounts, prospectuses were reviewed to verify that investments conformed to City's Investment Policy, the debt issue's Indenture's section regarding acceptable investments, and the State's code on investments.

Treasury annually receives the Fidelity Treasury Portfolio Fund Account's prospectus, which includes investments conforming to the City and State Investment guidelines. The last one received was dated May 24, 2003. This prospectus also is available to Treasury staff via the Internet. We have downloaded the First American Government Obligation Fund D prospectus and re-examined it for compliance with City policy. The Fidelity Money Market is exclusively invested in U.S. Treasury securities and the First American Government Obligation Fund is invested in U.S. agency securities. Both investments carry AAA ratings by the major national rating agencies. While the Treasury Division purposely selected funds that conform to City and State Investment standards, it will review both prospectuses annually

Investment Policy

The California Government Code Section 53601 states that maturities of Bankers' Acceptances must not exceed 180 days. The City's Investment Policy, adopted June 17, 2002, says that maturities of Bankers' Acceptances must not exceed 270 days. The City should correct this limitation to comply with the Code with the next revision of the Investment Policy and review the current Code for any other revisions prior to adopting the Investment Policy each year.

Staff Response: We concur with Maze and Associates' comments. The California Government Code Section 53601 on Bankers' Acceptances has been changed to "not to exceed 180 days." The City's Investment Policy will be changed in the FY 04-05 budget process. The Treasury did not receive this information in time to make the change for FY 03-04. In the future, Treasury will review the California code prior to proposing the following year's Investment Policy. Since the City has no Banker's Acceptances in its portfolio, it is theoretically in compliance with the 180 days rule. In the interim, the City's Quarterly Investment Activity Reports, which reflects performance compliance with the Investment Policy, will use the 180-day standard.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Worker's Compensation Account Outstanding Checks

During our review of the bank reconciliations for the Workers' Compensation, General Auto Liability, and Dental accounts we noted a number of outstanding checks that are dated as far back as September 1999. It is our understanding that these accounts are administered by a third party and are not subject to the City's policy concerning stale dated checks older than one year. However, the City should contact the third party and inquire about some of the older outstanding checks to ensure that these are still valid amounts owed.

Staff Response: Staff reviewed Workers' Compensation account for stale dated checks. Stale dated checks were either included on the published list of June 2003 or written off following City and State policy. The Dental (established December 2001) and General Auto Liability accounts are current.

Schedule of Expenditures of Federal Awards

Under OMB Circular A-133, the implementing regulations under the Single Audit Act, as amended in 1996, the City is responsible for preparation of the Schedule of Expenditures of Federal Awards. Amounts included on this Schedule should only include expenditures of federal awards. Generally accepted accounting principals plus certain other balances define expenditures as defined in A-133. Only the portion of costs reimbursed with federal awards should be included on the Schedule.

Staff has proved us with a draft of the Schedule during the interim phase of our audit for our use in our single audit tests. Upon review of expenditures for the Highway Planning and Construction Grant program included on the Schedule, we noted that a portion of the expenditures that Accounting staff reported to us were incurred in the prior year. These should be included only if all eligibility requirements, included the preparation of the reimbursement request, were satisfied in the current year. Another portion of the expenditures were actually reimbursed from State funds rather than Federal funds. This program is administered by CALTRANS, which used a combination of federal awards and state funds to reimburse the City for program expenditures. The portion of expenditures funded with state moneys should be excluded from the Schedule.

During fiscal 2002-2003, the City established two new funds to account for activities related to the Federal Equitable Sharing from the U.S. Treasury and Department of Justice. Although the City appears to have only received about \$5,000 in revenue with no corresponding expenditures to date, the City will need to include expenditures from these sources on the City's Schedule of Expenditures of Federal Awards for the Single Audit.

Staff Response: The recommendations above were incorporated in the FY02-03 year-end reporting.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Appropriations Limit Resolution

A copy of the resolution adopting the City's 2002-2003 Appropriations Limit provided to us by the City was unsigned. We requested a signed copy from the City Clerk's office, where it was discovered that the original resolution was never signed prior to filing. Subsequent to our requests, the appropriate signatures were obtained and we were provided a signed resolution for our work. We examined four other resolutions as part of our interim work and noted they were properly signed. We do not perform a detailed review of all resolutions and ordinances as part of our financial statements and are concerned that there may be other resolutions that are unsigned.

We are aware that the City uses a control log to document the status of all resolutions and ordinances. The City Clerk's Office should review this log to ensure that there are no other resolutions or ordinances that have been filed without signature.

Staff Response: The Clerk's office confirmed that the log did not indicate that the Resolution had been routed and fully-executed, however the Resolution file confirmed that Resolution 8182 had been fully-executed and filed accordingly, this may have been a timing issue. To ensure proper compliance the Clerk's Office is reviewing their files.

In addition, ASD believes the Clerk's Office retains the responsibility for finalizing all resolutions and ordinances with signature. However, in an attempt to address the issue surrounding the budget adoption ordinance and Appropriations Limit resolution, the signed copies of these two documents will be included in the adopted budget document each year.

Appropriations Limit Compliance Calculation

The City's original 2002 Appropriations Limit calculation contained a calculation error due to the City using the lower of two population factors. This error was corrected when the 2003 Appropriations Limit was calculated and adopted. However on page 307 of the City's 2002-03 Operating Budget the "Historical Appropriations" includes the original calculation, but the "Computation of Appropriation Limit" section on the same page includes the corrected calculation for the 2002 Limit. The City should either correct the historical data or footnote the change/correction on this page in the next budget document.

Staff Response: The City has chosen to amend relevant historical data in the 2003-04 adopted budget document to reflect using the lower of the two population factors. Only fiscal 2001-02 figures should have been revised as the two other data points used the lower figure in their original calculation; this change moved the City to being 16% below the appropriations limit (from 14%).

Redevelopment Agency Dissolution

In February 2003 the City discontinued the project area study for the Edgewood Shopping Center, which was to be the Redevelopment Agency's first project area. And, in the proposed budget for fiscal years 2003-2005 the City has only included appropriations for the cost of the annual audit and preparation of the annual controller's report. The Agency has not yet approved a project area nor has it begun to receive tax increment, and it is our understanding that the City does not anticipate approving a project area in the near future. The City should consider dissolving the Agency, which would eliminate the staff time and costs incurred recording transactions and maintaining general ledger funds, and budgeting. Also audit costs and controller's report preparation costs would be avoided.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

Staff Response: City staff will analyze the viability of the Palo Alto Redevelopment Agency in the next year. As indicated, there are no current project areas or any proposed new agency actions. Therefore, staff has reduced all agency related cost to only those prescribed by law.

CITY OF PALO ALTO
MEMORANDUM ON INTERNAL CONTROL STRUCTURE

STATUS OF PRIOR YEAR RECOMMENDATIONS

Recommendation #01-1 – GASB 34 Implementation

Status: Implemented.

Recommendation #01-2 – Redevelopment Agency Start-up Issues

Status: Comment Moot

Recommendation #01-3 – Medical Retiree Liability

Status: In process

Recommendation #01-4 – Fraud Detection & Prevention

Status: Implemented.

Recommendation #01-5 – Gann Limit

Status: Implemented.

Recommendation #01-6 - Disbursements

Status: Implemented.

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INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH THE PROPOSITION 111
2002-2003 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, 2003. 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 2002-2003 Appropriations Limit of \$83,213,394 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. We recomputed the 2002-2003 Appropriations Limit to be \$83,213,394 by multiplying the revised 2001-2002 Prior Year Appropriations Limit by the annual 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

May 22, 2003

CITY OF PALO ALTO
PUBLIC IMPROVEMENT CORPORATION
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2003

**CITY OF PALO ALTO PUBLIC IMPROVEMENT CORPORATION
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2003**

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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, 2003 as listed in the Table of Contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 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, 2003, 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 and Required Supplemental Information is supplementary information required by the Government Accounting Standards Board, but is not part of the basic financial statements. We have applied certain limited procedures to this information, principally inquiries of management regarding the methods of measurement and presentation of this information, but we did not audit this information and we express no opinion on it.

Maze Associates

October 24, 2003

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.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Palo Alto Public Improvement Corporation, a component unit of the City of Palo Alto, has implemented the provisions of Government Accounting Standards Board Statement 34, "Basic Financial Statements – and Management's Discussion & Analysis – for State and Local Governments", known as GASB 34. 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 three debt issues and has turned the proceeds of these issues over to the City, which pledged certain lease payments as collateral for this debt, as discussed in Note 4 to the financial statements.

FISCAL 2003 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. These issues plus the 1998 Golf course Capital Improvements COPs issue comprise all its outstanding debt.

Interest expense on these COPs issues was \$487 thousand in fiscal year 2003. The interest on leases on the assets securing these COPs issues was \$437 thousand; this revenue and \$83 thousand in interest income resulted in an income of \$33 thousand in fiscal year 2003.

The Corporation ended fiscal year 2003 with total assets of \$13.9 million, including \$3.8 million in cash and \$8.7 million in present value of leases receivable from the City of Palo Alto. It had liabilities of \$13.1 million, including \$12.9 million in long-term debt.

At the Fund level, the Corporation reported a negative \$1.2 million excess of revenues over expenditures, which was principally due to the construction expenditures financed by the 2002B Downtown Parking Improvements Certificates of Participation bond proceeds.

As of June 30, 2003, the Corporation has two funds, Debt Service Fund, which reported a \$1.6 million fund balance and the Capital Projects Fund, which reported a \$2.2 million fund balance.

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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

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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 purpose is to 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, and the financial position of all the Corporation's Business-Type Activities in a single column; these columns are followed by a Total column that presents the financial position of the entire Corporation.

The Corporation's Governmental Activities include the activities of its Capital Projects and Debt Service 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 format of the Statement of Activities differs considerably from those used in the past. It presents the Corporation's expenses first, listed by program, and follows these with the expenses of its business-type activities. 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 each governmental and business-type program. The Corporation's general revenues are then listed in the Governmental Activities or Business-type Activities column, as appropriate, 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, 2003

ASSETS

Cash and investments held by trustee (Note 3)	\$3,802,685
Interest receivable	13,483
Construction in progress	1,329,217
Investment in leases to City of Palo Alto (Note 2E)	<u>7,945,888</u>
 Total Assets	 <u>13,091,273</u>

LIABILITIES

Interest payable	202,819
Long-term debt (Note 4):	
Due in one year	690,000
Due in more than one year	<u>12,215,000</u>
 Total Liabilities	 <u>13,107,819</u>

NET ASSETS

Unrestricted	<u>(16,546)</u>
 Total Net Assets	 <u><u>(\$16,546)</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, 2003

EXPENSES

Interest and fiscal agent charges	\$487,089
Total Program Expenses	487,089

REVENUES

Interest on leases from City of Palo Alto	437,409
Net Program Expenses	(49,680)

GENERAL REVENUES

Interest from cash and investments	82,598
Change in Net Assets	32,918
Net assets at the beginning of year	(49,464)
Net assets at the end of year	(\$16,546)

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**

FUND FINANCIAL STATEMENTS

Major funds are defined generally as having significant activities or balances in the current year. No distinction is made between Fund types and the practice of combining like funds and presenting their totals in separate columns (Combined Financial Statements) has been discontinued, along with the use of the General Fixed Assets and General Long-term Debt Groups of Accounts.

All of the Corporation's Funds were determined to be Major Funds fiscal 2003.

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

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

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
BALANCE SHEET
JUNE 30, 2003

	Debt Service	Capital Projects	Totals
ASSETS			
Cash and investments held by trustee (Note 3)	\$1,635,825	\$2,166,860	\$3,802,685
Interest receivable	12,279	1,204	13,483
Investment in leases to City of Palo Alto (Note 2E)	7,945,888		7,945,888
Total Assets	\$9,593,992	\$2,168,064	\$11,762,056
LIABILITIES			
Deferred revenue	\$7,945,888		\$7,945,888
Total Liabilities	7,945,888		7,945,888
FUND BALANCES			
Reserved for:			
Debt service	1,648,104		1,648,104
Capital projects		\$2,168,064	2,168,064
Total Fund Balances	1,648,104	2,168,064	3,816,168
Total Liabilities and Fund Balances	\$9,593,992	\$2,168,064	
Accrual adjustment to remove deferred revenue from the balance sheet			
Deferred revenue			7,945,888
Construction in Progress used in governmental activities is not a financial resource and therefore not reported in funds			1,329,217
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			(202,819)
Due within one year			(690,000)
Due in more than one year			(12,215,000)
NET ASSETS OF GOVERNMENTAL ACTIVITIES			(\$16,546)

See accompanying notes to financial statements

PALO ALTO PUBLIC IMPROVEMENT CORPORATION
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENTS OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCES
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

	Debt Service	Capital Projects	Totals
REVENUES			
Lease receipts from City of Palo Alto:			
Principal	\$790,000		\$790,000
Interest	464,246		464,246
Interest from cash and investments	55,761	\$26,837	82,598
Total Revenues	1,310,007	26,837	1,336,844
EXPENDITURES			
Debt service:			
Principal repayment	790,000		790,000
Interest and fiscal agent charges	655,695		655,695
Capital projects		1,049,598	1,049,598
Total Expenditures	1,445,695	1,049,598	2,495,293
EXCESS OF REVENUES OVER (UNDER) EXPENDITURES	(135,688)	(1,022,761)	(1,158,449)
OTHER FINANCING SOURCES (USES)			
Transfers in	336,886		336,886
Transfers out		(336,886)	(336,886)
	336,886	(336,886)	
EXCESS OF REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES AND OTHER USES	201,198	(1,359,647)	(1,158,449)
Fund balances at beginning of year	1,446,906	3,527,711	4,974,617
Fund balances at end of year	\$1,648,104	\$2,168,064	\$3,816,168

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, 2003

Net change in fund balances-total governmental funds	(\$1,158,449)
Amounts reported for governmental activities in the statement of activities are different because:	
<p>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	790,000
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	1,163,163
<p>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 Investment in leases	(790,000)
Change in Interest payable	<u>28,204</u>
Change in net assets of governmental activities	<u><u>\$32,918</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, 2003.

NOTE 2- SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

The accompanying financial statements are presented on the basis set forth in Government Accounting Standards Board Statement 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, which the Corporation implemented in fiscal 2002. GASB Statement 34 requires that the financial statements described below be presented.

The accompanying financial statements are presented on the basis set forth in Government Accounting Standards Board Statements No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, No.36, *Recipient Reporting for Certain Non-exchange Revenues, an Amendment of GASB Statement No. 33*, No. 37, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments; Omnibus*, and No. 38, *Certain Financial Statement Note Disclosures*.

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.

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 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

GASB Statement 34 defines major funds and requires that 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.

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

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

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

C. Non-exchange Transactions

In connection with its adoption of GASB Statement 34, the Corporation has adopted GASB Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions*.

D. 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. During fiscal 2002-2003, net financing costs amounting \$113,565 were added to construction in progress.

**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)

E. Investment in Leases

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

NOTE 3 - CASH AND INVESTMENTS HELD BY TRUSTEE

A Trustee under the provisions of the Corporation's COP issues holds and invests all the Corporation's cash. The Corporation's investments are categorized below to give an indication of the level of credit risk assumed by the Corporation at June 30, 2003. Category 1 includes investments that are insured or registered or for which the securities are held by the Corporation or its agent in the Corporation's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the Corporation's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty, or are held by the counterparty's trust department or agent but not in the Corporation's name. Pooled investments are not categorized because of their pooled, rather than individual, nature.

At June 30, 2003 the Corporation's investments were recorded at market value and comprised the following:

Category 1 Investments:

U.S. Agency Obligations	\$740,619
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Pooled Investments (non Categorized):

California Arbitrage Management Program	28,642
Mutual funds	<u>3,033,424</u>

Total cash and investments held by trustee	<u><u>\$3,802,685</u></u>
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The Trustee is only permitted to invest in US Corporation securities, US dollar denominated deposit accounts, federal funds, banker's acceptances, mutual funds, money market accounts, pre-funded municipal obligations, written repurchase agreement, and the California Arbitrage Management Program. Investments are purchased and held in the name of the Trustee on behalf of the Corporation and are held to maturity to match with payments required under the COP issue.

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

NOTE 4 - CERTIFICATES OF PARTICIPATION

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

	Balance June 30, 2002	Retirements	Balance June 30, 2003	Current Portion
Governmental Activity Debt:				
Certificates of Participation				
1998 Golf Course				
4.00-5.00%, due 09/01/2018	\$6,640,000	\$405,000	\$6,235,000	\$270,000
2002A Civic Center Refinancing				
2.00-4.00%, due 03/01/2012	3,500,000	300,000	3,200,000	315,000
2002B Downtown Parking Improvements				
4.55-6.00%, due 03/01/2022	3,555,000	85,000	3,470,000	105,000
	<u>\$13,695,000</u>	<u>\$790,000</u>	<u>\$12,905,000</u>	<u>\$690,000</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.

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)

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.

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 beginning in 1999.

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
2004	\$690,000	\$603,056
2005	720,000	580,564
2006	740,000	555,687
2007	770,000	528,327
2008	805,000	497,310
2009-2013	4,150,000	1,933,159
2014-2018	3,390,000	1,008,834
2019-2023	1,640,000	196,925
Total	\$12,905,000	\$5,903,862

The Bond documents require a Trustee to hold a portion of proceeds in a reserve fund for debt service purposes only. At June 30, 2003, the Trustee held \$1.414 million reserved, as discussed in Note 3.

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

NOTE 5- NET ASSETS AND FUND BALANCES

GASB Statement 34 added the concept of Net Assets, which is measured on the full accrual basis, to the concept of Fund Balance, which is measured on the modified accrual basis.

A. Net Assets

Net Assets are divided into three captions under GASB Statement 34. These captions apply only to Net Assets as determined 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 use 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, 2003

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, 2003 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 City of Mountain View and Los Altos for the year ended June 30, 2003 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 24, 2003

CITY OF PALO ALTO
REGIONAL WATER QUALITY CONTROL PLANT
STATEMENT OF NET EXPENDITURES AND NET CHANGES IN COMMITMENTS
FOR THE YEAR ENDED JUNE 30, 2003

	<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	\$1,053,026	\$389,725	\$140,263	\$523,038
Public Outreach	113,646	42,060	15,138	56,448
Permitting and enforcement	681,156	238,727	16,113	426,316
Operations and maintenance	7,660,612	2,835,192	1,020,393	3,805,027
System improvement CIP (Note 2)	<u>2,286,471</u>	<u>846,223</u>	<u>304,558</u>	<u>1,135,690</u>
Total Direct Expenditures	<u>11,794,911</u>	<u>4,351,927</u>	<u>1,496,465</u>	<u>5,946,519</u>
INDIRECT ADMINISTRATIVE EXPENDITURES:				
Source control program	247,542	91,615	32,973	122,954
Permitting and enforcement	328,684	112,342	7,583	208,759
Operations and maintenance	<u>1,340,728</u>	<u>496,204</u>	<u>178,585</u>	<u>665,939</u>
Total Indirect Expenditures	<u>1,916,954</u>	<u>700,161</u>	<u>219,141</u>	<u>997,652</u>
DEBT SERVICE EXPENDITURES:				
Refunding 1990 Series A Bonds	310,225	158,215	24,198	127,812
1999 Wastewater Treatment New Project	<u>540,478</u>	<u>204,787</u>	<u>51,183</u>	<u>284,508</u>
Total Debt Service Expenditures	<u>850,703</u>	<u>363,002</u>	<u>75,381</u>	<u>412,320</u>
TOTAL EXPENDITURES	14,562,568	5,415,090	1,790,987	7,356,491
DEDUCT JOINT SYSTEMS REVENUES (Note 5)	<u>(89,780)</u>	<u>(33,228)</u>	<u>(11,959)</u>	<u>(44,593)</u>
NET EXPENDITURES	14,472,788	5,381,862	1,779,028	7,311,898
ADD NET CHANGES IN COMMITMENTS	<u>(1,163,905)</u>	<u>(430,761)</u>	<u>(155,032)</u>	<u>(578,112)</u>
NET EXPENDITURES AND NET CHANGES IN COMMITMENTS DUE FROM MEMBERS	<u>\$13,308,883</u>	<u>\$4,951,101</u>	<u>\$1,623,996</u>	<u>\$6,733,786</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, 2003

	<u>City of Mountain View</u>	<u>City of Los Altos</u>
BILLINGS BY QUARTER BEGINNING:		
July 1, 2002	\$1,429,787	\$405,160
October 1, 2002	1,541,145	428,518
January 1, 2003	1,429,787	405,160
April 1, 2003	<u>1,295,043</u>	<u>456,946</u>
 Total quarterly billings	 5,695,762	 1,695,784
 Net expenditures and net changes in commitments	 <u>4,951,101</u>	 <u>1,623,996</u>
 Excess of net expenditures and net changes in commitments over total billings	 <u>\$744,661</u>	 <u>\$71,788</u>

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 \$1,961,354 at June 30, 2003 less commitments of \$3,125,259 at June 30, 2002. 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, 2003 to allocate expenditures, commitments and revenues were:

	<u>City of Mountain View</u>	<u>City of Los Altos</u>	<u>City of Palo Alto</u>
Public outreach, operations and maintenance system improvement CIP, commitments and joint system revenues	37.01%	13.32%	49.67%
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	34.76%	2.35%	62.89%

The City is allocated 49.67% 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 2002-2003 allocations are as follows:

East Palo Alto Sanitary District	7.17%
Stanford University	5.57%
Town of Los Altos Hills	0.93%
Remaining City percentage	<u>36.00%</u>
Total	<u><u>49.67%</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.

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

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 \$2,286,470 for 2002-2003.

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 1990 Series A Bonds.

During the year, the City of Palo Alto, City of Mountain View, City of Los Altos, Town of Los Altos Hills, East Palo Alto Sanitary District and Stanford University (members) agreed to issue new bonds 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, 2003, 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 the refunding of the 1990 Series A Bonds amounted to \$10,325,665.

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

NOTE 4 – DEBT SERVICE EXPENDITURES (Continued)

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

	1999 Wastewater Treatment New Project	Refunding 1990 Series A Bonds	Total
City of Palo Alto	\$2,583,431	\$888,916	\$3,472,347
City of Mountain View	2,565,153	1,813,391	4,378,544
City of Los Altos	641,119	277,342	918,461
Town of Los Altos Hills	517,228	423,124	940,352
East Palo Alto Sanitary District	356,102	145,782	501,884
Stanford University	106,966	7,111	114,077
Total	<u>\$6,769,999</u>	<u>\$3,555,666</u>	<u>\$10,325,665</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, 2003, totaled \$89,780. This consisted of \$15,000 for salt water marsh services, \$39,898 from the City's Water Fund for lab services, \$37,550 for septic tank hauling services and \$690 for other revenues. During the fiscal year joint system revenue in the amount of \$3,358 was written off due to a company discontinuing operations.

NOTE 6 - RELATED PARTY TRANSACTIONS

During fiscal 2003, the Plant paid the City \$1,668,718 for utility costs. Such costs are included in the statements of net expenditures and net changes in commitments as operations and maintenance expenditures.

Vehicle replacement charges of \$26,106 were paid to the City of Palo Alto Equipment Replacement Fund. Such costs are included in the statement of net expenditures and net changes in commitments as operations and maintenance expenditures.

CABLE TV FRANCHISE
STATEMENTS OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED
DECEMBER 31, 2002 AND 2001

**CABLE TV FRANCHISE
STATEMENT OF FRANCHISE
REVENUES AND EXPENDITURES
FOR THE YEARS ENDED DECEMBER 31, 2002 AND 2001**

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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, 2002 and 2001 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, 2002 and 2001 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.

Maze + Associates

October 24, 2003

CABLE TV FRANCHISE
 STATEMENTS OF FRANCHISE REVENUES AND EXPENDITURES
 YEARS ENDED DECEMBER 31, 2002 AND 2001

	<u>2002</u>		<u>2001</u>	
REVENUES:				
Franchise fees	<u>\$802,489</u>		<u>\$819,389</u>	
Total Receipts	<u>802,489</u>		<u>819,389</u>	
EXPENDITURES:				
Franchise administration	108,568		60,751	
Consulting fees	<u>22,803</u>		<u>16,539</u>	
Total Expenditures	<u>131,371</u>		<u>77,290</u>	
Net Receipts	<u><u>\$671,118</u></u>		<u><u>\$742,099</u></u>	
DISTRIBUTED NET RECEIPTS:				
	<u>2002</u>		<u>2001</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Allocation of Net Receipts:				
City of Palo Alto	\$336,882	50%	\$375,642	51%
City of Menlo Park	179,153	27%	195,788	27%
Town of Atherton	46,132	7%	53,365	7%
City of East Palo Alto	72,098	11%	76,598	10%
County of San Mateo	14,958	2%	16,134	2%
County of Santa Clara	<u>21,894</u>	<u>3%</u>	<u>24,572</u>	<u>3%</u>
Total	<u><u>\$671,117</u></u>	<u><u>100%</u></u>	<u><u>\$742,099</u></u>	<u><u>100%</u></u>

See accompanying notes to financial statements

**STATEMENT OF 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. The Agreement terminates ten years from the effective date. 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 as the Cable Cooperative Program (the "Program") which is accounted for as part of the office of the City Clerk 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.

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

NOTE 2 - PRIOR FRANCHISE SETTLEMENTS

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

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

These amounts have been deposited and are being held in the City and are earning interest. As of December 31, 2002, the total amount on deposit amounted to \$688,646

CITY OF PALO ALTO
BICYCLE/PEDESTRIAN PROJECTS
FINANCIAL STATEMENTS
FOR THE YEARS ENDED
JUNE 30, 2003 AND 2002

CITY OF PALO ALTO
Bicycle/Pedestrian Projects
Financial Statements
For the Years Ended June 30, 2003 and 2002

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the financial statements of the City of Palo Alto Bicycle/Pedestrian Projects (Projects) of the City of Palo Alto, as of and for the years ended June 30, 2003 and 2002, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on the financial statements based on our audit.

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

As discussed in Note 1, the financial statements present only the City of Palo Alto Bicycle/Pedestrian Projects and are not intended to present fairly the financial position and results of operations of City of Palo Alto, in conformity with generally accepted accounting principles in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the City of Palo Alto Bicycle/Pedestrian Projects at June 30, 2003 and 2002 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles.

In connection with our audit, we also performed tests of compliance as required by the California Administrative Code, Title 21, Chapter 3, Subchapter 2, Article 5.5.

In our opinion, based on the procedures described in the preceding paragraph, the funds allocated to the Projects were expended in conformance with the applicable laws, rules and regulations of the Transportation Development Act issued by the State of California Department of Transportation and allocation instructions of the Metropolitan Transportation Commission.

Maze + Associates

October 24, 2003

CITY OF PALO ALTO
 BICYCLE/PEDESTRIAN PROJECTS
 BALANCE SHEETS
 JUNE 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
ASSETS		
Cash		\$3,029
Accounts receivable	<u>\$190,037</u>	<u>117,090</u>
Total Assets	<u><u>\$190,037</u></u>	<u><u>\$120,119</u></u>
 LIABILITIES		
Advance from MTC		\$3,029
Due to the City	<u>\$190,037</u>	<u>117,090</u>
Total Liabilities	<u><u>\$190,037</u></u>	<u><u>\$120,119</u></u>

See accompanying note to financial statements

CITY OF PALO ALTO
 BICYCLE/PEDESTRIAN PROJECTS
 STATEMENT OF REVENUES AND EXPENDITURES
 FOR THE YEARS ENDED JUNE 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
REVENUE		
TDA Article 3.0 (Note 2)	<u>\$190,037</u>	<u>\$117,090</u>
TOTAL	<u><u>\$190,037</u></u>	<u><u>\$117,090</u></u>
EXPENDITURES		
San Mateo Drive Bike Bridge	\$6,567	\$2,600
Design and Engineering for Arastradero Bike Lanes Project	80,324	80,324
Embarcadero Bike Bridge	95,510	34,166
Bicycle Safety Education Program	5,000	
Bikeway System Improvement	<u>2,636</u>	
TOTAL	<u><u>\$190,037</u></u>	<u><u>\$117,090</u></u>

See accompanying notes to financial statements

**CITY OF PALO ALTO
BICYCLE/PEDESTRIAN PROJECTS
Notes to Financial Statements**

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The City of Palo Alto has developed the Bicycle/Pedestrian Projects (Projects) under the Transportation Development Act (TDA), Article 3.0 for the construction of pedestrian pathways and wheelchair ramps and bicycle master plan studies. The Projects are funded by TDA grants.

The following is a summary of significant accounting policies of the applicable to the Projects which conform to generally accepted accounting principles as applicable to governments.

A. Fund Accounting

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

B. Basis of Accounting

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

NOTE 2 - TDA ARTICLE 3.0 REVENUE

During the year ended June 30, 2002 the City received allocation instructions from the Metropolitan Transportation Commission for the following projects:

Instruction #	Project Name	Grant Award	Revenue at June 30, 2003
02336623	Sidewalk improvement	\$50,000	
02336624	Bicycle education safety program	5,000	\$5,000
02336625	Upgrade bicycle facilities in high demand areas	5,209	2,636
02336626	Embarcadero Bridge and Extension	95,510	95,510
02336627	San Mateo Drive Bike Bridge	6,567	6,567
03345212	Arastradero Bridge and Extension	80,324	80,324
03345210	Homer Avenue Undercrossing	200,000	
03345211	San Mateo Drive Bike Bridge	16,567	
04355009	California Avenue and US 101 Bike Project	15,993	
04355010	Pedestrian Walkway Warning System	20,000	
			\$190,037

REDEVELOPMENT AGENCY OF
THE CITY OF PALO ALTO
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED
JUNE 30, 2003

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
COMPONENT UNIT FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2003

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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, 2003, 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 dated October 24, 2003 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, 2003 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 supplementary information required by the Government Accounting Standards Board, but is not part of the basic financial statements. We have applied certain limited procedures to this information, principally inquiries of management regarding the methods of measurement and presentation of this information, but we did not audit this information and we express no opinion on it.

Maze Associates

October 24, 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Redevelopment Agency (Agency) of the City of Palo Alto, a component unit of the City of Palo Alto, has implemented the provisions of Government Accounting Standards Board Statement 34, "Basic Financial Statements – and Management's Discussion & Analysis – for State and Local Governments", known as GASB 34. 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 Agency is controlled by the City of Palo Alto and was formed on October 9, 2001.

FISCAL 2003 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 2003, the Agency incurred on-going costs in the amount of \$101 thousand and had a net asset deficit in the amount of \$3 thousand from fiscal year 2002. The Agency received a transfer from the City of Palo Alto in the amount \$104 thousand to fund these costs and deficit. As of June 30, 2003, 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 INITIATIVES

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

CONTACTING THE AGENCY'S FINANCIAL MANAGEMENT

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

THE REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO
A COMPONENT UNIT OF THE CITY OF PALO ALTO
STATEMENT OF NET ASSETS
JUNE 30, 2003

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, 2003

EXPENSES	
Planning and Community reimbursements to the City	<u>(\$101,342)</u>
Change in Net Assets	(101,342)
GENERAL REVENUES	
Transfers from the City of Palo Alto	<u>104,383</u>
Net assets (deficit) at the beginning of year	<u>(3,041)</u>
Net assets at the end of year	<u><u> </u></u>

See accompanying notes to financial statements

REDEVELOPMENT AGENCY OF THE CITY OF PALO ALTO

FUND FINANCIAL STATEMENTS

The Redevelopment Agency (Agency) of the City of Palo Alto only has one fund in fiscal 2003, 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
BALANCE SHEET
JUNE 30, 2003

	<u>General Fund</u>
LIABILITIES	
Accounts payable	_____
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, 2003

	General Fund
OTHER FINANCING USES	
Transfers in from the City of Palo Alto (Note 2)	\$104,383
Transfers (out) to the City of Palo Alto (Note 2)	(101,342)
Fund (deficit) at beginning of year	(3,041)
Fund 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
STATEMENTS OF REVENUES, EXPENDITURES
AND CHANGES IN FUND BALANCES - BUDGET AND ACTUAL
GENERAL FUND
FOR THE YEAR ENDED JUNE 30, 2003

	Budgeted Amount		Actual Amount Budgetary Basis	Variance with Final Budget Positive (Negative)
	Adopted	Adjusted		
REVENUES				
Return on investment	\$8,800	\$8,800		(\$8,800)
Total Revenues	8,800	8,800		(8,800)
EXPENDITURES				
Current operations:				
Planning and Community Environment	184,800	83,458		83,458
Total Use of Funds	184,800	83,458		83,458
EXCESS (DEFICIENCY) OF REVENUES OVER EXPENDITURES	<u>(176,000)</u>	<u>(74,658)</u>		<u>74,658</u>
OTHER FINANCING SOURCES (USES)				
Transfers in from the City of Palo Alto		176,000	\$104,383	(71,617)
Transfers out to the City of Palo Alto	(176,000)	(101,342)	(101,342)	
Total Other Financing Sources (Uses)		176,000		(176,000)
EXCESS (DEFICIENCY) OF REVENUES AND OTHER FINANCING SOURCES OVER EXPENDITURES AND OTHER USES	<u>(\$352,000)</u>		<u>3,041</u>	<u>\$3,041</u>
Fund (deficit) at beginning of year			<u>(3,041)</u>	
Fund at end of year			<u><u> </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, 2003

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 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 Statements 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*

GASB Statement 34 defines major funds and requires that the Agency's major governmental-type funds be identified and presented separately in the fund financial statements. The Agency considers the Redevelopment Agency General Fund to be a major fund.

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.

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, 2003

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 Authority's assets over all its liabilities, regardless of fund. Net Assets, which is determined only at the Government-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, 2003

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 Palo Alto 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. As of June 30, 2003, the Agency owed the City \$329 thousand in advances without specified repayment terms.

Agency activities are performed by City staff. During fiscal year 2002-2003, the City charged the Agency \$101,342 for costs incurred on Agency activities. This amount was transferred to the City's General Fund as reimbursement.

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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

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

We have audited the financial statements of the Redevelopment Agency (Agency) of the City of Palo Alto for the year ended June 30, 2003, and have issued our report thereon dated October 24, 2003. We have conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

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 grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Those provisions include provisions of laws and regulations identified in the *Guidelines for Compliance Audits of California Redevelopment Agencies*, issued by the State Controller. 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.

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 assurance 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 misstatements 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. We noted other matters involving internal control over financial reporting that we have reported to management of the Agency in a separate letter dated October 24, 2003.

This report is intended for the information of the Agency Board, management and the State Controller. However, this report is a matter of public record and its distribution is not limited.

October 24, 2003

